Corporate social responsibility: Doing well by doing good

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Abstract  Saving the rain forest from yet another palm oil plantation would certainly garner a company favorable attention from environmentalists, but how would its shareholders react? In this article, we show that by strategically practicing corporate social responsibility (CSR), a company can 'do well by doing good'; in other words, it can make a profit and make the world a better place at the same time. CSR is regarded as voluntary corporate commitment to exceed the explicit and implicit obligations imposed on a company by society's expectations of conventional corporate behavior. Hence, CSR is a way of promoting social trends in order to enhance society's basic order, which we define as consisting of obligations that cover both the legal framework and social conventions. Due to globalization, companies are now less constrained by society's basic order than they have been in the past. Because different countries have different laws and standards, there are more ways to get away with less than ideal behavior in the quest for greater and greater profits. Nearly everyone agrees that this is not a good thing, but what can be done? Via this article, we offer an understanding of CSR that could be the answer. Herein, we contend that practicing CSR is not altruistic do-gooding, but rather a way for both companies and society to prosper. This is especially true when CSR is conceived of as a long-range plan of action.

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Corporative social responsibility; Stakeholder; Shareholder; Principal–agent; Society's basic order

1. CSR as win–win strategy

Can companies enhance society's basic order, and, if so, is this advantageous for them? With this question in mind, it is the goal of this article to take a closer look at the opportunities and frontiers of a strategic, profit-maximizing use of corporate social responsibility (CSR). In doing so, CSR is regarded as voluntary corporate commitment to exceed the explicit and implicit obligations imposed on a company by society's expectations of conventional corporate behavior. Society's basic order consists of both the legal framework and social conventions; it is always a representation of the society's prevailing ideas and opinions. New, emerging social trends cannot pass into society's basic order per se; in fact, they need to be promoted so that they might establish over time. Companies can support this procedure and in doing so, gain profits at the same time. Porter and

In the United States, the interrelation between a company's social commitment and its profitability has been of scientific concern since at least the 1970s. Among scholars, Margolis and Walsh (2001) and Orlitzky, Schmidt, and Rynes (2003) present a broad review of the existing literature, arriving at the same conclusion that the market rewards enterprises' social activities. CSR can thus be considered an efficient management strategy (Baron, 2003), and can be a crucial factor in the company's success. Short-term actions such as donating money for social purposes or sponsoring popular events, however, are not the most effective means of attaining this goal. Rather, effective CSR is usually a long-term proposition. The practice of CSR is an investment in the company's future; as such, it must be planned specifically, supervised carefully, and evaluated regularly. Used well, it is a way of actively contributing to the society's basic order and, in doing so, enhancing the company's reputation. From a supply-side perspective, a good reputation is necessary to attract, retain, and motivate quality employees. From a demand-side perspective, a good reputation increases the value of the brand, which, in turn, increases the company's goodwill.

The possibilities for CSR actions depend heavily upon a country's prevailing economic policy. Until recently, CSR was primarily a phenomenon found in the United States and the United Kingdom; continental Europe had not yet expressed much interest in the concept. These different attitudes are a reflection of differing economic views: Great Britain under Prime Minister Margaret Thatcher leaned toward the American, liberal economic policy prone to deregulation, whereas most of continental Europe relied on a relatively high density of regulation. If CSR is understood as a voluntary corporate commitment that helps establish social trends and institutional demands, the differences in its level of importance for countries become evident. As long as society's basic order binds companies to comply with social demands, there is no necessity for CSR. Untill society's basic order is unable to represent social trends in an appropriate way will CSR come into play.

Because European interest in CSR is a relatively recent phenomenon, there are not in existence very many continental European studies on the subject. Increasing globalization and the use of global public goods, along with the declining influence of national institutions, however, is making CSR a more vital issue in this part of the world. The national basic order is becoming less important for companies. Multinational enterprises face a plurality of different institutional conditions. In the absence of global governance, which could introduce and establish a supranational institutional framework, companies can force a race to the bottom concerning regulatory regimes. Civil society, however, reacts with hostility to such behavior; scandals such as that involving Nike's sweatshops are illustrative. Therefore, cost savings in the short run need to be balanced against the potential risk to the company's goodwill in the long run. It would be in their own self-interest if companies would consider filling this regulatory gap, rather than exploiting it.

