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Defining the value of doing good business

In the global market economy, the role of a company is about more than maximising profits alone. Corporate social responsibility means doing business with integrity and fairness – and it may even improve the bottom line

It is impossible for managers to sidestep corporate social responsibility (CSR). But while no manager can dismiss CSR, the broader and more pressing question is: "What does it mean?"

CSR is one of the rare business topics whose very existence is regularly called into question. Yet almost no one denies that issues arising under its banner are important: the environment (including sustainability), obligations to employees, sourcing from developing countries, host country government relations, relationships with local communities, and regulating gifts and sensitive payments.

Definitions of CSR range from broad ones that focus on large environmental and social problems, such as Aids, poverty, health and pollution, particularly in developing economies, to more specific ones that focus on doing business with integrity and transparency.

The common denominator is that corporate activity should be motivated in part by a concern for the welfare of some non-owners, and by an underlying commitment to basic principles such as integrity, fairness and respect for persons.

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◆ The CSR debate

It seems strange that anyone would allege that CSR is a bad thing but some intelligent critics do exactly that. The economist Milton Friedman famously argued that the only social responsibility of business is to maximise profit. To do anything else, the logic went, is to slide dangerously towards socialism. The incomparable strength of a free market is its ability to allocate resources efficiently, and misguided managers who struggle nobly to enhance social welfare forget their proper function in the market: to compete and win.

Still worse, managers who pursue the dream of CSR are using other people's money. Investors give their hard-earned savings to managers in order to make more money. That is why they invest. So, managers who spend money to pursue CSR projects are "stealing" from their investors.

In response, CSR defenders note that business organisations do not live in a vacuum; they owe their very existence to the societies they inhabit. Corporations are allowed status as a single agent in the eyes of the law as a fictional person (*persona ficta*), and are usually granted limited liability and unlimited longevity. What is more, they are granted access to society's labour pool and its storehouse of natural resources, two goods in which every member of society has a stake.

Even Adam Smith, the father of capitalism, pointed out that the efficiency of the market rests partly on transparency, the absence of corruption and the avoidance of manipulation. At the same time, he did not believe that self-interested pursuit of profit was the right way to live. Benevolence, Smith argued, is the highest virtue.

In important ways, the battle over CSR is overblown. On closer inspection it turns out to be largely about whether to endorse a "fat" or "skinny" interpretation of responsibility. Even critics of CSR quietly state exceptions to their more aggressive denials and usually end up embracing a slimmed-down version.

For example, Mr Friedman readily acknowledges that the pursuit of profits does not excuse a manager from engaging in fraud or deception and, furthermore, corporations themselves are obliged to conform to the morality of the surrounding society. Mr Friedman and other conservative economists also frequently display moral concern; for example, when they observe managers abusing their responsibility by gathering up lavish perks and compensation.

Finally, critics of CSR willingly admit that free markets behave efficiently only in the context of an effective regulatory environment. Sadly, many developing countries lack this type of regime. Without effective legal and regulatory systems, corporations must assume heightened responsibilities.

On the other side of the debate, even the most zealous defenders of CSR acknowledge that corporations have special and profound obligations to their investors. They also agree that corporate managers are not democratically elected, and that corporations should not adopt government-like social responsibilities. In short, as management thinker Peter Drucker once remarked: "Even if archangels inhabited corporate boardrooms instead of mere mortals, they would have to be concerned about profits." The deeper issue, then, is not whether CSR exists, but how thinly or heavily it should be defined.

◆ Does CSR pay?

Both managers and business researchers frequently observe how corporate responsibility often converges with maximising shareholder interests. Lee Preston at the University of Maryland has shown that the interests of the major stakeholders – stockholders, employees and customers – usually rise and fall together. In other words, management decision-making is not a zero-sum game for stakeholders, and while managers must sometimes make trade-offs among competing stakeholder interests, the prudent manager attends to all of them.

Empirical studies have also demonstrated that companies with good ethical reputations attract and retain better employees, that customers and suppliers are drawn to companies with better reputations for integrity, and that employees are more loyal to their company when they have a good impression of its ethics.

