

A Pragmatic Approach to Corporate Social Responsibility- Address Given to The School of Management, the London School of Economics, 19 May 2003

Introduction

I would like to begin by thanking Geoffrey for inviting me to speak to you today on the subject of corporate social responsibility. As Geoffrey has said, a book of mine called *Socially Responsible Investment - A Global Revolution*, was recently published. It took two years to write, and was the product of five years' earlier research. One of my aims in writing the book was to add some conceptual rigour and accurate statistics to an area that was conspicuously lacking in both. I'd like to do the same for corporate social responsibility (CSR), although obviously a 30 minute lecture gives a rather more restricted scope. I suspect some members of the audience may have a negative view of corporate social responsibility, but I hope to show you today that they are based upon an incorrect understanding of what CSR actually is. At the end of my talk I will welcome questions on either corporate social responsibility or socially responsible investment (SRI).

Critics of Corporate Social Responsibility

Let me start with the negative perspective. Many economists have publicly attacked the idea of corporate social responsibility. Take Samuel Brittan in the *Financial Times*: 'Corporate responsibility lacks the legitimacy of either the market or the political system' ¹, or Elaine Sternberg: 'using business resources for non-business purposes is theft- an unjustified appropriation of the owners' property.' ² One of the first, and probably the most famous, counterblast against corporate social responsibility was an article written by Milton Friedman and published in the *New York Times*. ³ I think it only fair to Friedman to state that that this was a relatively short and offhand article, and I suspect that he never suspected that the article would be subjected to the intense level of analysis and criticism it has subsequently received. For example, he uses a level of rhetoric that is quite natural in a newspaper article, but seems out of place in an academic paper. Friedman starts off by declaiming that anyone advocating social responsibility for business is 'preaching pure and unadulterated socialism', and that they: 'are notable for their analytical looseness and lack of rigour.' ⁴

Friedman's arguments can be divided into two types: philosophical and economic. Friedman's philosophical argument is that: 'only people can have responsibilities....business as a whole cannot be said to have responsibilities'. ⁵ To Friedman the latter remark may have seemed a self-evident axiom. The statement that ethics only concerns individuals, and cannot apply to groups or organisations is a fundamental tenet of Anglo-Saxon individualism. In the history of thought such an assertion goes back to philosophers such as David Hume, who was a friend and influence on Adam Smith. However, in other cultures such a view of ethics is not generally accepted. Much of Continental Europe is based upon a 'communitarian' ethic, while in Japan the idea that individuals can have ethical rights and duties in their own right, rather than responsibilities to society, would be regarded as incoherent and abhorrent. In general business ethicists have not been impressed with Friedman's article. For example, let me cite Robert Solomon, Professor of Philosophy at the University of Austin, Texas, who brought his professional expertise to bear upon Friedman's article. Solomon argued that from the point of view of business ethics Friedman has:

'Misconceived business activity in an amoral way, subsumed (or hidden) under the all-purpose imagery of 'competitiveness'. But "competition" is but one of a large number of relationships that companies have with one another and with other members of the community, and an overemphasis on competition can be disastrous for the sense of community, and for the underlying co-operation that is necessary for any business activity.' ⁶

Solomon went on to be fairly dismissive of Friedman's article, criticising:

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'Its nonsensically one-sided assumption of responsibility to his pathetic understanding of stockholder personality as "homo economicus"... such talk about the primacy of profits and the obligation to provide them is not only vacuous and misleading, it eclipses the larger picture and all the other purposes that business is designed and managers are hired to serve.' 7

Friedman is of course on more solid ground when writing about economics. His economic argument is the traditional one that businessmen are no more than agents of the shareholders who ultimately employ them. In his view, when functioning as businessmen their only duty is to these owners. He therefore concludes that any action by a businessman that does not aim to maximise profits amounts to a tax on that business, which should be left to government alone. Friedman is therefore dismissive of any notion of corporate social responsibility:

'The doctrine of social responsibility... is fundamentally subversive.....there is one and only one social responsibility of business- to use its resources and engage in activities designed to increase its profits so long as it engages in open and free competition without deception and fraud.' 8

Before leaving Friedman we should briefly note his article was written in response to a particular set of circumstances, i.e. the climate of big business in the late 1960s. This was the period characterised by J.K. Galbraith as the 'New Industrial State', 9 a time when large companies seemed to be dominated by managerial elites with little interest in shareholder returns. Many companies experimented with corporate philanthropy, although a cynic may wonder whether they were genuinely concerned about ethical issues, or whether the real agenda was to get the chief executive into the country club in the US or a knighthood in the UK. This was the backdrop to Friedman's article, and I believe that he was quite right to condemn the practice of 'corporate philanthropy'.

