Business Ethics and Corporate Social Responsibility:

An Industrial Organization and Managerial Economics Approach

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Part 1: From Sustainable Development to Corporate Social Responsibility

- The global challenge: Ensuring sustainable development, i.e., a balance between economic-social-environmental development.
- United Nations (2015): Initiated the non-legally binding Agenda for Sustainable Development with 17 Goals for 2030 which are adopted by governments, businesses and civil society.
- United Nations (2013): Two types of companies' contribution to sustainability:
  - Minimize their negative impacts: Upholding respect for universal principles in their operations.
  - Maximize their positive impacts: Supporting advances on new products, services and business models.

1.1 CSR: Some basics

- European Commission (2001): CSR is “a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis”.
- CSR is a mainstream business practice worldwide:
  - KPMG (2015): Nearly 95% of the top 250 companies of Fortune Global 500 state a full CSR strategy.
  - Regulations: Increasingly require companies to publish non-financial information (e.g. Directive 2014/95/EU).

1.1 CSR: Some basics

- Types of CSR activities (Porter and Cramer, 2002; 2006):
  - Philanthropy oriented donations fulfilling the society's expectations for responsible corporate citizenship towards social cohesion and quality of life.
  - Investments in production technologies and business processes, along the value chain, in favor of the firm's stakeholders.
- Porter and Kramer (2011): CSR activities connect company success with social progress and constitute a profit center while creating value for society.

1.2 Factors that raise attention for SD and CSR

- **UN:** Awareness for the unsustainable current developmental dynamics.
  - CSR: Corporate initiative to respond against these dynamics towards sustainability.
- **Intergovernmental bodies (UN, OECD, ILO)**: Principles for responsible business conduct.
  - CSR: Addresses issues about human rights, environment and anti-corruption.
- **The corporate sector's impact** on political, social and environmental issues raises questions about transparency and accountability.
  - CSR: Addresses issues about accountability.
- **Consumers and investors** demand information on how companies address social and environmental issues.
  - CSR: Increases the responsiveness to consumers' demand and lowers the cost of capital.

1.3 The business case of SD and CSR

- Identification of business opportunities in growing markets for innovative solutions.
  - Business models and innovative technologies to increase energy efficiency.
  - Meeting the needs of untapped markets for products and services improving the lives of those living in poverty.
- Increasing the value of corporate sustainability.
  - Consumers and investors are increasingly basing their purchasing decisions on their perception of a company's sustainability performance.
- Strengthening stakeholder relations and keeping the pace with policy developments.
  - Companies that support SDGs will be likely to: Improve trust among stakeholders, strengthen their license to operate, reduce legal, reputational and other business risks.

1.4 International standards for CSR

- Ongoing dialogue among businesses, governments and civil society has shaped international frameworks for business conduct:
  - Principles of the United Nations Global Compact
  - United Nations Guiding Principles on Business and Human Rights
  - OECD Guidelines for Multinational Enterprises
  - ILO Tri-partite Declaration of Principles Concerning Multinational Enterprises and Social Policy
  - OHSAS 18001
  - ISO 14000
  - EMAS
  - ISO 26000:2010
  - SA8000 Standard
  - AA1000

1.5 Benefits from CSR

- **Benefits from a competitive strategy point of view:**

  Supply-related

  - Development of VRIN assets.
  - Attracting financial resources from socially responsible investors.
  - Enhanced ability to recruit and retain higher quality employees.

  Demand-related

  - Create unforeseen market opportunities.
  - Attract socially conscious consumers.
  - Reduce consumer price sensitivity.

- **Benefits from stakeholders' point of view:**
  - Better management of risk by those concerned with the firm's footprints.
  - Mitigation of the likelihood for negative regulatory action.
  - More robust "social license" to operate.

Part 2: The motivations behind CSR

- Two points of view - Firms invest in CSR:
  - Because they take into account the preferences of their internal and external stakeholders.
  - As a competitive strategy for input/output differentiation for gaining competitive advantage.

2.1 CSR driven by the preferences of stakeholders

- **Internal stakeholders – Owners**

<u>Benabou and Tirole (2010):</u>

- Through CSR a firm incorporates its stakeholders' objectives in its value chain.
- CSR aims at providing public goods and internalizing the firm's negative externalities.
- CSR allows a firm's owners to meet the preferences of socially conscious stakeholders, through:
    - Participation in socially responsible actions.
    - Donations to philanthropic intermediaries.

