

# Corporate Social Responsibility through Business



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# **CORPORATE SOCIAL RESPONSIBILITY THROUGH AN ECONOMIC LENS**

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## ABSTRACT

Business leaders, government officials, and academics are focusing considerable attention on the concept of “corporate social responsibility” (CSR), particularly in the realm of environmental protection. Beyond complete compliance with environmental regulations, do firms have additional moral or social responsibilities to commit resources to environmental protection? How should we think about the notion of firms sacrificing profits in the social interest? *May* they do so within the scope of their fiduciary responsibilities to their shareholders? *Can* they do so on a sustainable basis, or will the forces of a competitive marketplace render such efforts and their impacts transient at best? *Do* firms, in fact, frequently or at least sometimes behave this way, reducing their earnings by voluntarily engaging in environmental stewardship? And finally, *should* firms carry out such profit-

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## 1. Introduction

Business leaders, government officials, and academics are focusing more and more attention on the concept of “corporate social responsibility” (CSR). The central issue is the appropriate role of business. Everyone agrees that firms should obey the law. But beyond the law -- beyond full compliance with environmental regulations -- do firms have additional moral or social responsibilities to (voluntarily) commit resources to environmental protection?

One of the challenges of examining the concept of CSR is simply identifying a consistent and sensible definition from among a bewildering range of concepts and definitions that have been proposed in the literature.<sup>1</sup> We adopt a simple definition originally offered by Elhauge (2005): sacrificing profits in the social interest. This definition has the merit of being consistent with some of the most useful prior perspectives (Graff Ziven and Small 2005; Portney 2005; Reinhardt 2005), while focusing the discussion on the most interesting normative and positive questions.

Of course, questions regarding sacrificing profits in the social interest apply beyond the environmental sphere. The academic debate over the legality of sacrificing profits in the public

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interest appears to have begun in 1932 with opposing articles (Dodd 1932, Berle 1932) in a *Harvard Law Review* symposium on “For Whom Are Corporate Managers Trustees?” The debate in economics began more recently, with Milton Friedman’s 1970 article, “The Social Responsibility of Business Is to Increase Its Profits,” in the *New York Times Magazine*. Since then, the debate has continued, and CSR has received considerable attention from both scholars and the public, especially in the environmental protection area.

The purpose of this article, which is part of a three-article symposium on Corporate Social Responsibility and the Environment,<sup>2</sup> is to introduce and provide an overview of the major issues related to CSR, synthesize what is known about CSR in the environmental arena, and thereby identify where the greatest uncertainties remain. To this end, we address four key questions about the issue of firms sacrificing profits in the social interest.<sup>3</sup> *May* they do so within the scope of their

actually *do* engage in CSR. Here we review and synthesize empirical evidence to assess whether some firms truly exceed full compliance with the law, and if so, whether their “socially responsible” actions actually sacrifice profits. To address our fourth question, *should* firms -- from a societal perspective -- be carrying out such activities, we

rules of the society, both those embodied in law and those embodied in ethical custom (Friedman 1970).

A more subtle version of the shareholder primacy argument is the “nexus of contracts” approach (Jensen and Meckling 1976; Easterbrook and Fischel 1991), which views the corporation as a nexus of legal contracts between the suppliers of various factors of production, who agree to cooperate in order to generate monetary returns. These agreements specify that in exchange for their contributions, the owners of most factors of production -- labor, land, intellectual property rights, etc. -- will receive set payments with little risk. Shareholders -- the suppliers of capital -- accept the residual financial risk of doing business, and in return receive the residual profits. Since shareholders have no contractual guarantee of a fixed payment from the firm’s activities, any profits that are diverted towards other activities, such as pursuit of “the social good,” come directly out of their pockets (Butler and McChesney 1999). Thus, from this perspective, CSR is close to theft.