Of course, much has changed over the last thirty years. A modern criticism of corporate social responsibility was recently produced by David Henderson in a 90 page paper entitled *Misguided Virtue- False Notions of Corporate Social Responsibility*. 10 Henderson characterises CSR as 'misguided virtue' stating:

'CSR involves the voluntary adoption by businesses of broader objectives, more complex procedures, and more exacting standards. To this extent it would tend to impair enterprise performance, with effects on both costs and revenues, short-run and long-run. ...The system effects of CSR, as well as the enterprise effects, will tend to make people in general worse off....(CSR) forms one element of new millennium collectivism. Its adoption would reduce competition and economic freedom and undermine the market economy. The commitment to it marks an aberration on the part of the business concerned, and its growing hold on opinion generally is a matter for concern.' 11

Henderson's criticism of corporate social responsibility is different from Friedman's. Whereas Friedman was concerned that corporate executives were adopting misguided objectives, Henderson is worried about an outside interference with efficient resource allocation. He defines corporate social responsibility as what he calls the modern trend of non-government organisations (NGOs) 'typically hostile to capitalism and the market economy' putting undue pressure on businesses. Henderson accuses CSR as being an anti-capitalist ideology, 'a salvationist illusion':

'The salvationist illusion that globalisation has transferred power from governments to business. It also confers on business and NGOs alike a status which they have no rightful claim to, since they are neither elected nor politically accountable....CSR holds that business should assume a leading role in making the world a better place: they should demonstrate corporate citizenship. This is taken to mean endorsing and pursuing the

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objective of sustainable development...CSR supporters presume, mistakenly, that the notion of sustainable development is well defined and universally agreed' 12

Now if corporate social responsibility is nothing more than an interference with the price mechanism, it is obviously something that all economists must reject. However, I am afraid that Henderson's paper is vitiated by two things: its overwrought tone, and its definition of the term 'corporate social responsibility'. It also makes some highly debatable assertions. For example, Henderson states that there no generally accepted and precisely defined 'notion of sustainable development'. This is simply wrong. In 'green' circles the Brundtland Report's description of 'sustainable development' is generally regarded as definitive, and quoted with the same kind of respect that Islamic scholars quote the Koran. 13

However, the main objection to Henderson's criticism of corporate social responsibility is that he does not understand, or does not want to understand, what corporate social responsibility actually means. The efforts by NGOs to impose social and environmental constraints on business cannot be identified with CSR. It is a pity Henderson has made this fundamental mistake, because I share his unease about the role of unelected NGOS in shaping public opinion, in particular the way they actively promote an agenda which combines a mixture of 'green' and anti-business thought. To my mind this cannot be described as corporate social responsibility, but it could, and perhaps should, be described as 'anti-capitalist' or anti-globalist'. The 'neo-Puritanism' of the green movement was described as early as 1994 by Charles Rubin, in his book *The Green Crusade*:

'Being an environmentalist, in other words, means being part of a political or moral crusade for a better world. Environmentalism (in the US) is heir to the antislavery and temperance movements and thus a part of the ongoing saga of evangelical reform that has characterised American history....We know it wants to save the earth. We forget just how much, in the spirit of its predecessor, it seeks to save us from ourselves.' 14

Of course, anti-globalisation activists will try and make use of any opportunity to push their own agenda- that is their role. In a democratic society we cannot criticise them for doing so, as long as their methods are legal. However, this does not mean that CSR can be identified with anti-globalisation, as corporate social responsibility includes a wide range of agents and motives. For example many large organisations such as the accountancy firm KPMG are offering CSR services for purely capitalist, profit-maximising objectives.

Earlier I described Solomon's criticism's of Friedman's approach to business ethics. It makes the point that business ethics and economics have differing perspectives on the purpose of business, each of which is legitimate within its own frame of reference. At this level we have a rather sterile debate. Over two hundred and fifty years ago the philosopher David Hume noted the immense gulf between the words 'is' and 'ought'. I therefore propose that economists should leave questions of 'ought' to philosophers, and concentrate on questions of 'is'.

A Pragmatic Account of Corporate Social Responsibility

Let me then define what I mean by the phrase 'corporate social responsibility'. In my opinion CSR describes the practical reality that companies are increasingly being judged not just by the products and profits they make, but also by *how* these profits are made. It is important to stress however that this definition is limited to the societal and environmental constraints put upon a company's core function of profit maximization by the provision of goods and services. Companies respond to these constraints in response to the two classes of 'stakeholders' who really do matter to them: customers and shareholders. Earlier I stated my agreement with Friedman that companies should not give shareholders' money away. To repeat, corporate social responsibility is *not* an invitation for companies to take over charitable functions better left to foundations and

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publicly elected bodies. In economic terms it can be described as a constraint upon business activity which must be integrated into management decision-making in order to maximise long-term profits.