2.1 CSR driven by the preferences of stakeholders

- **Internal stakeholders – Managers**

  Argument for the positive role

  Andreoni (1989):

- A manager may act in a responsible way because he gets intrinsic, i.e., non-pecuniary, rewards grounded on own "impure altruism".

  Argument for the negative role

  Crifo and Forget (2015):

- A manager's concerns for own reputation may induce overinvestment in CSR, from the owner's point of view, without necessarily resulting to profit increases.

2.1 CSR driven by the preferences of stakeholders

- **Internal stakeholders – Managers**

  <u>Evidence supports the positive role</u>

  <u>Francoeur et al. (2015):</u>

- Environmentally friendly firms pay their CEOs less total compensation and rely less on incentive-based compensation than environment careless firms.

  This negative relationship is stronger where national environmental regulations are weaker.

2.1 CSR driven by the preferences of stakeholders

- **Internal stakeholders – Employees**

  Lindgreen et al. (2009):

  - CSR is one of the decisive reputation factors and appears to considerably influence an organization's attractiveness to potential employees.

  Flammer and Luo (2016):

  - Companies react to increased risk of adverse behavior by increasing their investment in employee-related CSR, as a strategic tool to align the incentives between employees and the firm and decrease the attractiveness of outside jobs.

2.1 CSR driven by the preferences of stakeholders

- **External stakeholders – Consumers**

Mishra and Suar (2010):

- Consumers' preferences about certain products depend on their beliefs upon the producing firm's social and environmental footprint.

Siegel and Vitaliano (2007):

- Firms selling experience or credence goods are more likely to engage in CSR than firms selling search goods.

2.1 CSR driven by the preferences of stakeholders

- **External stakeholders – Consumers**

  Manasakis et al. (2013):

- Consumers with social and environmental preferences perceive CSR as a "quality improvement" and express a willingness to pay a premium for responsible firms' goods and services.

  Baron (2001):

- Firms facing boycotts by consumers can proactively engage in CSR activities.

2.1 CSR driven by the preferences of stakeholders

- **External stakeholders – Activists and NGOs**

  Crifo and Forget (2015):

- CSR strategies, aiming at the reduction (diffusion) of negative (positive) externalities, are responsive to the pressure exercised by activists and NGOs.

2.1 CSR driven by the preferences of stakeholders

- **Stakeholder governance**

  Jo et al. (2016):

- Stakeholder governance is more important than board and other governance mechanisms, especially in countries characterized by weak investor protections and weak board governance.

  Hawn and Ioannou (2016):

- The wider the difference between CSR activities for internal vs. external stakeholders, the higher the risk for the firm's market value.

2.2 CSR driven by a competitive strategy

- CSR investments strengthen the sustainability of a company's competitive advantage which depends on the ability of the company:
  - To use VRIN resources.
  - To manage the value chain through sustainable and inclusive business models.
  - To supply differentiated products and services.

2.2 CSR driven by a competitive strategy

- **Differentiation of inputs**

  Barney (1991):

  - Within the resource-based view context, CSR activities allow firms to develop VRIN resources that improve shareholders' and stakeholders' wealth in a sustainable way.

  Flammer and Luo (2017):

  - Argue that "CSR programs are firm-specific incentives that are relatively difficult to imitate by other companies.

2.2 CSR driven by a competitive strategy

- **Differentiation of products**

  Crifo and Forget (2015):

- CSR activities can be an effective tool to resolve information asymmetry and signal the credence attributes of a product to socially conscious consumers so as to build reputation.

  Manasakis et al. (2013):

- Consumers perceive these attributes as a "quality improvement" within a vertical product differentiation context and increase their willingness to pay for this product.

2.2 CSR driven by a competitive strategy

- **Question: How does the intensity of competition in an industry affect CSR investments?**

Bagnoli and Watts (2003):

- The fiercer the completion the lower the level of CSR efforts.

Fernández-Kranz and Santaló (2010):

- Firms operating in more competitive industries are more socially responsible.

Manasakis et al. (2014):

- The “escape competition effect” dominates the “rent dissipation effect” and hence, the fiercer the completion the higher the level of CSR efforts.

Part 3: Modeling CSR

- Two points of view - Depending on whether firms invest in CSR:
  - Because they take into account the preferences of their internal and external stakeholders.
  - As a competitive strategy for input/output differentiation for gaining competitive advantage.