A second view of the role of the corporation is found in the team-production model (Blair and Stout 1999), which views the corporation as the solution to the moral hazard problem that arises when the owners of factors of production must make firm-specific investments but fear they will not be rewarded *ex post*



if doing so reduces shareholder profits (Elhauge 2005). The judiciary's unwillingness to second-guess matters of business judgment has the practical effect of shielding managers who choose to

fiduciary duties typically refer to the “best interests of the corporation”, but whether the corporation’s “best interests” include only its shareholders or a wider set of constituents is not immediately clear (Cox and Hazen 2003). The prevailing opinion is that fiduciary duties are owed to shareholders (Blomquist 2006), but a minority supports the view that corporations can be managed in part for the benefit of other stakeholders (Lee 2005).

Every U.S. state recognizes the right of businesses to make charitable contributions. Seven states allow charitable donations regardless of corporate benefit, and nineteen other states allow donations that benefit the business or advance the public welfare (Choper, Coffee, and Gilson 2004).

The business judgment rule “acts as a presumption in favor of corporate managers’ actions” (Branson 2002). It requires courts to defer to the judgment of corporate managers, as long as their decisions satisfy certain basic requirements related to negligence and conflict of interest. The basic premise is that since corporate managers are far more skilled at making business judgments than courts, allowing courts to second-guess managers’ decisions would create potentially large transactions costs (Elhauge 2005).

The business judgment rule makes fiduciary duties difficult to enforce, and it effectively grants managers discretion to “temper business decision making with their perceptions of social values” (Clark 1986; Fisch 2006; Scalise 2005; Blair and Stout 1999).<sup>6</sup> As a practical matter, as long as managers can plausibly claim that their actions are in the long run interests of the firm, it is almost impossible for shareholders to challenge the actions of managers who act in the public interest.

The business judgment rule also offers managers protection from accusations of conflict of interest, primarily because it does not recognize most non-financial incentives as conflicts (Elhauge 2005; Branson 2002). Corporate managers’ decisions can be regarded as irrational -- and thus not protected by the business judgment rule -- only if they “go so far beyond the bounds of reasonable business judgment that their only explanati

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<sup>6</sup> For example, Clark cites the 1968 case of *Shlensky v. Wrigley*, in which the Illinois Court of Appeals allowed William Wrigley, Jr., the president and majority shareholder of the Chicago Cubs, to refuse to install lights at Wrigley Field because of his belief that night games would be bad for the surrounding neighborhood (1986).

the company's yearly net profit, on an art museum named after its 91 year old CEO, Armand Hammer.

So, are firms in the United States prohibited from sacrificing profits in the public interest? And if so, is the prohibition enforceable? The answers to these two questions appear to be “maybe” and “no,” respectively. “While case law falls short of unequivocally mandating shareholder wealth maximization, it also falls short of unambiguously authorizing the pursuit of non-shareholder interests other than instrumentally for the benefit of the shareholders” (Lee 2006, p. 557). And as long as managers claim some plausible connection to future profitability, the business judgment rule grants them substantial leeway to commit corporate resources to projects that benefit the public.

### **2.3 The Legality of CSR in Other Countries**

With their cultural traditions of social democracy or firm loyalty to employees, most European countries and Japan have legal systems that differ from the system in the United States. The legal systems in these other countries place a greater emphasis on stakeholder participation, and sometimes codify this by legalizing various forms of profit-sacrificing behavior. Europeans have sought to incorporate CSR into their investment climate, both at the institutional and individual level (Sutton 2004), and in strong social democracies, such as Germany and France, stakeholders (particularly employees) have much stronger legal positions than in the U.S. (Roe 2000). Corporations in Europe and Asia are also more likely to have a few large shareholders, who may take social responsibilities seriously, particularly those towards employees (Roe 2000). This contrasts with the pattern of highly dispersed share ownership in the United States.

