

AIESEC Corporate Social Responsibility Seminar

The Meaning Of Corporate Social Responsibility

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AUCKLAND
3 DECEMBER 1996

CORPORATE SOCIAL RESPONSIBILITY

Introduction

I would like to begin this talk on the theme of corporate social responsibility by asking a question. Why is there more interest in, and debate about, the social responsibility of *business* than about the social responsibility of other institutions? It is, of course, perfectly legitimate to raise the issue of the social responsibility of business. But we hear rather less about the social responsibility of, say, the churches, the media, trade unions, the professions, universities, or even the government. This point is worth making, I think, because it tells us something about current attitudes, at least in New Zealand, towards business and other social institutions. But when people collectively organise themselves in business organisations of one kind or another, do those impersonal legal entities really acquire social responsibilities which differ from those of other collective entities?

Everyone here will know that the New Zealand Business Roundtable supports the system of private enterprise in a market economy. We argue that the activities of private business are socially beneficial so long as they are conducted under the rule of law and within a framework of open competition. When subjected to those disciplines, business by and large promotes its interests in a way that promotes the interests of the whole community, and, moreover, promotes the community interest more efficiently and reliably than any other economic arrangement.

I believe that this argument is now accepted pretty well everywhere. The big story of the last 10 years has been the collapse of socialist economies, the basic alternative to market economies. It has now been demonstrated conclusively that central planning does not work, and that prosperity depends on a private sector in which business people are free to back their own commercial judgments but are also expected to bear the consequences of their mistakes. Only in this way can an economy be guided towards producing goods and services that the public actually wants to consume. As well, only such an economy can be relied on to produce the resources that governments must have if they are to provide services like defence, law and order, education, health care and social welfare.

And yet, although the indispensability of free enterprise has been accepted, its moral foundations remain under a cloud. As the Catholic theologian Michael Novak has remarked:

... religious leaders speak inadequately about business - more so than about almost anything else they preach on. ... Some of them, of course, have been misled by the kind of leftist sentiments uttered by the great Harvard theologian, Paul Tillich, who wrote, long before the collapse of socialism in 1989: "Any serious Christian must be a socialist."¹

Many people are uneasy about the profit motive, suspecting that profits emerge only from exploitation. They fear that free enterprise encourages greed and selfishness.

¹ Novak, Michael, *Business as a Calling: Work and the Examined Life*, The Free Press, New York, 1996, p. 5.

They are reluctant to accept the logic of Adam Smith's famous metaphor of the invisible hand, which holds that business people promote the general interest more effectively by pursuing their own interests than by directly trying to 'do good'. People are offended by the idea that behaviour which may be morally neutral can have good consequences. Conversely, it's assumed that the people who work for non-business institutions are motivated by concern for the general interest - by the 'non-profit' motive, we could say - and that their activities must therefore deserve greater esteem. I suggest that this is why we hear little about the social responsibilities of the churches, charities, and so on. Business, in contrast, is assumed to have a problem about its social responsibilities because it is driven by motives that militate against concern for the common good. So it is sometimes argued that if business is to be allowed to get on with the production of wealth, it must be made, by a combination of law and public pressure, to discharge responsibilities that are additional to the maximisation of profit.

I would like to challenge this set of assumptions, in two ways. First, moral doubts about the profit motive have been around for a long time, at least since socialists and conservatives began opposing capitalism in the nineteenth century. But the thinkers who first started to analyse the workings of what we call today a free and open society argued that commerce was a civilising force. Their arguments are worth recalling and considering.

The eighteenth-century French philosopher Montesquieu noted that the spread of commerce into Northern Europe had moderated the warlike tendencies of the inhabitants by bringing to them a peaceful alternative form of self-enrichment. The thinkers of the Scottish Enlightenment in the late eighteenth century built on Montesquieu's work. David Hume showed how sustained interaction between strangers eventually produced the conventions of morality, like stability of possession and the obligation to keep promises, from which we are all the beneficiaries. Adam Smith's exploration of what he called 'the system of natural liberty' showed that free trade would promote world harmony by engaging everyone in a system of peaceful exchange and division of labour. So far from competition being immoral, it was the efforts of business people to reduce competition by cartels and state protection that did public harm. And as the sociologist Max Weber wrote in *The Protestant Ethic and the Spirit of Capitalism*, the assertion that capitalism promotes greed belongs in the kindergarten of sociological opinions.