The goal of this article is to assess strategic use of CSR. We begin with a short historical summary of the scientific debate over the term CSR. This background facilitates better understanding of how CSR works and illustrates that the practice does not necessarily conflict with a company's economic well-being. In fact, CSR often turns out to give a company an advantage. If a company realizes early on that a certain social trend is gaining ground, it can act quickly to take advantage of the situation by establishing itself at the forefront of an issue that may become of major public interest. For example, consider a scenario in which the public becomes alarmed at the effects of caffeinated beverages on the behavior of young children. An alert and aware company that produces such beverages could come out with a line of decaffeinated drinks, accompanied by a targeted advertising campaign stressing the healthy aspects of its product, and thus perhaps garner the public's favor and an edge on the competition. The later a company jumps on the bandwagon of a new trend, the less chance it has of becoming a leader in the field or having much influence on the direction of future regulation; put another way, the sooner a company acts, the more influence it will have. Accordingly, there is an incentive to act pro-actively so as to gain a first-mover advantage. We will show how social trends can be classified in such a way that it is possible, using our proposed managerial decision-making process, to devise a win–win strategy to take advantage of them. Finally, frontiers for the strategic use of CSR are briefly discussed.

2. CSR in the course of time

Within the scientific literature, the term CSR was first formalized by Bowen (1953), who argued in a normative way that "it refers to the obligations of businessmen to pursue those politics, to make those decisions, or to follow those lines of actions which are desirable in terms of the objectives and values of society" (p. 6). A decade later, several authors, including Davis (1960), Fredrick (1960),
McGuire (1963), and Walton (1967), undertook further development of the concept. Notably, these authors, like Bowen before them, refer only to 'businessmen'. In 1967, Davis (1967) finally enlarged the definition of CSR to include institutions and, thus, enterprises. This was a crucial development, as to that point, use of the term businessmen implied that an enterprise's owner was also its manager, and thus bore the cost of every social commitment personally. When CSR is expanded to include enterprises in their own right as legal entities, however, the attribution of costs is not so easy. In the case of a manager-led enterprise, for example, the legal representatives of the enterprise, the managers, do not bear the costs of social conduct; instead, they decide to take these actions in their role as agents of the principals. This caused Nobel Prize winner Milton Friedman (1962, 1970) to fundamentally reject corporate social commitment.

From Friedman's point of view, managers in a free economic system are obliged by contract to shareholder value; it is their primary task to maximize the value of the enterprise. To this end, resources are put to their best possible use and employed efficiently (which, according to classic economist Adam Smith, best serves society as a whole). Managers' actions are bound only by legal guidelines: the economic rules. Commitment beyond legal requirements to general social interests is in breach of this postulate, as there are no corresponding gains; thus, such commitment should not be undertaken. Shareholder value is the only value to be maximized. If managers want to work toward the betterment of society, they should do so as private individuals at their own expense, not as agents of their principals and at their principals' expense (Friedman, 1970).

Friedman's basic assumption is the best possible legal framework including completely assigned property rights. External effects are ruled out by definition. Therefore, the relevant question is not whether an enterprise behaves in a socially desirable way, but whether existing legal requirements provide incentives that cause enterprises to so act. In other words, the important thing is not that enterprises or individuals can assume responsibility, but that society's basic order has been designed to cause the desired conduct. Due to these assumptions, there is no need for CSR in Friedman's approach.

In reality, however, the assumption of a perfect basic order is no longer valid. There are several factors that hinder its accomplishment. To begin with, it must be understood that the design of current institutions is the result of a reaction to social needs, but the delay between a change in social preferences and an accordant institutionalization creates a regulation gap. Filling this gap is sometimes more easily accomplished by companies than by governing entities. As stated by Kofi Annan (2001) in a speech at the American Chamber of Commerce, "Business is used to acting decisively and quickly. The same cannot always be said of the community of sovereign States. We need your help—right now."

Furthermore, due to increasing global sourcing, enterprises are no longer subject to just one national regulation, but are now confronted with various laws and standards. As no world government exists, much less one with adequate authority to sanction, there is no binding legal framework on a supranational level. Therefore, global market failures, especially global external effects, can no longer be adequately internalized.