#### *2.3.1 Industrialized Countries*

Common law industrialized countries, primarily former British possessions, share many legal features with the United States. Corporations in these countries have similar board structures, face similar legal requirements, and even share some legal precedents. In such countries, CSR is



by important business partners (Corfield 1998). These shareholder-creditors have financial goals that are similar to those of long-term employees, particularly in terms of corporate stability and minimizing risk (Roe 2000).

### 2.3.2 *Developing Countries and Multinational Enterprises*

Corporate law in developing countries has a number of special characteristics. First, the corporate legal system is often new. As a result, businesses have little experience complying with the law, and there are fewer judicial precedents mapping out the law's boundaries. Second, legal institutions in developing countries are often weak. Regulations can go unenforced; agency problems can be a serious issue; and members of the judiciary may be corrupt. Third, the operations of multinational corporations in these countries can lead to conflicts between the interests of home and host states.

Thus, both the laws governing CSR and the degree to which those laws are enforced may vary substantially across developing countries. Assuming that the laws in most developing countries allow some scope for managerial activity that may sacrifice profits, the question remains whether firms can do so in view of competitive pressures in the markets for their outputs and inputs. It is to this question that we now turn.

## **3. Can Firms Sacrifice Profits in the Social Interest?**

Just because the legal system may allow firms to sacrifice profits in the social interest does not mean that firms *can* do so on a sustainable basis in the face of competitive pressures. Under what conditions is it economically feasible for firms to sacrifice profits in the social interest? Before turning to this question, we address a somewhat broader question: under what conditions might it be sustainable for firms to produce goods and services, such as public goods, that benefit individuals other than their customers (Lyon and Maxwell 2004; Vogel 2006)?

We identify six conditions that would facilitate the production of such goods and services. All six of these conditions involve government intervention, imperfect competition, or both. First is the imposition of regulatory constraints that require a firm as well as its competitors to carry out some socially beneficial actions. Second is the possibility that such production is not costly to the firm. For example, restaurants frequently donate leftover food to homeless shelters. The third condition is that the socially beneficial actions may reduce a firm's business expenses by an amount greater than the cost of the actions themselves. For example, installation of energy-saving (climate friendly) technologies may generate long-term cost savings that outweigh upfront costs. Fourth, in some cases socially beneficial actions may yield an increase in revenue. It is easy to think of goods and services that are differentiated along environmental lines, such as clothing made of organic cotton, or wood from forests managed in accordance with some principles of sustainability. Socially beneficial actions could also generate goodwill, improving a firm's reputation and sales. Fifth, firms may choose to go beyond full compliance with environment, health, or safety laws in order to improve their position in current or future regulatory negotiations. By doing so, they may be able to deflect or influence future regulation or deflect enforcement of existing regulation. Sixth, some firms may use over-compliance to spur future regulation, which would provide a competitive advantage over less adaptable firms

We now turn to our more restrictive definition of CSR and address the question raised above: under what conditions is it economically feasible for firms to sacrifice profits in the social interest?

### **3.1 When Is it Feasible for Firms to Engage in Profit-Sacrificing CSR?**

In some cases firms undertake CSR actions voluntarily, while in others they engage in CSR only under pressure from market participants or other social forces. In practice, it is difficult to discern voluntary from "reluctant" CSR. Whether CSR initiatives are voluntary or reluctant, their

economic sustainability depends on the market pressures and social expectations confronted by the firm (Borck, Coglianesi, and Nash 2006).

### *3.1.1 Voluntary CSR*

The first possibility -- that stakeholders voluntarily sacrifice profits -- is what some observers would think of as the “purest form” of CSR. The primary economic agents who could fund such activities are shareholders and employees.