The second way I would like to challenge modern attitudes towards business is by questioning whether other institutions that are officially driven by the non-profit motive should be let off so lightly. Whereas business by and large does get on with doing business, non-business institutions nowadays often engage in activities that are not central to their official functions, and, conversely, often neglect the tasks that they officially exist to serve. Some representatives of the churches, especially the established ones, seem to have lost interest in helping to save souls; indeed, they sometimes seem to have lost their own faith, and can be quite contemptuous of the old-fashioned morality that it used to be their job to sustain. In extreme cases their members have even defended forms of dishonesty such as theft. Instead, they devote themselves to 'progressive' social causes and promote a sort of generalised compassion for the disadvantaged, even though many people share that compassion without needing a religious basis for doing so.

For their part, charities sometimes devote resources donated by their supporters to lobbying governments to spend more on social welfare and foreign aid, even though their donors have by their actions indicated support for voluntary rather than compulsory transfers. Some within the universities seem more preoccupied with issues like 'gender balance' and 'diversity', and exposing and punishing sexual harassment and smoking, than with teaching and research. I would add that governments have often lost sight of their proper functions and allowed themselves to be dragged by special interests and public pressure into activities that should be left to citizens' private initiative. This is, I believe, a major factor behind the low esteem in which politicians are often held. Politicians take on tasks that they cannot properly perform, but in so doing they leave less space and fewer resources for groups within civil society - in both the for-profit and non-profit sectors - that could carry them out much more effectively.

These general points lead me to a preliminary answer to the question of the social responsibility of business. We get there by way of answering the question of the social responsibility of any lawful institution, which is that it should perform its proper function to the best of its ability. As commerce students, you will recognise here the principle of comparative advantage: that the general welfare is most reliably promoted when countries and firms do only what they do best. If they stray from that rule, not only do they produce less of what they should be producing, but they consume resources that could be used more productively by other institutions or firms. In some broad sense, all institutions are entrusted by the community with their special functions. It follows that 'the business of business is business'. Using scarce economic resources efficiently, providing the enormous range of goods and services needed by consumers in a modern economy, and being enterprising and innovative in the search for ever-better ways of meeting people's needs is the immensely important vocation of business. As Pope John Paul II has put it, "When a firm makes a profit this means that productive factors have been properly employed and corresponding human needs have been duly satisfied". Yet it is precisely this idea that is questioned by those who think that business is failing to discharge its social responsibilities.

In what follows, I want to defend the following claims.

First, Milton Friedman was right when he said, in a famous article published in 1970 in the *New York Times Magazine*, that "the social responsibility of business is to increase its profits", subject to the constraint of "conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom". I believe that Friedman's answer is the correct one, so long as 'profit' is interpreted in a suitably general way. If you think earning a profit is a morally neutral rather than a morally good way to acquit a responsibility, would you hold that deliberately making losses is ethical - particularly if it's with someone else's money?

Second, businesses that are devoted to the pursuit of profit will often become engaged in social activities that are conventionally described as the 'social responsibilities' of business, such as training for the young, schemes to preserve the environment, promotion of good causes related to the communities that businesses become associated with, and philanthropic donations to charities and the arts. Such activities are not typically 'social responsibilities', but remain discretionary activities for which managers should be held responsible only to the shareholders who employ them. The more competitive the environment in which a business operates, the less scope it has

to indulge in social activities that are not strictly instrumental in enhancing its profitability or implicitly supported by shareholders willing to accept lower returns on their investments.

Third, such social responsibilities as do exist attach to us all as private individuals, not as members of business corporations or other institutions. Business firms are merely a vehicle for pursuing a vital activity: the production and distribution of goods and services of value to consumers. A company is as impersonal a vehicle as a motor car. It is surely only those who put the vehicle to use, i.e. the owners in their individual or collective capacity, who can bear any responsibility for their actions, not the institution. To question whether business has any social responsibility beyond that of maximising returns to its owners is not to doubt whether additional social responsibilities exist. Rather, it allocates those responsibilities where they belong. I believe that recent changes in the way business is conducted are tending to clarify this point and serving to push the burden of social responsibility back towards individuals.