In the absence of a perfect basic order, enterprises, particularly those multinational in nature, can contribute to closing this regulation gap. Such socially desirable conduct is not in conflict with Friedman's presumption of profit maximization if: (1) an enterprise views its individual commitment as a long-term investment, or (2) all enterprises agree on closing the regulation gap, making it a collective commitment. In fact, a company's active role in designing society's basic order leads to an adjustment of Friedman's implicit assumption of a perfect basic order. In reality, there are external effects that are not yet internalized, and Freeman's stakeholder theory approach provides the theoretical framework to consider them.

In his seminal book, Strategic Management: A Stakeholder Approach, Freeman (1984) argued that the "shifts in traditional relationships with external groups such as suppliers, customers, owners and employees, as well as the emergence and renewed importance of government, foreign competition, environmentalists, consumer advocates, special interest groups, media and others, mean that a new conceptual approach is needed." (p. 27)

This insight was the impetus behind Freeman's stakeholder theory approach, which focuses on the enterprise's external environment. Under this framework, anyone who might affect the business objective and anyone who might be affected by its realization is considered a stakeholder. Thus, society can be divided into clusters of different stakeholders by considering their interrelation with the company (e.g., shareholders, employees, strategic partners, suppliers, NGOs). According to the stakeholder theory approach, consideration of externalities and their impact on stakeholders is critical to the company's current and future success.

In order to make sure that this is achieved, CSR can be strategically used to deal with the identified...
stakeholders’ claims. Management can employ CSR as a prescriptive instrument in making plans that will satisfy both the stakeholder and shareholder approaches.

Fig. 1 illustrates the interrelation between Friedman’s (shareholder) approach and Freeman’s (stakeholder) approach, and introduces strategic CSR into the relationship. Awareness of how all three interrelate will help solve the win–win puzzle: How can management identify and classify social trends and plan corresponding strategic CSR actions?

3. Solving the win–win puzzle

In attempting to solve the win–win puzzle, management needs to answer the question of which stakeholders should be considered and, correspondingly, how much is at stake. These queries can be satisfied by employing a multi-stage process. As illustrated in Fig. 2, the decision-making process is initiated by a social trend. At its inception, a trend is a social claim of unknown size. Thus, the first task of strategic planning is to evaluate the trend. Is it merely the claim of a marginal group and liable to disappear quickly, or is it possibly a claim of great public interest that will become increasingly important? If government does not react to a trend of broad public interest, the company might be able to step in and address the public’s concern. The decision as to whether the company should act must be based on an evaluation of the opportunities and threats involved. A cost-benefit analysis calculating the expected net present value of the future cash flow would likely be appropriate in making this decision. The
procedure portrayed in Fig. 2 is a template for the decision-making process.

Once a given trend has been evaluated, it must be determined whether any of the company’s stakeholders are involved or interested in it. If not, the company should remain disengaged. If, however, stakeholders are involved or interested, the claim could have either direct or indirect effects on the company. In such a case, management should deal with the trend, assigning it priority appropriate to the interested stakeholder’s importance. Stakeholder importance is determined by the stakeholder’s influence on the company’s cash flow. To evaluate and thus be able to prioritize a stakeholder’s importance, the influence of all known stakeholders needs to be mapped regarding their potential to interfere with the company’s cash flow. As illustrated in Fig. 3, this leads to three different categories of stakeholders.

Stakeholders in the first category are known as key stakeholders. This group includes all actors that have a direct connection to the company and can interfere significantly with the company’s current and expected cash flow. Accordingly, they are the ones that need to be considered when calculating the expected net present value of the CSR action. Key stakeholders are evaluated only once in a specific context, after which their status is fixed until the relationship changes fundamentally. The volatility of the key stakeholders’ expected cash flow is low. This group includes, inter alia, the most important suppliers, as well as major clients and crucial employees.