Some shareholders may be willing to subsidize firms’ profit sacrificing behavior. Stock issued by socially responsible firms is a composite commodity which combines a financial investment product with a charitable giving vehicle



Evidence suggests that some individuals are willing to pay more for socially responsible goods (Jensen *et al.* 2002). The existence of such “ethical investors” could -- in principle -- have consequences for firms that do not participate in CSR activities (Heinkel, Kraus, and Zechner 2001). For example, if ethical investors’ choices increase the cost of capital for “irresponsible” firms, some of these firms might be forced to adopt more socially responsible practices. If the share price differential becomes sufficiently large, these firms may decide to participate in CSR activities to increase their own stock price (Heinkel, Kraus, and Zechner 2001; Graff Zivin, and Small 2005). But the effect of green investors on the cost of capital may be small. Because irresponsible firms will generate higher returns (relative to their stock price), investors in these firms will accumulate capital more quickly than socially responsible investors, and over time may dominate the capital market. This would lead to a decrease in the cost of capital for irresponsible businesses (Heinkel, Kraus, and Zechner 2001).

Employees may sacrifice part of the returns to labor to further the social good. This could occur explicitly if employees are given the opportunity to use their own salary and benefits to fund CSR projects. For example, some executives may be able to channel part of their compensation towards the cost of CSR activities, or lawyers may be able to donate their time to pro bono work. Employees may also fund CSR implicitly, such as when a firm works in a field that employees perceive as socially responsible (e.g., providing services to the elderly, remediating oil spills). Employees may be willing to accept less than the fair market value of their labor (as determined by the wage they would receive for working in a less socially responsible industry), because they are compensated in other ways through the knowledge that their work benefits society at large (Frank 1996).

Unfortunately, empirical evidence on CSR and wages is inconclusive. Most revealed preference studies show that wages are lower at non-profit firms than at for-profit firms, but this

non-profit wage penalty disappears in econometric analyses that control for worker and firm-specific characteristics (Francois 2004). If non-profit status is a proxy for social responsibility, then socially responsible firms may not enjoy a significant discount on labor prices. This conclusion is supported by findings that CEO compensation at firms listed in the Domini Social Index (DS 400) is not significantly different from CEO compensation at other firms in similar industries (Frye, Nelling, and Webb 2006).

### 3.1.2 *Reluctant CSR*

Corporate decisions are actually made by individual managers and directors, not by the “firm” *per se*. Those decisions often further the interests of profit-minded shareholders, but not always. Investors may have little choice but to accept some degree of CSR profit-sacrificing activities. It may be less costly to accept a degree of principal-agent “slack” than to eliminate it completely, because managers who are excessively constrained may be ineffectual.

Investors may also be forced to accept profit-sacrificing activities that are the result of external constraints. This may be particularly relevant in the developing world, where environmental regulatory standards lag behind those of industrialized countries. For example, equipment purchased from industrialized countries may incorporate pollution control technology that meets standards considerably stricter than those in effect in a developing country (Jaffe, Peterson, Portney, and Stavins 1995).

The magnitude of the profits that managers can sacrifice against investors’ wishes depends on the structure of managers’ compensation and the strength of shareholder oversight. Principal/agent problems can be costly. Managers have been observed to “satisfice” profits, that is, they seek to achieve an adequate rate of return for shareholders and then divert the firms’ resources to their personal ends (Choper, Coffee, and Gilson 2004; Clotfelter 1985).

### 3.1.3 *Unsustainable CSR*

Under many conditions, firms that participate in costly CSR activities will have to raise prices, reduce wages and other costs, accept smaller profits, or pay smaller dividends -- and accept the economic consequences. For example, a firm's stock price may decline until it is proportional to returns, and attracting new capital may be difficult because returns are below market averages. Other short-term economic consequences may include loss of market share, increased insurance costs, increased borrowing costs, and loss of reputation. In the long term, the firm may face shareholder litigation, corporate takeover, or closure. Such consequences simply illustrate the general proposition and observation that (financially) inefficient firms tend to disappear (Alchian 1950; Altman 1999).