The Social Responsibility of Business Is to Increase its Profits

Friedman's claim is a way of making business stick to its knitting, so that it concentrates on its function of generating wealth. Friedman himself doesn't quite argue that way, although what he does say is consistent with that point. Rather, Friedman stresses the nature of the relationship between shareholders and management, which is that of principal and agent. Managers act on behalf of shareholders, the value of whose investments they have a fiduciary duty to maximise. If they are burdened with additional 'social' responsibilities, they may be deflected from this obligation.

Friedman's caveat that business must act within a framework of law and "ethical custom" may cover some so-called social responsibilities. Businesses may be legally obliged to hire a number of people with disabilities, to install affirmative action programmes, to enforce no-smoking or anti-harassment rules in the workplace, to observe occupational health and safety regulations, or to provide severance pay for employees made redundant. Such regulations may be criticised or defended on various grounds. So might some of the "ethical customs" that Friedman mentions but does not expand upon. But insofar as all domestic firms in the same industry are subject to such legal or ethical obligations, none is placed at a competitive disadvantage with respect to the others (though they might all be placed at a disadvantage relative to other industries or their international competitors). The debate is therefore about social activities that remain discretionary.

Friedman's answer does not provide any guidance on how a firm should go about measuring its profits. That makes sense, because it is up to shareholders to decide how to evaluate the activities of management. Modern business is sometimes criticised for 'short-termism', a search for quick profits that allegedly does less general good than investments whose returns are slow to mature. Not only is that claim dubious, but it remains the prerogative of shareholders to decide the term over which they want to see their returns maximised. A firm whose shareholders are looking for long-term secure returns could well allow its managers wide discretion to engage in social activities that they judge will add value to the firm. Contrary to the popular view, maximisation of shareholder wealth is normally a long-run enterprise, and

expected wealth creation by a firm is recognised in present-day share values. But it is wealth maximisation that legitimises value-adding social activities, not the putative extraneous benefits that they generate.

'Profit' may even be defined in terms of social activity. Some firms are actually set up with social activities in mind. One example is the Body Shop, which aims to be an environmentally sustainable business. As well as advertising its products or retail outlets, it sponsors causes such as the campaign against battery hen farming. Another example is 'ethical' investment funds, which avoid investing in certain areas of business like arms manufacture or what are believed to be environmentally harmful activities, or in countries whose governments pursue immoral policies. In such cases, social or ethical activities are not traded off against profits, nor are they investments in future profit; rather, they constitute part of the actual profit of the business. The management is responsible to the shareholders for ensuring that the charters of such businesses are complied with. Friedman's answer to the question of the social responsibility of business can thus be interpreted broadly to mean that managers are responsible for carrying out the aims of the shareholders. Obviously a sole owner-manager can more easily use a company to pursue multiple objectives than a company with many owners because of their likely differences of opinion about the trade-offs between objectives.

Stakeholder Theory

The soundness of Friedman's argument is thrown into sharp relief when contrasted with its polar opposite: stakeholder theory. This is not really a new idea but it has recently been revived by Tony Blair, the leader of Britain's Labour Party, and writers of the 'communitarian' school of thought.

Applied to business, stakeholder theory teaches that corporations are communities of diverse constituencies, each of which has a stake in the corporation and therefore a legitimate voice in its governance and destiny. The shareholders form just one constituency among several: hence the preference for the term 'stakeholder'. Other constituencies include the corporation's employees, customers, suppliers, and even the localities in which the corporation operates. Some advocates of stakeholder theory argue that the corporation acquires such obligations from an implicit contract between the corporation and the wider society: in return for various legal privileges such as limited liability, the corporation must accept accountability to society at large. The policy implications of this approach are clear: corporate boards must represent not only the shareholders, but also the employees and the consumers.