If executives really aim to maximise shareholder value, they should explicitly focus on long term profits. (Recent US financial history shows what can happen when executives put too much attention on producing rising earnings per share.) Now this is really Hick's old definition of the value of an asset as consisting of the discounted value of the cash flows arising from it. There is a related point that follows from this: the lower the discount rate, the more important the longer term becomes. In the high inflation period of the 1970s and 1980s, interest rates approaching 17% meant that potential profits achieved more than a few years hence were essentially insignificant. Clearly this is not the case when interest rates are below 4%. Hence the need to protect long-term profitability by taking account of CSR factors is much greater when interest rates are low, than it was when they are high.

Some people may feel that the above argument is rather abstract, so let me give some practical examples. Corporate social responsibility includes issues such as a company's general business practices, executive pay levels, global practices on health and safety, policy towards bribery etc. It also includes policies towards trade unions, and working conditions of overseas suppliers. However it is important to stress that I am not trying to make any ethical case that companies should do so, as I believe that this can be justified in classical profit maximisation terms.

Hence my use of the term corporate social responsibility does not make any kind of value judgement. In this context 'socially responsible' simply means *responsive* to the concerns of *society*. The avoidance of the word 'ethical' is deliberate. Some critics might feel that current social responsibility concerns have a high degree of political correctness; that it is simply *wrong* that newts and owls are given a higher priority than say starving children in Africa. However, this is the world we live in, and in a democratic and pluralistic society we cannot object if it decides upon values that we feel are misguided. Henderson was worried about unelected NGOs promoting their own single issue agenda. However he failed to realise that such NGOs would have little impact if their concerns were not shared, at least to a certain extent, with that of the populace at large. For a contrary example, think of the dedicated minority of far-right extremists, and how they have fortunately failed to secure popular support for their objectives. The public's growing interest in the environment may perhaps be best illustrated by a table of membership of some UK environmental organisations in the 1970s and 1980s. (There has been a similar growth in support for human rights groups like Amnesty International.) This was a period when church attendance fell steadily, when membership of political parties dropped away and even community groups like the Scouts saw significant declines in membership. However membership of environmental organisations grew steadily:

Table One: Growth in Environmentalism 1971-1993

	1971	1981	1993
	000s	000s	000s
National Trust	278	1,046	2,189
RSPB	98	441	850
Greenpeace	0	30	410
Friends of the Earth	1	20	150
Worldwide Fund for Nature	12	60	207

The need to meet the public's environmental and social concerns is therefore something that business must address. There are a number of reasons for this. The first is question of *needs*, the

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simple fact that, in developed countries at least, we live in a rich society. This means that our wants and desires are more sophisticated than they were 100 years ago. Think of this if you will as a simple Maslovian hierarchy. The cost of food and shelter take up a much smaller proportion of our income, and we are therefore able to elect to pay more for goods and services that meet our requirements in other ways. Take a look around any supermarket shelves, and you will see plenty of examples of this, such as expensive free-range eggs. A related aspect of this, resulting from both globalisation and increased affluence, is that people increasingly purchase 'brands' rather than 'objects', such as a famous brand of sportswear whose manufacturing cost is only one percent of its retail price

Companies perceived to be behaving badly with regard to the environment or human rights standards are increasingly at risk of falling sales. This is particularly true for consumer products companies operating in the field of fashion textiles and sportswear. In the US for example both Gap and Nike found their sales and profits growth were badly hit by consumer boycotts. However, it has been true for a wide range of other industries including food and oil. This phenomenon may be summed up as the economics of reputation. Corporate added value increasingly consists of intangible items such as brand image; or goodwill. Let me give you a practical demonstration of the above point: the relationship of the total market value of the US stock market compared to the net asset value of US industry. This ratio is sometimes called Marshallian K. Over the last twenty years it has risen steadily.

Having mentioned the CSR requirements of consumers, I now wish to move on and describe the corporate social responsibility demands of investors. In this context CSR is rooted in corporate governance issues but it goes far beyond them. The vast majority of investors save through institutional vehicles of insurance companies and pension funds. This fact gives institutional investors a concentrated power to assert CSR issues in a more high profile way than consumers. For example, in the UK the top ten investment management companies have effective control, i.e. they own over 50% of the shares, of the majority of UK quoted companies.