3.1 CSR driven by the preferences of stakeholders

- **<u>Kopel and Brand (2012)</u>**
  - Linear and homogenous Cournot market with symmetric costs.
  - One strict profit-maximizing firm: $\pi_P = (p - c)q_P$
  - One socially responsible firm: $V_R = (p - c)q_R + \theta CS, \theta \in [0,1]$
    Weighted average of profits and consumer surplus
  - Each firm can hire a manager and delegate the production decision
  - Compensation contract of the profit-maximizing firm's manager:
    $U_P = (1 - \gamma_P)\pi_P + \gamma_P P_P q_P$
  - Compensation contract of the socially responsible firm's manager:
    $U_R = \pi_R + \theta CS + \gamma_S(CS - \pi_R)$
- Findings:
  - Both firms hire a manager and delegate the production decision
  - The responsible firm has higher market share and profits than the profit-maximizing firm.

3.1 CSR driven by the preferences of stakeholders

- **<u>Kopel et al. (2014)</u>**
  - A group of socially concerned firms, maximizing profit plus a fraction of consumer surplus, competes with a group of profit-maximizing firms.
  - Consumers perceive the quality of products of socially concerned firms to be higher, without any extra cost for these firms.
  - The choice of each firm's objective function is endogenized in an evolutionary duopoly.
- Findings:
  - Depending on the degree of horizontal and vertical product differentiation as well as on the level of social concern, the industry can evolve towards either a homogeneous population of firms or a heterogeneous state where both types of firms coexist.

3.1 CSR driven by the preferences of stakeholders

- **<u>Lambertini and Tampieri (2015)</u>**
- Linear demand with homogenous Cournot product market with symmetric costs.
- The production of the final good results to a negative environmental externality.
- Strict profit-maximizing firms: $\pi_P = (p - c)q_P$
- Except of one, socially responsible firm: $V_R = (p - c)q_R + \theta CS.\ \theta \in [0,1]$
- Findings:
  - For a sufficiently large market, the responsible firm's profit is higher than each rival firm's profit and its presence improves social welfare.

3.1 CSR driven by the preferences of stakeholders

- **<u>Lambertini et al. (2016)</u>**
  - Differential game over continuous time of a Cournot duopoly with constant and symmetric marginal costs and environmental pollution.
  - Each firm accumulates productive capacity to supply its good:

$$\dot{k}_i = Ak_i(t) - q_i(t) - \delta k_i(t)$$

  - One of the two firms' objective is strict profit-maximisation, while its rival firm is socially responsible.
- Findings:
  - In a large (small) market, the responsible (profit-maximising) firm earns relatively higher profits and accumulates relatively more capital.
  - In a medium-size market, the responsible firm earns relatively higher profits too but accumulates less capital than its rival firm.

3.2 CSR driven by a competitive strategy

❖ Three lines of research

1. CSR is an explicit strategic variable with certain price and cost effects.
2. CSR is an exogenous vertical differentiation parameter.
3. CSR investment results to the accumulation of “ethical capital”.

3.2 CSR driven by a competitive strategy

Line #1: CSR is an explicit strategic variable

- **<u>Manasakis et al. (2013)</u>**
- Oligopolistic market: Each firm produces one brand of a differentiated good and can invest in CSR activities along the value chain.
- Firms' products combine horizontal and vertical differentiation aspects
- Vertical differentiation aspects: Firms' CSR activities that socially conscious consumers perceive as "quality improvement" increasing their willingness to pay.
- Consumers are heterogeneous on their valuation of CSR activities.
- The CSR attributes of products are credence goods → Imperfect information causes the breakdown of the SR goods' market.
- Need for an information disclosure mechanism to credibly signal the firms' CSR efforts to consumers.
- The certification process is undertaken by three certifying institutions:
- A for-profit certifier, a public certifier maximizing total welfare, a NGO maximizing consumer surplus.

3.2 CSR driven by a competitive strategy
Line #1: CSR is an explicit strategic variable

- **<u>Manasakis et al. (2013)</u>**
- Findings:
  - The certification of firms' CSR activities benefits firms and consumers.
  - Firms seeking for a competitive advantage in the market, undertake CSR efforts complying with the respective standard.
  - The CSR certification standard depends crucially on the certifying institution.
  - The certification standard of private certifiers (the NGO) is always the lowest (highest).
  - The certification standard under the public certifier lies in between.
  - Alignment of market and social incentives for the certification of firms' CSR activities.

3.2 CSR driven by a competitive strategy
Line #1: CSR is an explicit strategic variable

- **<u>Liu et al. (2015)</u>**
  - Follow the formal approach of Manasakis et al. (2013).
  - Consider a duopolistic market where firms cause environmental pollution.
- Findings:
  - The NGO sets a standard lower than the optimal one, yet, higher under Cournot than under Bertrand.