To my mind, stakeholder theory suffers from a range of problems. The most serious is the one of making shareholders bear the cost of other so-called stakeholders' decisions. For that is what would happen: non-shareholder representatives on boards would in effect be able to exercise power over corporate decisions without having to bear the cost of any mistakes. In such cases, the shareholders would be the exploited, not the exploiters. It's worth observing that in Germany, where employee representation on the boards of large corporations is mandatory, and in Japan, where large corporations have traditionally offered lifetime employment, sharemarkets are relatively undeveloped and much investment has been funded by bank loans, although these patterns appear to be breaking down.

A second problem with stakeholder theory is that it offers no principled solution to the inevitable conflicts between those who have contributed the capital that enables the firm to operate and other stakeholders. It's easy to imagine instances in which shareholders' interests would conflict with those of employees: for example, a firm that needs to maintain its value may have to close some operations and make staff redundant. Again, shareholders may run into disputes with consumer representatives if the latter want to keep raising the quality of the firm's products beyond a viable level. And in cases where a particular locality is heavily dependent on a single firm for employment, pressure may be applied to prevent the firm from closing. This is not to say that agreement among these constituencies is impossible to reach. The point is that the decisions are likely to reflect political rather than economic pressures and priorities, thus risking a reduction in the profitability of the firm and the benefits it bestows on the nation as a whole.

Conflict could even occur between the different stakeholder roles of the same individuals. For example, pension and superannuation funds are emerging as major shareholders of corporations, with the ability and the incentives to monitor closely the activities of their managements and boards. Such funds are responsible to a great number of working people who have invested their savings with them and thereby become indirect shareholders of a wide range of corporations. So a conflict between shareholders and employees could result in many people having a stake in both sides. Such a conflict was very evident in Yugoslavia, which, before it disintegrated, conducted a famous experiment in workers' control of industry. The experiment was a failure because the workers tended to vote themselves wage increases at the expense of profits and future investment, thereby eventually impoverishing their industries. As employees they undermined their own interests as shareholders.

In New Zealand we have also had plenty of experience of conflict between stakeholder constituencies in the case of state sector enterprises before they were corporatised in the 1980s. These enterprises became political footballs, expected to perform a range of mutually incompatible goals: soaking up unemployment; providing subsidised training; yielding a return on taxpayers' investments; and delivering services at artificially low prices to favoured groups of consumers. The result was that state enterprises performed none of these goals satisfactorily and most simply added to the nation's debt. Since then, state enterprises have been reformed along lines that Friedman would approve of: they have been made to concentrate on profitability, and in some cases have been privatised, while their social activities involving non-shareholder constituencies have either been hived off or financed transparently through special budgetary arrangements. I suggest we are the better off for it. Interestingly, once subjected to rigorous scrutiny, the justifiable non-commercial or 'social' activities of these enterprises have turned out to be few and far between.

My final objection to stakeholder theory is that, once corporate responsibility is extended beyond shareholders, there is no good reason to limit it to identifiable groups of stakeholders. It's true that employees, consumers and localities may be intimately affected by the corporate decisions of shareholders. But the general public is affected as well, often in ways that impinge powerfully on particular individuals even though we cannot identify them. For example, a corporation may be prevailed upon to keep open an unprofitable operation in a remote locality that depends heavily on it. But if that results in less investment elsewhere, as it probably would, then unknown individuals are deprived of employment. It seems to me that such

unknown and unemployed individuals are as much entitled to be called 'stakeholders' of that corporation as are its employees. But, being unidentifiable and unorganised, they have no way of bringing their interests to bear on the corporation's decision.

In fact, the logical conclusion of stakeholder theory is socialism: the collective ownership and central planning of all enterprise so that the entire community's stake can be recognised and safeguarded. The trouble is, of course, that collective ownership and central planning don't work. Milton Friedman's approach, on the other hand, does work, by and large. If business remains focused on profitability, and if public policy enforces the rule of law and promotes a competitive environment, the general benefit that business confers on the community is maximised. If we are concerned about particular groups of individuals who may be harmed by corporate decisions, we have the option of taking collective responsibility for them by assisting them through private forms of voluntary welfare or the state welfare system.