This process of economic survival of the fittest suggests that firms that engage in unsustainable CSR may find themselves being pushed out of business. The forces of globalization only increase this pressure. Given the seemingly inevitable outcome of this process, why would any firm choose to participate in unsustainable CSR activities? First, principal/agent problems may lead managers to make decisions that commit the firm to short-term CSR actions, even if those activities will not be continued in the long run. Second, managers may misjudge the potential profitability of certain actions, leading them to invest in actions that benefit society but harm the firm's bottom line. Neither the managers' probability assessments nor their motivations are transparent to outside observers, making it very difficult to distinguish between them (Baron 2006).

### **3.2 Economic, Structural, and Organizational Constraints**

A variety of factors influence the economic actors who make decisions about engaging in CSR activities. These factors include managerial incentive and monitoring constraints, and organizational structure and culture.

Whether or not firms are able and likely to engage in CSR depends on managers' incentives and constraints, which in turn are determined by managers' preferences, ethical beliefs, contracts,



#### **4. Do Firms Sacrifice Profits in the Social Interest?**

As described above, there are specific circumstances in which firms can sacrifice profits in the social interest without suffering serious adverse economic consequences. Whether they actually do so is another matter. This section discusses empirical evidence about the existence of such profit-sacrificing behavior.

Before interpreting the evidence, it is important to be aware of several challenges to making inferences about CSR. First, it is difficult to test whether firms' actions actually go beyond ordinary compliance with environmental regulations. Data on environmental performance are typically very limited, and because of the difficulty of observing appropriate counterfactuals, it is difficult to

Of course, distinguishing between motivations and outcomes is even more difficult. Although most firms are likely motivated by a combination of social and financial concerns, managers may cite social responsibility as the motive for actions that were actually driven by profitability. Or managers may use profitability to justify socially responsible business choices, even when those choices result in smaller profits (Baron 2006).

#### **4.1 Do Firms Over Comply?**

A first step in evaluating whether firms participate in CSR is to determine whether they over comply with regulations or participate in other costly activities that benefit society. We consider five sources of evidence: voluntary government programs, voluntary industry initiatives, voluntary action by individual firms, corporate charitable donations, and shareholder resolutions.

##### *4.1.1 Voluntary Government Programs*

In principle, the willingness of a firm to participate in a voluntary government program could be evidence of CSR activity. A variety of studies have evaluated the determinants of participation in voluntary government programs (e.g., Borck, Coglianese, and Nash 2006). Several patterns emerge. First, larger firms are more likely to participate in voluntary programs. Second, participation is more likely for firms that either produce final goods or experience more pressure from NGOs and consumers. Third, firms with higher emissions or poor compliance records are more likely to participate in voluntary programs. And fourth, participation may be positively influenced by factors such as industry association membership, R&D expenditures, organizational culture, and managerial discretion. However, there is no consensus that voluntary government programs have generated environmental benefits net of the opportunity cost of the resources required to implement them.

##### *4.1.2 Voluntary Industry Initiatives*

In addition to voluntary programs administered by governments, industry associations have created voluntary initiatives. For example, the Responsible Care program, established in 1989 by

the U.S. Chemical Manufacturers Association, requires participating facilities to adopt ten guiding principles and six codes of management practices related to the environmental and social dimensions of community interactions, facility management, and customer and supplier interactions. By and large, the program was ineffective because it did not provide strong incentives for compliance (King and Lenox 2000). Similarly, the Institute of Nuclear Power Operations (INPO) was created in the wake of the 1979 reactor meltdown at Three Mile Island, a nuclear power plant in Harrisburg, Pennsylvania. A third example is Sustainable Slopes, a voluntary program for reporting and encouraging improved environmental performance at ski resorts. The evidence indicates that firms took advantage of positive publicity, although the actual environmental benefits are debatable (Rivera and de Leon 2004).

In general, industry-sponsored programs exhibit the same kinds of participation patterns as government-administered voluntary programs. That is, larger firms, more prominent firms, and firms with poorer environmental records are more likely to participate. Again, there is no systematic evidence of positive environmental impacts net of social costs.