Members of the second group are known as emerging stakeholders. They do not have a current direct connection to the enterprise’s cash flow and do not influence the expected net present value. This situation can change rapidly, however, and management needs to keep an eye on this group in case some of its members suddenly become key stakeholders. The volatility of the emerging stakeholders’ expected cash flow is high; thus, this group must be evaluated regularly. This group includes, among others, suppliers that might gain influence in the future, NGOs dealing with sensitive issues, and politicians with the power to change the institutional framework.

Minor stakeholders make up the third group. These stakeholders cannot interfere with the company’s cash flow in the medium-term, and as such, although management needs to be aware of them, it does not have to pay them much attention. This group’s expected cash flow volatility is low.

Management’s decision criterion is the expected net present value of the social investment. If this value is positive, the investment should be undertaken. In making the investment decision concerning the new social trend, it might be possible to transfer the key stakeholders’ contributions to the cash flow from one context to another. This would leave a need only to reevaluate the emerging stakeholders’ contributions, something which should be done regularly in any case. For these reasons, the decision will not take much time or incur much expense.

Depending on what is at stake, the investment can be either an individual or a collective commitment. The company should choose a strategic action of an individual commitment type if the claim can be met by the company itself without any risk of...
opportunist behavior on the part of competitors. We call this an exclusive stake. This behavior is strategic because the goal is to attain a first-mover advantage (Jones, 1995). The enterprise that undertakes and leads a socially desirable action can improve its reputation among customers, and thus secure or expand its market share (Werther & Chandler, 2005). The enterprise's action may also prompt new social standards that serve as entry barriers for potential competitors.

Migros, Switzerland's largest retail chain, is a good example of a company that successfully chose strategic action of the individual commitment type. With supermarkets located in Switzerland, France, and Germany, and exporting products to Austria, the United Kingdom, and the United States, Migros, in 2002, committed itself to a standard for palm oil production. One of the most important oils on the world market and steadily growing in demand, palm oil is an important raw material in the production of margarine, washing agents, soap, and cosmetics. Unfortunately, increased palm oil production historically came at the cost of lost rain forest acreage. The revolutionary palm oil standard introduced by Migros, however, guarantees responsible sourcing because the company will not buy palm oil produced from plantations that have been established at the expense of the rain forest. Introducing this standard paid off for Migros — twice! First, Migros won a UN award for its action. Second, and even more important, the company became an outrider in the global consumer goods industry and thus gained influence. In championing this cause, Migros initiated a Round Table on Sustainable Palm Oil (RSPO), and its standard has now become the global standard.

As a means of overcoming collective problems, a single enterprise's individual commitment is a risky investment that will be successful only if it does not lead to a competitive disadvantage in the long run. If the individual enterprise's activities weaken its competitive position, competitors will be quick to take advantage and, down the road, the enterprise will either be forced to conform to the competitors' standard of behavior or leave the market. No social improvement will occur in this situation. Collective commitment has to take the place of individual commitment.

Structural action should be undertaken when a collective commitment is required. It would not be rational for an individual enterprise to take action; rather, a collective action must be undertaken, something that is effected by and affects all competitors equally. The action could lead to a concerted initiative to establish appropriate institutions or a voluntary, collective commitment to a common code of conduct by several enterprises of a market segment. Because all competitors (in the ideal case) are subject to this code, there are no, at least no ruinous, distortions of competition. For example, consider the issue of corruption. If corruption (i.e., bribery) is endemic in a certain industry, it would be nearly suicidal for a single company in that industry to commit itself to a code of conduct not permitting any use of bribery. Structural action would be needed to change this situation and make it possible for the industry as a whole to avoid great expense (i.e., stop paying the bribes). According to the World Bank, corruption adds at least 10% to the common costs of doing business in many parts of the world. One of the most popular initiatives supporting collective commitment is the UN Global Compact, by which enterprises commit themselves to respect 10 rules in the fields of human rights, work, environment, and corruption. The free-rider problem, which is inherent in such situations, can be minimized by nonpolitical social organizations that monitor compliance with the code of conduct and thus act as watchdogs (Werther & Chandler, 2005).

Both structural action and strategic action are ways of practicing strategic CSR. If the actions move into the mainstream of society, they may become part of society's basic order, either as explicit, legal standards or as implicit, socially desired standards. Of course, it is possible that, over time, implicit social standards can become a part of the legal framework. Martin (2002) provides a detailed description of this process. Essential is that once an action becomes part of society's basic order, it is established in the public mind as such.