The Social Activities of Business

As I've already mentioned, many corporations become involved in social activities. We are all familiar with the logos that appear on brochures, advertising corporate support for artistic or environmental or similar endeavours. Some corporations make donations to private sector public policy research institutes. Corporations may provide benefits and facilities for their employees that go beyond normal remuneration. Long-established customers may receive special treatment from corporations that is not generally available to new customers. And so on.

It is hardly a secret that corporations generally engage in such social activity in order to promote their images, their reputations, and so their profitability. But, according to an item in a consumer magazine on environmental sponsorships, managers sometimes cite additional reasons:

As Mainland's general manager of marketing Alan McConnon, told us, the company is involved with the hoiho "primarily . . . for commercial reasons. We seek to add to the wealth of our shareholders by selling more product". ... But McConnon adds that there are other reasons, also strongly held, for taking up green issues. He says Mainland also wanted to "give something back to the community at large". Other companies expressed similar views.²

One wonders about these "other reasons". Do managers think that their corporations are *obliged* to "give something back to the community" in addition to their product? If they do so think, is there not a danger that they could do so sometimes *at the expense* of the corporation and its shareholders? Would it not be better to avoid the charge of insincerity and hypocrisy by insisting that social activities are designed solely to promote the corporation's image, reputation and shareholder value?

A body of academic literature has arisen around this subject. Some of it supports corporate social activity, viewing it not as an expense of business but as a form of investment in the long-term value of corporations. The following statement is reasonably representative of this approach:

² *Consumer* 349, June 1996.

There is nothing in company law to prevent directors having regard to other interests if they judge reasonably and in good faith that to do so is conducive to the health of the company. Indeed, for directors *not* to give appropriate weight to *all* the company's key relationships may well be a breach of their fiduciary duty. That duty is to arrive at a balanced judgment about maximising the company's value on a sustainable basis, and not necessarily to take a short-term view of maximising returns for current shareholders.³

Certainly it is the duty of management to "give appropriate weight to all the company's key relationships". But the contrast drawn between "maximising the company's value on a sustainable basis" and "a short-term view of maximising returns for current shareholders" is basically muddled. If a company is behaving in a manner that is maximising shareholder value, and is ensuring that capital markets are informed of its strategy so that investors can make informed judgments, then the postulated trade-off is non-existent. The present value of the company, as indicated by its share price, will reflect all expected future cash flows given the risks associated with them. The interests of present and future shareholders are equally well served.

Decisions about social activity, like other corporate decisions, can be expected to be benign if two conditions are met: the shareholders are able to exert an appropriate level of discipline over management, and the corporation operates lawfully in a competitive environment. But neither condition can be taken for granted. Managers may be able to capture a corporation to some extent if they are insufficiently exposed to the possibility of takeover, or if shareholders have difficulty exercising their rights; and businesses may enjoy a certain amount of monopoly power if they are state-owned or benefit from regulations that reduce domestic or international competition. These defects create opportunities for management to indulge in social activities that may not really promote the corporation's profitability, or do so less reliably than strictly commercial activity would.

To summarise this point: well-governed corporations should be free to decide whether, and how much, and in what forms, to invest in social activity. It may well make sense for them to fund activities which are outside their business but which add to its long-term value. Managers are responsible solely to shareholders for such decisions, as they are for purely commercial decisions. Any dilution of that discipline is likely to lead to an inefficient expansion of social activity, serving the private agenda of management itself or of constituencies of so-called 'stakeholders', and reducing the benefits that profitable economic activity brings to the nation as a whole. Current pro-competitive trends in public policy and in business practice are probably increasing the focus on strictly commercial activity.

Only Individuals Have Social Responsibilities

The last of the three claims I want to defend is that social responsibilities belong to us as individuals, not as members of corporations or any other types of organisation. I believe that we do have a duty to care for amenities such as the environment and endangered species, to make voluntary efforts to alleviate poverty and other social problems, and to support worthy projects from which we could all benefit at no

³ Royal Society for the Arts, Manufactures and Commerce, *Tomorrow's Company: The Role of Business in a Changing World*, London Royal Society for the Arts, Manufactures and Commerce, 1995.

personal cost if we so chose, such as artistic endeavour. We could argue about the nature of such responsibilities. Are they strict moral obligations, or are they general duties that we may observe in our own ways? This is not the occasion on which to address such issues. My point is rather that those who argue that corporations have social responsibilities beyond enhancing shareholder value are mistaken, not about those responsibilities themselves, but about who has them.