There are two popular misconceptions about corporate governance which are widespread at present: that it is about resolving the problems set by one or two 'rotten apples' such as Enron and WorldCom, and that it is a restricted, legalistic subject of limited interest. In my opinion both are incorrect. There is, in fact, increasing public concern about corporate governance around the world. For example Korea's reforming Prime Minister Roh Moo Hyun took office in February 2003 pledging to put better corporate governance of the country's giant *chaebol* conglomerates high up his list of governmental priorities. Improving corporate governance is being discussed at the highest political levels in the European Union, in Tokyo, and in Hong Kong.

Nevertheless, it is probably correct to state that the subject has been given the greatest airing in the Anglo-Saxon world. This is hardly surprising, as the sudden and unexpected collapse of a large quoted company resulting from corruption or incompetence is surely the most prominent example of corporate governance failure. Such corporate failure, and the consequent public outrage it brings, is most evident in the United States, in the wake of the *causes celebres* referred to earlier. In my opinion the British financial press tends to take a rather complacent view of corporate governance in the UK. Perhaps UK corporate governance is of a high standard, but it would be complacent to ignore the significant number of former FTSE 100 constituent members who have fallen upon hard times: British Energy; Cable & Wireless; Independent Insurance, Invensys; Marconi; and Railtrack. It is true that Independent Insurance is the only member of this list that seems to have suffered from Enron style corruption, with the rest the victims of weak management. However, the result for shareholders has been the same- a decline, and in some cases an evaporation, in the value of their shares.

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However, there is growing public indignation over what many observers would call the *real scandal* of corporate governance, i.e. the way executives of many large companies have abused their position to transfer significant amounts of shareholders' wealth to themselves. Not all large companies have of course behaved like this, but such 'corporate malfeasance', to use Alan Greenspan's terminology, has left a residue of suspicion about business among the public and politicians alike. The UK was the first place where corporate governance really emerged as a significant issue in its own right, following a number of corporate scandals linked to the late Robert Maxwell. This series of events prodded the UK government to convene a substantial review of corporate governance- the 1992 Cadbury Committee, which defined corporate governance as: 'The system by which companies are directed and controlled.' It may be worth recalling that at this level, concern about corporate governance is no more than an 'agency problem' identified by Adam Smith as far back as 1776:

'The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot be well expected that they should watch over it with the same anxious vigilance with which the partners in a private partnership (copartnership) frequently watch over their own.' 16

A relatively new phenomenon pushing for greater corporate social responsibility is the rapid growth of socially responsible investment funds (SRI), who use their shareholder ownership rights to push for corporate social responsibility. **Table Two** shows the quite extra-ordinary growth in the investment universe of UK SRI funds which increased by a factor of ten in the four years from 1997. SRI truly moved from fringe to mainstream in Britain during this period, the catalyst being the decision by the UK government to introduce legislation requiring pension funds to report on SRI issues. **Table Three** demonstrates the sheer size of socially responsible investment funds around the world.

Table Two: Growth in UK SRI Investment Assets 1997-2001

	1997	1999	2001
	£bn	£bn	£bn
Church Investors	12.5	14.0	13.0
SRI Unit Trusts	2.2	3.1	3.5
Charities	8.0	10.0	25.0
Pension Funds	0.0	25.0	80.0
Insurance Companies*	0.0	0.0	103.0
Total	22.7	52.2	224.5

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Table Three: Global SRI Investment Assets 2001

	US\$bn
United States	2,332.0
United Kingdom	326.6
Canada	31.4
Europe	17.6
Japan	1.9
Australia	1.1
Total	2,710.6

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It must be admitted that until recently there has been negligible overlap between corporate governance and socially responsible investment. Historically corporate governance has been seen

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as a purely technical, legalistic issue, whereas SRI was based essentially upon negative exclusion criteria, i.e. so-called 'ethical funds' sold to the public on the basis of not investing in areas such as alcohol or tobacco. What has changed is the growing adoption by large pension fund investors of SRI shareholder activism, i.e. the use of their voting rights as shareholders to press for good CSR practice. This in turn reflects a growing political consensus among the Anglo-Saxon political establishment that corporate social responsibility must be encouraged. This can be seen in the ethics and whistle-blowing clauses of the US Sarbanes-Oxley Act, in UK and Australian legislation to encourage SRI and shareholder voting, and lastly, but not least, the recent amendments to the Canadian Business Corporations Act which now permit shareholder activism.