Hence, CSR can be viewed as part of the dynamic process of discovery described by Hayek (1978). Society's basic order will always be imperfect, or incomplete, as it only reflects prevailing social opinion. Developments to come (i.e., trends) cannot be foreseen and dealt with in advance. However, the way social trends are made a part of the social order (that is, by government intervention or self-regulation) can be influenced and managed, and it is in this aspect that companies have an opportunity to do well by doing good.

4. Principal-agent hurdles

Taking the above into consideration, it becomes obvious that the theory of stakeholders is, in the long run, nothing but a shareholder value approach. The theory of stakeholders formalizes and categorizes challenges the company needs to meet if it wishes to pursue a long-term corporate strategy. This is generally the default strategy of owner-led companies. As the same person is both
manager and owner, there is no principal-agent conflict. Accordingly, businessmen usually follow a long-term strategy and stakeholder claims are considered per se.

The situation is a little different for manager-led companies, but even here a long-term approach to stakeholder management can be viable. The main problem will be the incentive structure. If managers are paid on a short-term performance basis, they will necessarily act in a short run manner so as to maximize their compensation, which will conflict with the long-term goal of effective and profitable stakeholder management. Social investment might have a different expected net present value for owners than it does for managers. If managers are short-term oriented, they will have a higher individual discount rate. Accordingly, the expected net present value is more likely to be negative and the investment will not be made. With a change in compensation scheme, however, CSR can be integrated into manager-led companies to their benefit, and thus to society at large. This point is corroborated by Tirole (2001), who contends that the stakeholder society is best served by flat remuneration structures, meaning fixed salaries without performance-oriented incentive structures. Different studies back Tirole's postulation empirically. For example, there appears to be a connection between variable performance-based compensation and earnings management problems or accounting fraud.

If wage restructuring is not practicable, a more feasible and less radical solution to this problem is the use of equity-based long-term incentives (e.g., stock options or restricted stocks). Stock options allow managers to purchase a certain amount of stock at a fairly long-term point in the future at a preset strike price. Restricted stocks require a certain length of time to pass or a given target to be met before they can be sold. However, to avoid the possibility of yet again setting up a less-than-optimum incentive structure, there are several issues that must be considered when using these long-term incentive instruments. Among others:

- Managers need to have their 'skin in the game' (De Ruiter & Souër, 2005); in other words, they must have a stake in the company. Stocks or options should not be granted as a bonus, but instead be part of the basic compensation so that managers either purchase them with their own money or through exchange programs. This will make managers responsible for the consequences of their decisions, good or bad.
- The restrictions placed on stocks or options need to be chosen carefully. It is not enough to simply set a fairly long-term vesting period; there need to be constraints on the period before the stocks can be sold or the options can be executed. Otherwise, the problems that accompany a short-term orientation are merely shifted to the future.
- As equity-based incentive schemes could create earnings management problems and lead to accounting fraud, executives must be monitored (for example, by the supervisory board). In this vein, it should be noted that transparent compensation schemes make such monitoring easier.

So-called 'target long-term incentives' are a non-equity-based remuneration scheme that can be used to short circuit short-term oriented management, as well. This type of incentive compensation is granted for fulfilling certain long-term performance-based goals. However, finding and agreeing on adequate targets that meet the final goal of long-term profit maximization will not be without difficulty.

The pros and cons of these different incentive schemes will need to be evaluated carefully before implementation. The challenge for companies will be to appropriately calibrate incentive awards with performance outcomes, particularly for long-term incentive programs. Apple's latest problems with backdated stock options reflect the ongoing need for creative action. In doing so, principal-agent hurdles can be reduced and management's behavior can be more closely aligned with the owner's goal of long-term profit maximization.

5. It can work

In conclusion, we believe that strategic practice of CSR will involve a long-term shareholder value approach, which implies a long-term view of profit maximization, as well. In the case of manager-led companies, this will make necessary a change in incentive structure so that the manager does well by doing good. If it is a company's goal to survive and prosper, it can do nothing better than to take a long-term view and understand that if it treats society well, society will return the favor.

References


