Operationalizing Norms, Material Incentives and Climate Action

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Operationalizing Norms, Material Incentives and Climate Action

   - Interaction effects between norms and incentives
   - U-shaped relationship between CFP and CEP

2. Operationalization: How to measure/observe norms, material incentives and climate action

3. Roundtable Methodology (Sarah Van Eynde)
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Background Paper – “The Reinforcement Effect: How Climate Concerns Foster Competitiveness in the Global Economy”

- What is a norm?
  - “Standard of appropriate behaviour for actors with a given identity” (Finnemore and Sikkink 1998: 891)
  - Logic of appropriateness: where actors follow a rule or shared idea that is perceived as the “right thing to do”
  - Examples:
    - Smoking in public places
    - Child labour
    - Drug abuse

- At this Roundtable: “genuine” climate concerns present within an organisation as a whole (e.g. company, government agency)
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- What are material incentives?
  - Tangible, material rewards for certain types of behaviour
  - Often associated with a logic of (expected) consequences (rational choice), where actors aim to maximize utility.

- At this Roundtable: companies are often perceived as purely “rational” actors. But observations show a puzzling variation.

![Figure 1. Traditional distinction between norms and material incentives](image)

*Source: author, based on e.g. Belis and Kerremans 2016; March and Olsen 1998; 2011; Fearon and Wendt 2002.*
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Figure 1. Traditional distinction between norms and material incentives

- Material incentives: Logic of consequences, Utility maximization
- Social norms: Logic of appropriateness, Rule following
- Climate-related behaviour

Source: author, based on e.g. Belis and Kerremans 2016; March and Olsen 1998; 2011; Fearon and Wendt 2002.

- Beyond the dichotomy: interaction effects of norms and incentives
  1. Blinding effect
  2. Cognitive dissonance
  3. Reinforcement effect
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- **Blinding effect**: Norms trump material incentives
  - When a company (or other organisation) is “blinded” by an overemphasis on the logic of appropriateness, creating negative impacts in terms of profitability

Examples:
- too optimistic expectations vis-à-vis customer uptake of green products
- too costly or “wrong” investments in green equipment
- Over-subsidization of solar panels

- Often create backlash in both economic and environmental ways (e.g. solar panel subsidies in Flanders)
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- **Cognitive dissonance effect**: material incentives trump norms
- When a company (or other organisation) is deliberately chooses a GHG-intensive investment with high short-term return on investment even when a viable climate-friendly alternative with a longer term IRR (internal rate of return) is available.
- Over time, the company may be forced (e.g. by its shareholders or because of reputational concerns) to reconsider this investment.
- **Examples**:
  - Extensive coal power development plans in several Asian countries (notably India)
  - Investments in oil exploration in the Arctic
- These investments are often turned back, leading to suboptimal economic and environmental outcomes (similar to the blinding effect)
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- **Reinforcement effect**: material incentives and norms are balanced.
- Takes place when both logics are implemented coherently and reinforce each other.
- A logic of appropriateness could provide an extra “push” to invest time and resources in a company’s search for long-term solutions that improve both its business performance and its climate impacts.
- Iterative, mutually reinforcing process that could also involve the following elements:
  - Longer term cost savings (energy, waste reductions)
  - Attraction of a loyal segment of (new) customers
  - Stable and collaborative partnerships with other companies and organisations (e.g. joint transport solutions)
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- **Reinforcement effect**: material incentives and norms are balanced
- A logic of appropriateness could provide an extra “push” to invest time and resources in a company’s search for long-term solutions that improve both its business performance and its climate impacts.
- At the level of the employees / board of directors of the firm:
  - “Extra” motivation to find optimal solutions, both in terms of profitability and environmental performance, for example most efficient lighting, or most cutting-edge production equipment.
  - Collaboration between financial, technical and sustainability departments
  - Expected to thrive best in innovative, creative enterprises (e.g. Apple, Tesla, …)
  - IMPORTANT LINK WITH INNOVATION
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- **Reinforcement effect**: material incentives and norms are balanced
- **Example of Unilever:**
  - about 50 percent of its growth in 2014 came from sustainable living brands, which also grew at twice the rate of the rest of the business
  - “This sense of purpose and our USLP attracts and retains talent”
- But CEO Paul Polman, architect of Unilever’s SD strategy also warns against a “blinding effect”:
  - “imperative that the relationship between the ethical and the financial be understood as one of reciprocity and balance: just as the pursuit of financial capital should not be at the expense of the environment, businesses should not resort to excessive philanthropy” (Bell 2013: 39).