3.2 CSR driven by a competitive strategy

Line #1: CSR is an explicit strategic variable

- **<u>Manasakis et al. (2014)</u>**
  - The firm's owners define the mission of their firm's CSR strategy.
  - The CSR attributes of products are credence goods.
  - A firm's opportunism to cheat consumers is overcome only if there is a binding contract to a manager who faces ex-post reputational/legal penalties for cheating consumers.
  - Hiring a specific type of manager, and delegating to him the firm's CSR activities and market decisions, acts as the firm's owners' self-commitment device for a certain entrepreneurial CSR attitude.
- Findings:
  - By hiring a responsible manager, owners "strategically" signal to consumers that the missioned CSR activities will be undertaken.
  - In turn, consumers increase their willingness to pay for this firm's product which then obtains a competitive advantage in the market and increases its profits.

3.2 CSR driven by a competitive strategy

Line #2: CSR is the vertical differentiation parameter

- **<u>García-Gallego and Georgantzís (2009)</u>**
- Duopoly with full information for CSR activities that are implemented through a fixed cost.
- The standard product is sold by a competitive fringe of firms, which do not adopt any kind of CSR.
- Findings:
  - Exogenous increases in the consumers' social consciousness yield higher profits to SR firms and may lead to higher levels of social welfare, provided that the market structure is left unchanged.

3.2 CSR driven by a competitive strategy

Line #2: CSR is the vertical differentiation parameter

- **<u>Doni and Ricchiuti (2013)</u>**
  - A physically homogeneous good's production generates pollution which can be reduced, through a clean-up technology.
  - A unit mass of environmentally conscious consumers, who are heterogeneous with respect to their willingness to pay for "clean" products, is interested in buying only one unit of the good.
  - There are two responsible firms: One chooses the high and the other chooses the low level of clean-up effort.
- Findings:
  - The effect of a higher degree of responsibility of consumers and/or firms on total abatement and social welfare depends on the relative responsibility among agents.
  - When consumers' willingness to pay is high enough, responsible firms may overprovide environmental quality, triggering a reduction in social welfare.

3.2 CSR driven by a competitive strategy

Line #3: CSR implies the dynamic accumulation of "ethical capital"

- **<u>Wirl et al. (2013)</u>**
  - Consider how a firm should pursue its CSR activities over time, relative to its competitors, so as to maximize its net present value of profits.
  - An individual firm's CSR activities strengthen its competitive position against its rival firms, depending on own and average industry-wide CSR activity.
  - Findings:
    - The initial level of CSR activities determines whether CSR will survive as an optimal strategy in the long run.
    - Allowing for strategic interactions among firms in a symmetric setting may eliminate the occurrence of history dependent solutions.

3.2 CSR driven by a competitive strategy

Line #3: CSR implies the dynamic accumulation of "ethical capital"

- **<u>Wirl (2014)</u>**
  - Similar context with Wirl et al. (2013).
  - Findings:
    - The derivation of the open loop and Markov perfect Nash equlibria suggest that strategic issues dominate while dynamics alone explain relatively little.
    - The relative valuation of CSR by consumers is a crucial factor for fast and strong market penetration of CSR.

3.2 CSR driven by a competitive strategy
Line #3: CSR implies the dynamic accumulation of "ethical capital"

- **<u>Becchetti et al. (2014)</u>**
- A horizontal differentiation model where a profit maximizing monopolist sells a good to consumers who are uniformly distributed across the line segment [0,1] according to their concerns for CSR.
- The monopolist maximizes its profits with respect to the price of the final good and his CSR activities accumulating "ethical capital".
- Findings:
  - If consumers' care for social responsibility does not grow enough with ethical distance, the incumbent monopolist does not invest in CSR after the entry of a responsible firm.

Part 4: CSR by multinational enterprises

- Kitzmueller and Shimshack (2012): Transitional economies typically have limited formal regulation → CSR activities by MNEs may be especially important.
- Aguilera-Caracuel et al. (2015): CSR activities by MNEs influence the welfare of developing countries in which they operate.
- Hah and Freeman (2014): The motivation for CSR by MNEs stems from the principle of legitimacy, i.e., the "social license" to operate in a foreign host country.
- Park et al. (2014): To attract and retain customers, MNEs try to address the preferred and desirable values of the society in which they have operations.

Part 4: CSR by multinational enterprises

- Lucea and Doh (2012):

  A MNE's CSR strategy: "one-size-fits-all" vs. "every-country-a-different-strategy"?