Research also shows the importance of commitment and trust for efficient economic activity, both inside a corporation and in the broader economy. A massive literature has developed over the past two decades on game theory, detailing how, in many forms of business interactions, a failure of trust implies a loss in profits and benefits for everyone.

The same lesson holds even at the level of a national economic system. The economist Amartya Sen has argued that failures of trust entail failures of economic efficiency, an insight with special relevance for developing economies. For example, massive corruption in the former Soviet Union and its satellites has certainly retarded the evolution of capitalism there. It is little wonder that the IMF and the World Bank have made fighting corruption one of the pillars of their development strategies.

Of course, when business managers take ethics and responsibility seriously, they must at least sometimes turn down profitable opportunities that fail to satisfy their ethical tests. So, corporations must be prepared to lose money, at least in the short run, in the pursuit of CSR. The driving question, then, becomes: is the money that responsible corporations gain in the long run greater than the money they lose by being responsible?

A recent analysis of 95 empirical studies on corporate social performance and corporate financial performance by Harvard's Joshua Margolis and JP Walsh at the University of Michigan showed that about nine times as many studies revealed a positive correlation between corporate social performance and corporate financial performance as those that indicated a negative one. These results suggest that, over the long run, CSR pays off. Nonetheless, it should be noted that the difficulties of conducting such studies are huge, and even these encouraging data should be taken with a grain of salt. Hundreds more studies may be necessary before we can claim on the basis of research that corporate responsibility pays.

Whatever one's view about CSR, most research indicates that the majority of practising managers reject a profit-only philosophy of corporate management. Numerous studies over the past four decades reveal that most managers prefer to assume some responsibility for serving the interests of other stakeholders, such as employees, customers and members of the surrounding community.

Internationally, the US has the highest percentage of managers who endorse a profit-only perspective, but even in the US the percentage has never risen above 40 per cent. In other countries, such as Japan, the percentage is in single digits.

Even conservative finance experts, such as Michael Jensen at Harvard often endorse an "enlightened stakeholder" perspective in which managers recognise that serving investors efficiently also means serving the interests of other stakeholders such as employees and customers. (However, Mr Jensen continues to insist that managers must be evaluated solely on financial performance, given that other measures are insufficiently rigorous.)

◆ The management approach

If optimising financial performance in the long run requires at least some attention to CSR, then the debate shifts partly to how managers should think. Should they have a single motive to maximise the financial welfare of the owners? Or should they have multiple motives, including social responsibility?

Often, it is not possible to discern from the outside just what motivates a given manager. Is a manager who treats his employees with dignity and respect doing so because he thinks it is the right thing to do or because he believes that in the long run the company will make more money? Research by Thomas Jones at the University of Washington suggests that it is only when managers do what is right because it is the right thing to do that they achieve maximal financial benefit for the company.

In recent years, an exogenous factor has entered the debate, in the form of socially responsible mutual funds and social indices such as the Calvert Social Balanced Fund and the Domini Social Equity Fund in the US, and the UK-based FTSE4Good Index.

To the extent that investors sometimes evaluate stocks on the basis of measures other than financial return, it follows that company stock price will reflect social as well as financial characteristics. This implies yet another factor encouraging a correlation between CSR and financial performance. Stocks with good CSR ratings may enjoy a small price premium, even as ones with poor ratings carry a price discount.

Social funds and indices must evaluate the social quality of any candidate company and establish standards of membership in the index or fund. In the early years, the social quality problem was handled simply: the funds barred all so-called "sin stocks", such as companies selling tobacco or armaments.

Today, a number of funds maintain this sin-stock approach to establishing membership credentials. But as socially responsible funds grew in popularity, criteria other than alcohol, tobacco and weaponry were introduced, and most funds have moved not merely to exclude particular stocks but proactively to include ones that demonstrate an active commitment to transparency, environmental sustainability or human rights.

