

Firms' willingness to pay for certification leniency: Evidence from the global wood industry

Abstract:

Voluntary third-party certification of quality standards is used in many markets to mitigate inefficiencies caused by asymmetric information, including information on negative production externalities such as deforestation and forest degradation. But where firms choose and pay the third parties that certify their compliance, the efficiency gains from this system are at risk if firms shop for more lenient certifiers. The degree to which private and public regulators of certifiers can improve market outcomes by suspending bad certifiers is limited by firms' option to drop out of certification when it becomes too costly. To assess these risks, I develop a structural model of auditing and demand for certification. To estimate it in the context of forest management certification, I assembled a novel panel dataset of audit results for the forests that were certified according to the FSC-standard between 2015 and 2019, as well as survey data on the fees paid to different certifiers. I find important differences in certifiers' leniency and evidence for selection of less compliant firms into less rigorous certifiers. The estimates suggest that forest firms are willing to pay substantially more to a certifier whom they expect not to report a major violation than to a certifier that would report it.