Global CSR – Advantages:

- **Globally integrated and standardized strategy.**
- Upward harmonization of CSR standards internationally.
- Policies, processes, and structures consistent across cultures.

Global CSR – Disadvantages:

- **Insensitivity to local needs.**
- Reduced ownership and legitimacy.
- Approaches that live up to minimum host requirements.

Local CSR – Advantages:

- **Tailored to local cultural differences and preferences.**
- Nationally responsive and adapted to local context.

Local CSR – Disadvantages:

- **High coordination and control necessary.**
- Fragmented, inconsistent and reactive strategies.
- Approaches that live up to minimum global requirements.

4.1. Modeling CSR in international markets

- Two points of view - Depending on whether the MNE invests in CSR:
  - Because it incorporates the preferences of consumers in its objective function.
  - As a competitive strategy for input/output differentiation for gaining competitive advantage.

4.1. Modeling CSR in international markets

- **<u>Wang et al. (2012)</u>**
- Two foreign firms, with each having the option to maximize a weighted average of profits and consumer surplus, export a homogenous good in a third country which imposes tariffs.
- Finding:
  - CSR by both exporting firms is beneficial for them as well as for the government and consumers of the importing country.

4.1. Modeling CSR in international markets

- **Chang et al. (2014)**
  - One domestic and one foreign firm have the option for a consumer-friendly initiative such as in Wang et al. (2012).
- Findings:
  - The importing country's government protects its domestic firm by increasing the tariff when the foreign exporter launches its CSR initiative unilaterally.
  - Both firms are better when both implement CSR.

4.1. Modeling CSR in international markets

❑ **<u>Manasakis et al. (2018)</u>**

- A MNE: Option to invest in CSR activities as in Manasakis et al. (2013).

  Serves a foreign country through exports vs. FDI.

- Exports → Liability of foreignness; Tariff /// FDI → Fixed set-up cost.

▪ Findings:

- The MNE's incentives to serve the foreign country through FDI

  (a) Are strengthened by:

  The average consumer's valuation for CSR

  The intensity of the foreign country's market competition

  (b) Are mitigated by:

  The MNE's liability in the foreign country.

- In each country, the preferences of the local firm, the consumers and the policy maker are not aligned over the MNE's mode of entry in the foreign country.

4.1. Modeling CSR in international markets

CSR as a trade barrier by the local firm against the MNE

- **<u>Flammer (2015):</u>**
  - Domestic companies, having tight relationships with their local stakeholders, can use CSR as a differentiation strategy to compete against their foreign rivals who may operate with a production cost advantage.
  - CSR becomes a “soft” trade barrier against foreign competitors.

Part 5: CSR from a public policy point of view

- **<u>Steurer (2010):</u>**

Three types of CSR policies:

1. Raise awareness and build capacities for CSR.
2. Improve disclosure and transparency towards investors, regulators, employees, suppliers, customers.
3. Facilitate socially responsible investments.

Part 5: CSR from a public policy point of view

European Union: CSR has become a top priority in the policy agenda

- European Commission (2001):

  A holistic approach aiming to initiate on how the EU could promote CSR at both the European and international level so as to reconcile the economic, social and environmental interests of various stakeholders towards sustainable corporate competitiveness, solidarity and social cohesion.

- European Commission (2006):

  Launched a European Alliance on CSR to increase the uptake of CSR amongst European enterprises and their stakeholders for fulfilling a number of public policy objectives towards sustainable development.

Part 5: CSR from a public policy point of view

European Union: CSR has become a top priority in the policy agenda

- European Commission (2011):

  Firms should collaborate with their stakeholders so as to integrate their concerns into business operations towards the maximization of shared value and the mitigation of their possible adverse impacts.

  Public authorities should play a supporting role through policy measures promoting transparency and accountability.

- Directive 2014/95/EU:

  Disclosure of non-financial information by certain large companies across Europe through statements containing information relating to at least: Environment, society, employees, anti-corruption.

Concluding remarks

- **<u>Porter and Cramer (2011)</u>**
  - Most companies remain stuck in a mind-set in which CSR is not in the core of the value chain and the relative business models.
  - There is need for an overall framework for connecting company success with social progress.

Concluding remarks

- **<u>Porter and Cramer (2011)</u>**

- The step forward can be done with the concept of “shared value” which focuses on the connections between societal and economic progress and can create economic value by creating societal value through three ways:
  - Reconceiving products and markets to provide appropriate services and meet unmet needs
  - Redefining productivity in the value chain to mitigate risks and boost productivity
  - Enabling local cluster development by improving external frameworks that support the company’s operations.

Thank you!