#### *4.1.3 Voluntary Action by Individual Firms*

An indicator of firm participation in independently developed CSR activities is whether firms adopt CSR plans, environmental management systems, or other plans that seek to encourage socially-beneficial decision making within the firm. These plans often have the nominal goal of taking a holistic management approach towards compliance with environmental and safety laws, contractual and voluntary environmental obligations, management of environmental and social impacts and risk, and other issues (Clark 2005). These systems may benefit firms by allowing them to manage the business aspects of environmental and social issues, but they may also serve as a mechanism for firms to improve environmental quality or otherwise benefit society.

One such mechanism is ISO 14001, an international standard that provides guidelines for monitoring environmental outputs, controlling environmental processes, and improving environmental performance (U.S. Environmental Protection Agency 2006). To demonstrate that its environmental management system complies with the standard, a business (or any other organization) must receive a third-party audit. Capital intensity, intensity of competition, and dependence on overseas markets are all positively associated with voluntary compliance with the standard (Chapple *et al.* 2001).

The best source of evidence about whether firms participate in CSR activities on their own initiative is independent studies of socially responsible actions. Perhaps surprisingly, many studies of individual beyond-compliance behavior analyze firms in developing countries (e.g., Hartman, Huq, and Wheeler 1995; Hettige *et al.* 1996; Pargal and Wheeler 1996; Blackman and Bannister 1998; Dasgupta, Hettige, and Wheeler 2000). One possible reason for this focus is that firms in industrialized countries are subject to a wide range of environmental regulations that make it difficult to judge whether their actions are legally required, risk-averting, or voluntarily beyond compliance. In contrast, in the developing world, pollution regulations may be poorly enforced or even nonexistent, making it easier to identify individual beyond-compliance behavior.

#### 4.1.4 *Corporate Charitable Contributions*

Evidence of corporations making financial contributions to charity supports the general hypothesis that corporations can and do commit corporate resources to CSR. Average contributions as a percent of net income before taxes increased, from less than 0.5 percent in the 1930s to 1.1 percent in the 1960s and 1970s (Harris and Klepper 1976). In general, CEOs and other high-level corporate officers have a high degree of control over the amount and destination of corporate charitable contributions, even if their company has established a separate charitable foundation (Kahn 1997). But charitable giving can be curtailed by debtholders (Brown *et al.* 2006; Adams and



Hardwick 1998). Overall, the evidence shows that charitable giving is more likely when financial and monitoring constraints are weak. Corporate charitable giving is also sensitive to firm income

relationship, and 2 percent show a negative relationship.<sup>6</sup> Margolis, Elfenbein, and Walsh argue that the evidence indicates that CSR, in general, has little effect on profitability. However, they note that there is stronger evidence to suggest some causality in the opposite direction: companies that are profitable are more likely to engage in more CSR activities.

The finding that there is little relationship between CSR and profitability is consistent with a market equilibrium in which firms invest in socially responsible projects until the marginal returns decline to the overall market rate of return. In this situation, investing in CSR is not profitable (in the sense that it does not generate economic rents), but neither is it a losing proposition. Instead it means that for most firms, CSR “pays for itself.”

These conclusions require a number of caveats. First, when evaluating studies of the relationship between social responsibility and profitability, it is important to keep in mind that not all companies that are classified as socially responsible actually sacrifice profits. Many operate in industries, such as software development, that by their very nature have little environmental or social impact. Second, many of the measures of CSR used in such studies are not consistent with CSR as we define it in this article. Thus, measured effects on profitability may have more to do with advertising, charitable contributions, or other tangentially relevant factors than with CSR.