Rather than directly making this case, let me do so indirectly by outlining two different arguments. First, the artificial nature of the corporation is becoming increasingly exposed by current changes in business structures. These changes are tending to push the burden of social responsibility away from corporations and on to individuals. Second, the belief that corporations have social responsibilities reflects certain modern attitudes to moral responsibility that are misplaced at best and hypocritical at worst.

It's worth looking more closely at the basis of the corporation, the existence of which we have so far been taking for granted. A theory of the firm associated with the economist Ronald Coase holds that firms exist because of the high transactions costs of negotiating contracts. In an ideal competitive economy, all goods and services would be delivered by contractual agreements between producers and consumers, with the terms and conditions of such agreements being renegotiated from moment to moment to reflect changing conditions of supply and demand. In practice, the costs of continuous contracting (which economists call 'transactions costs') can be high, and it is in order to economise on these that individuals come together in long-term arrangements and form firms. The law recognises such entities under various legal forms; the corporation is one such form, whose shareholders enjoy limited liability.

In the 1990s, however, we are witnessing what may be the beginning of the unravelling of the rationale of the corporation. Technological and other changes are transforming many economic relationships that used to be internal to the firm into fully open and contractual relationships. Corporations are focusing increasingly on their core activities and buying in inputs that they once produced themselves. Outsourcing, franchising and contracting out are increasingly common in both the public and the private sectors. As well, contracts are replacing traditional employer-employee relationships, which are based on the concept of a master-servant relationship in which employers exercise a 'right of control' over employees. New Zealand has, of course, enacted a contract-based employment system, although our courts still hark back to master-servant ideas. But similar changes are occurring in other western countries, spurred on by the corporate downsizing that has led many former employees to set themselves up as micro-businesses. Such changes are undermining implicit and ultimately unsustainable contracts, such as those that bind suppliers and employees to corporations in a relationship of loyalty, and forcing their terms into open and negotiable conditions. One commentator has described the process thus:

The challenge is to think of each individual as a business, with assets, skills, and, above all, the freedom to negotiate an infinite variety of contracts with other businesses. Such one-person businesses need be loyal only to their own professionalism and reputation ... Technological, legal and organisational changes are at last bringing down the high transaction costs that have in the

past propped up socialistic command-and-control mechanisms in the workplace in place of market ones.⁴

The more work relationships are based on contracts, the less substance remains of the corporation and the more obviously artificial it becomes; and any putative 'responsibilities' beyond those associated with its core function have to be either incorporated into explicit contracts or simply dropped and left to individual initiative. The whole idea of 'corporate social responsibility' is really as much a reflection of the feudal, pre-contractual origin of the corporation as is the master-servant employment relationship with its implicit exchange of loyalty and paternalism.

This brings me - and this is my final point - to the second argument that indirectly supports individual, as opposed to corporate, social responsibility. This is the tendency in modern moral debate to assume that individuals are not responsible for their own actions because their behaviour is decisively influenced by forces beyond their control. These forces are usually described as social or psychological; more recently they have also been seen as genetic. In practice, we don't really believe this because, when things go wrong, we are all too ready to blame people who presumably are *not* influenced by forces beyond their control: if not white male Anglo-Saxons, then certainly 'society', the 'government' and, of course, 'big business'. The demand that corporations discharge multifarious 'social responsibilities' is, I suggest, a way of avoiding our individual responsibilities. More than that, it makes possible that most modern form of hypocrisy: to appear caring and compassionate while avoiding the cost. In the end, accepting our individual responsibilities to society is a mark of honesty and maturity.

⁴ Phillips, Ken, 'Beyond Loyalty: Alternatives to Employment', *Agenda*, Vol 3, No 3, 1996, pages 393-396.