Paul Polman, CEO of Unilever
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- **Reinforcement effect**: material incentives and norms are balanced
- **Example of Triodos Bank:**

![Graph showing performance comparison between Triodos portfolio and MSCI in EUR from September 2005 to December 2015.]
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- U-shaped relationship between CFP and CEP (TLGT)
- Too-little-of-a-good-thing effect
- First proposed by Trumpp and Guenther (2015)
- Background:
  - Conflicting hypotheses since 1970s: In 1970, Milton Friedman kicked off the debate by stating that the “social responsibility of business is to increase its profits” (Friedman 1970). This led to the formulation of the trade-off hypothesis, which says that taking the environment into account in company decision-making will adversely affect profitability.
  - End-of-pipe technologies
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- U-shaped relationship between CFP and CEP (TLGT)
- Hypotheses supporting a positive relationship:
  1. Porter hypothesis: innovation + first-mover advantages
  2. Natural Resource Based View: organizational capabilities + anticipation of future regulation
  3. Instrumental stakeholder theory: reputational advantages, including higher stock market values + increased business performance
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- U-shaped relationship between CFP and CEP (TLGT)
- Possible reconciliation of these conflicting hypotheses: U-shaped relationship
  - “there is a negative CEP–CFP relationship for companies with low CEP and a positive association for high CEP” (Trumpp and Guenther 2015)
  - = Too little of a good thing (TLGT) effect
- Tested on 700 EU and US companies
- Companies employing a reactive strategy will tend to have more costs than benefits, while companies that pursue a proactive environmental strategy may have higher benefits than costs.

Figure 4. A U-shaped relationship between corporate environmental performance (CEP) and corporate financial performance (CFP). Source: adapted from Trumpp and Guenther (2015).
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- U-shaped relationship between CFP and CEP (TLGT)
- fits with the “three pillars” view of sustainable development, namely that economic prosperity depends on social and environmental protection and vice-versa. Perhaps the sustainable development paradigm is just as true for a single company as it is for the entire planet
- But also, and crucially, depends on the environment in which these companies operate
- More research is required to verify these claims!
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- Link between reinforcement effect and U-shaped relationship between CFP and CEP (TLGT)
- Not necessarily the case!
- TLGT effect can, in principle, be explained by a “rational” strategy, aimed at increasing business performance through all associated benefits
- However, best empirical examples show that some level of normative engagement seems to highly stimulate the employment of a proactive environmental strategy
- Perhaps linked to the credibility of such a strategy (both internal and external to the firm).
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Operationalization: How to measure/observe norms and material incentives for climate action

- How to measure/observe genuine normative concerns for climate change:
  1. **ASK**: how do firms communicate about climate change
  2. **CHECK**: what are the lobbying positions of firms (e.g. EC consultations on climate policies)
  3. **LOOK**: verify this with actual behaviour of the firm in terms of emission reductions
  4. **THIRD OPINION**: what do other, independent analysts think of the firm’s actual attitude?
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Operationalization: How to measure/observe norms and material incentives for climate action

- How to measure/observe material incentives for climate change
- Conditional on wide number of variables:
  1. Carbon pricing
  2. Standard setting (e.g. EE for appliances, buildings, cars)
  3. Energy costs
  4. Customer preferences
  5. Supply chain influence
  6. Competitiveness of the sector
  7. Availability of cost-effective alternative products/production methods, e.g.:
     • Steel or cement production
     • Electric vehicles
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The effect of the Paris Agreement on Norms and Incentives for Climate Action

- Paris Agreement
  - Major global relevance of the 2015 Paris Agreement
  - Joint US-China ratification at G-20 summit in Hangzhou
  - Major normative / material / policy “signal” to investors
  - But implementation remains key!
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Are we at a Tipping Point for climate action?
Thank you!