The point to note here is that SRI has changed, and in such a way that it is much more closely linked to CSR than used to be the case. It is important to highlight this recent development, since it has received little critical attention. Large pension funds and insurance companies have taken up SRI issues, using a model of dialogue with companies on issues of ethical concern, rather than using the older SRI approach of negative screening. This approach is well-known in the US, where investors have been filing SRI shareholder resolutions since the early 1970s. Over time US shareholder activism has developed a recognised code of procedure. By the 1990s many social resolutions were receiving the support of 10%-25% of the vote, pressurising corporate executives to respond positively to them.

In the UK, where social resolutions are relatively new, company executives often seem to regard them as an unwarranted interference in a company's affairs. (I would agree that such suspicions may be justified when they are filed by a single agenda campaigning group.) However, SRI resolutions can function as a feedback mechanism alerting senior management to potential problems lying ahead, thus illustrating the linkages between SRI and CSR. When US institutions started filing social proxies in the early 1970s, the atmosphere was often highly charged and adversarial. By the 1990s things had changed through what Tim Smith, the head of the church activism group ICCR called 'a process of maturation'. In other words each side of the process recognized that the other had something to value to offer, that the objective of the exercise was to benefit the corporation by improving its behavior- it was not aimed at damaging it. In Smith's words:

"Today a generation of parties to these negotiations has become accustomed to the idea that the interests involved are not mutually exclusive but are often complementary. In fact, this is what the corporate social responsibility movement has contended from the beginning. A "maturation" process is taking place on both sides. Increasingly investors are recognising and affirming the constructive role of social investors such as the churches to raise and work through issues that must be of concern to the corporation.' 19

Not everyone will agree with the speaker that corporate governance is really just one aspect of SRI. I asked Bob Monks, one of America's leading experts on corporate governance, and a pioneer of shareholder activism about this. Monks certainly sees a growing overlap between corporate governance and SRI:

'It's true that this is a relatively new area for me in the context of my writing. In fact it was Peter Drucker who convinced me just a couple of years ago that corporate governance was essentially just one aspect of investment. However, questions of business ethics have always concerned me.' 20

A similar reinterpretation of corporate governance was recently produced in Switzerland:

'In the 21st century, it will no longer be possible to measure corporate governance solely in terms of financial success and consumer satisfaction. Instead, the successful firm will have to pay more attention to, and balance the demands of society at large and the

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environment.... Growing demand for ecologically, socially and ethically sound products and services is likely to force companies to target their activities, as well as products and services, accordingly. This is undoubtedly part of the new reality of corporate governance that companies must address.' 21

In the speaker's opinion companies have to decide whether they are taking corporate social responsibility seriously or not. It seems to me that the current status of CSR is rather like that of quality management in the 1980s. At that time Western companies thought it was a matter of sampling at the end of the production process. They lost significant market share to Japanese companies who practised total quality management, i.e. the integration of quality management right from the design stage at the beginning of the production process through manufacture and assembly. I recently went to Paris to address the International Chamber of Commerce on this point. Perhaps I may be permitted here the luxury of quoting what I told them:

'I can understand the concerns of overworked and harassed business executives who worry that the CSR agenda is just one more burden placed upon them. But remember, your CSR concerns should be limited to the way you do business, and ultimately will differentiate your company from its competitors. It is up to you whether this is positive or negative. Let me conclude by stating that the subject of corporate social responsibility is not going to go away, and wishful thinking will not make it do so. It is just one more challenge that the successful business leaders of the new Millennium will need to address.' 22

Conclusion- Beyond Instrumentalism

To conclude, in my address to you today I have given some pragmatic, instrumental reasons why companies should include CSR issues when developing their business strategy. However, I would like to end by stating that my criticisms of Henderson do not mean that I am siding with the anti-globalisers. Free markets have brought unprecedented prosperity to the world over the last two hundred years. Let me quote an example recently given by John Kay:

'From the ruins of the second world war emerged the greatest controlled experiment in the history of the social sciences. Germany was divided into two zones- one a decentralised market economy, the other based upon central planning. After 15 years the experiment could only be maintained by building a wall to prevent residents of one zone fleeing to the other. Another 25 years later, the population tore down the wall and reunified the country. The result was clear, productivity levels in the east were perhaps a third of those in the west.' 23

Another way of looking at the question of corporate social responsibilities is that it concerns *externalities*; the deregulation of the 1980s and 1990s enabled profit maximising companies to pass onto society costs that they were previously forced to internalise. My 'ethical' point to economists is simply this: that societal concerns about social and environmental matters can be either be assuaged through the price mechanism in goods and capital markets, or they can lead to government re-regulation of the economy. I know which solution I would prefer. But if economists continue to turn their backs on CSR issues, the second alternative is likely to prevail.

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