In summary, evidence on sacrificing profits in the social interest is lacking. The bulk of the available evidence suggests that most firms view socially responsible actions in the same way that they view more traditional business activities, such as advertising and R&D. Instead of altruistically sacrificing profits, they engage in a more limited -- but more profitable -- set of socially beneficial activities that contributes to their financial goals. Hence, although proponents of sustainable business practices may argue that being environmentally responsible will inevitably lead to higher profits in the long term, the relationship between socially responsible activities and profitability may

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<sup>6</sup> Thirteen percent did not report a sample size that could be used to test significance.

be best characterized as *some* firms will generate long-term profits from *some* socially responsible activities *some* of the time (Reinhardt 2000).

## **5. Should Firms Sacrifice Profits in the Social Interest?**

Even if firms may, can, and do sacrifice profits

## 5.1 Social Welfare

In the context of CSR, the social welfare criterion suggests that: (1) firms should invest in projects that produce the highest level of social welfare; and (2) it is preferable to allow CSR if aggregate welfare is likely to be higher when CSR is allowed than when it is prohibited.

The benefits of CSR include direct welfare gains to individuals, such as asthmatics living near a power plant that voluntarily reduces its emissions. More broadly, if firms voluntarily internalize externalities, a more efficient allocation of resources may result. Of course, there is no reason, *ex ante*, to anticipate that firms will reduce externality-producing activities to efficient levels.

The direct costs of CSR are the loss of consumer surplus resulting from firms producing less output at higher cost and hence at higher prices. In addition, shareholders receive reduced financial returns. On the other hand, some shareholders may gain utility from the knowledge that their profits have been invested in socially responsible projects.

There are a number of reasons to believe that firms do not make socially optimal CSR investments, in the sense of choosing activities that generate the greatest net social benefits, subject to budgetary constraints. This is because firms' CSR decisions are influenced by a number of factors that are unrelated to social benefits and costs.

First, firms' CSR investment choices are influenced by managers' personal preferences and firm characteristics. For example, some managers may favor building art museums, while others favor the provision of affordable housing. This idiosyncratic element of personal preference is particularly likely if principal/agent issues drive CSR (Butler and Mcxf 5acv8es

extent that these factors are unrelated to the social benefits and costs of CSR, their influence on firm decisions about CSR may result in social inefficiency.

Second, although firms may be well informed about the private costs of CSR, they may have little experience evaluating its social benefits, leading them to choose inefficient levels of environmental protection effort. Third, firms may fail to consider alternative mechanisms to achieve their social goals. For example, firms may be able to achieve higher social returns by donating profits to charities, which are dedicated exclusively to the task of improving social welfare and thus presumably are well-suited to the task. If this is the case, then firms that fund CSR activities effectively “crowd out” their own donations to more efficient charities (Graff Zivin and Small 2005). Finally, choice of CSR activity is affected by the firm’s ability to sacrifice profits. Firms that are the most profitable are also the most able to sacrifice profits in the public interest. However, the opportunity cost of sacrificing profits may also be greatest for these firms, assuming they could otherwise invest the resources in their businesses and earn similarly high returns.

Although there are reasons to doubt the optimality of firms’ decisions about CSR, there are also reasons to believe that firms’ CSR investment decisions may increase welfare. First, firms have access to private information about their current and future pollution activities, including control costs. Such information can lead firms to identify better policies than less well-informed government agencies. Second, firms have relevant expertise and operational capacity. Third, government policies are driven by a variety of objectives, only one of which may be maximizing social welfare. Hence, compared with the counterfactual of prohibiting CSR but leaving government policy otherwise unchanged, allowing CSR may generate higher net social benefits.

Many types of potential CSR activities -- from reducing particulate emissions to preserving open space -- are mandated to some degree by federal, state, or local laws and regulations. To the extent that such regulations require a level of environmental protection that is below the socially

optimal level, additional corporate investment in these activities can increase social welfare (if incremental social benefits exceed incremental social costs). In addition, there may be socially responsible activities that address environmental issues that are unregulated but of significant scientific or political concern (e.g., global climate change). In such cases (i.e., in the absence of government policies), CSR activities may lead to positive net social benefits. However, given that it appears to be relatively rare for firms to actually sacrifice profits in the social interest, the overall net welfare flow from CSR, whether positive or negative, is unlikely to be large.