◆ Regional variations

Just as different investors use different criteria for selecting stocks, so geography has a lot to do with how companies respond to CSR. Thus, the US and Europe adopt strikingly different positions that can be traced largely to history and culture. In the US, CSR is weighted more towards "doing business right" by following basic business obligations such as not misleading customers, treating employees with respect, complying with laws and regulations, ensuring safety in factories, avoiding harassment and sexual discrimination, rejecting the use of bribery and manufacturing safe products.

In Europe, CSR is weighted more towards serving – or at least not conflicting with – broader social aims, such as environmental sustainability and human rights. Bluntly stated, when it comes to CSR, Europeans view US companies as too narrow, legalistic and compliance oriented, while Americans see their European friends as naïve and idealistic.

The differences between Europe and the US are probably not accidental. In Europe, law regulates labour relations more heavily than in the US, the population density is higher (with obvious consequences for the environment), and interaction with other nations and languages is more common.

However, interpretations of CSR are evolving. The discourse on CSR has moved away from an emphasis on the social, economic and political development of the native country to more universal concerns about environmental integrity and global welfare.

In general, corporations in developed countries such as the US, Germany, the UK and Japan tend to have more high-flying rhetoric (although not necessarily the actions to match) than those in developing countries, such as Brazil or Lebanon.

Nonetheless, important differences exist even among developed countries. Joachim Boll and others at the Copenhagen Business School have shown that corporate leaders from English-speaking countries use CSR language far more frequently than their counterparts in countries such as Germany, Japan and Italy.

As they attempt to implement CSR, companies are also confused by the cross-cultural issues this creates. One of the knottiest questions is how to behave in host countries, especially ones where practices of gifts, sensitive payments and bribery are common. One of the most encouraging developments is the appearance of co-operative efforts involving NGOs, corporations (especially at the industry level) and host country governments in efforts to reduce corruption.

For example, a coalition of more than 250 NGOs, including Global Witness, Cafod, Oxfam, Save the Children UK and Transparency International UK, engaged companies in the oil, gas and mining industries in the "publish what you pay" movement. The aim is to encourage greater transparency on sensitive payments in developing countries, with an eye to eventually cleaning up practices and levelling the economic playing field.

Similarly, questions of labour standards for first-tier suppliers have vexed the global corporations, especially in industries such as toys and apparel. Many companies have followed the lead of Nike, Levi Strauss and Reebok in demanding that suppliers in regions such as Asia and Latin America adhere to specific standards for hours, safety, wages and child labour. These standards are promulgated by many global organisations, including the Fair Labour Association (FLA) and the International Labour Organisation.

◆ Best practice

Many CSR specialists recommend that, as a first step, companies join one or more of the international organisations devoted to CSR, including the United Nations' Global Compact or the Global Reporting Initiative (GRI).

Other recommendations from CSR specialists include:

- Engaging stakeholders (and sometimes NGOs) in a dialogue.
- Establishing principles and procedures for addressing difficult issues such as labour standards for suppliers, environmental reporting and human rights

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- Adjusting reward systems to reflect the company's commitment to CSR
- Collecting, maintaining and publishing data relevant to CSR
- Having the senior leadership team and members of the board of directors engage regularly in an ongoing process of CSR risk and evaluation
- Establishing anonymous reporting and whistle-blowing policies and procedures
- Educating employees and managers about CSR policies and the company's commitment to CSR
- Having the senior leadership team communicate CSR priorities and set an example through their own behaviour

One of the most recent recommendations for best practice invokes creative philanthropy. Research by Thomas Dunfee at Wharton, Nikolai Rogovsky at the International Labour Organisation and David Hess at the University of Michigan has described how companies can enhance philanthropical impact by engaging in "Corporate social initiatives".

Corporate social initiatives differ from traditional philanthropy by being linked to the company's core values in a way that leverages core competencies. For example, in response to the recent Asian tsunami disaster, UPS, the logistics company, agreed to ship without charge up to £1m of emergency relief supplies from around the world; Johnson & Johnson distributed medical supplies throughout the affected region; and pharmaceutical giants, Novartis and GlaxoSmithKline contributed antibiotics, adult nutritional supplements and infant formula.

In a globalised market economy, CSR is part of modern business.