## **5.2 Legal, Political, and Social Considerations**

Although legality is not synonymous with social desirability (as evidenced by the legality of many socially undesirable activities), some observers would surely identify legality as a normative criterion by which to judge many actions. In the second section, we argued that in the United States and other common law countries, sacrificing profits in the social interest is not strictly legal, although in practice CSR is not prohibited because of the business judgment rule and problems of enforcement.

One argument that can be made against CSR is that it is not a democratic process. There is no particular reason to believe that society should prefer firms' choices and priorities over the choices and priorities of a democratic government. Some observers might also argue that corporations already dominate too many aspects of modern life, and that it would be undesirable for them to control the supply of public goods as well.

Under a broader interpretation of the idea of social responsibility, however, it can be argued that businesses have a moral commitment to hold themselves to higher ethical standards and to engage in activities that benefit society. In fact, in a poll of citizens' attitudes towards the responsibility of businesses in 23 developed and developing countries, public opinion seems to support the notion that corporations in the West should "set higher ethical standards and help build a

better society.” In countries such as China and Kazakhstan, however, the notion that corporations should “make profits, pay taxes, create jobs, and obey all laws” dominates (Enviro-nics International Ltd. 1999).

### **5.3 The Special Case of Developing Countries**

Given that economic, social, and environmental conditions in developing countries are so different from those in industrialized countries, one would expect the answers to normative questions about CSR to also be different. For example, environmental regulations in the developing world are often not well-enforced. Hence, many relatively cost-effective interventions that have already been implemented in industrialized countries may still be available to businesses that operate in the developing world. This suggests that CSR could lead to significant gains in net social welfare.

Other concerns about CSR arise in the developing country context. Precisely because legal and contractual systems often operate poorly in developing countries, it is important to prevent activities that could erode the basis for future economic growth. Thus, strong investor protections may be particularly desirable in developing economies (Marinov and Heiman 1998) to help buttress the political viability of privatization and market-based systems. Allowing managers to divert profits to socially responsible projects means giving managers substantial discretion. However, there is also the risk that this discretion could tempt managers to use corporate resources for personal gain.

## **6. Summary and Conclusions**





costs, increased borrowing costs, and loss of reputation. In the long term, the firm may face shareholder litigation, corporate takeover, or closure.

This process of economic survival of the fittest suggests that firms that engage in unsustainable CSR may find themselves being pushed out of business. Given the seemingly inevitable outcome of this process, why would any firms choose to participate in unsustainable CSR activities? First, the firms that engage (or say they engage) in CSR are often active in markets that are imperfect or distorted by government intervention, so that they are protected from Friedman's evolutionary imperatives. Second, principal/agent problems may lead managers to make decisions that commit the firm to short-term CSR actions, even if those activities will not be continued in the long run.

Despite a large and growing literature on CSR, evidence of firms actually sacrificing profits in the social interest is lacking. The bulk of the available evidence suggests that most firms view socially responsible actions in the same way that they view more traditional business activities. Instead of altruistically sacrificing profits, they engage in a more limited -- but more profitable -- set of socially beneficial activities that contributes to their financial goals.

Although proponents of sustainable business practices may argue that being environmentally responsible will inevitably lead to higher profits in the long term, the relationship between socially responsible activities and profitability may be best characterized as *some* firms will generate long-term profits from *some* socially responsible activities *some* of the time.

Is it in the social interest for firms to engage in CSR? More to the point, should governments allow such activity? To the extent that existing regulations require a level of environmental protection that is below the socially optimal level, additional corporate investment in CSR activities may increase social welfare. In this context, CSR should be viewed as a complement to, rather than a substitute for, increasingly effective government regulation.

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