Chapter 1

Introduction

On September 13, 1970, the New York Times featured an article by Milton Friedman in which he wrote:

“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 stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.”

This credence is well-established in neo-classical economics. It is argued that when competitive corporations maximize profits, production is achieved as efficiently as possible, yielding maximum welfare for society. In the process of profit maximization, business is bounded by consumer demand, production factor scarcity, technological limitations, and legal constraints. Friedman’s argument is true, as long as society ensures that the legal constraints are set in a socially optimal fashion. Naturally, a firm should “stay within the rules of the game”, but the question is: Does society play a fair game? Is society able to set the optimal rules?

In Friedman’s perfect world, the game is fairly played. In reality, however, some people feel that on occasion society allows for cheating, i.e. legal constraints are sub-optimal. For instance, in 2003, Honduran factory workers were paid $0.15 to make one Sean John-brand T-shirt. The same shirt cost its U.S. bulk importer $3.65 and the retail price was $40.00. The question is whether business is “playing a fair game” when multinational enterprises are allowed to shift their production to sweatshops in developing countries, countries that often still allow for child labor. However, in defense of the multinational enterprises one can argue that their employees would be even worse off, if these companies were not present. To give another example: even though efforts are made to reduce greenhouse gas emissi-
ons, today many large corporations can costlessly emit carbon-dioxides, while the global society and future generations bear the risks of global warming. The question of what is fair and what is unfair is not easily answered in general. There is a thin line between efficiency and exploitation. It is a difficult task to let laws and regulations draw this line in such a way that the rules of the game are fair.

Why would society fail to set its laws optimally? To thoroughly discuss the literature on optimal regulation is beyond the scope of this thesis, but we give a few explanations. First of all, societal processes are dynamic and legislative bodies now and then take time to catch up with the pace (some call this bureaucracy). For instance, up until the 1980s, asbestos was a very popular material and was used in, but not limited to, plasters and stuccos, fireproofing, pipes, brake pads, shoes, and gaskets. The material is strong, durable, isolating, fire-proof, and cheap. However, in the late 1960s it became clear that asbestos fibers were potentially threatening human health and that the substance can cause a number of serious illnesses. Today, asbestos is banned in most countries, although the actual implementation of the ban was almost 25 years after the negative properties of asbestos were discovered. In the first half of the 20th century, child labor was not uncommon in western Europe—today it is illegal. Society is dynamic; technology progresses, human knowledge increases, welfare grows, and moral attitudes change. Laws change accordingly, but the implementation of regulations lags. Failure to implement a specific law might be a temporary problem, but since in a dynamic society new problems continuously arise, failure of setting laws optimally in general is a structural problem.

A second reason for failure of achieving optimal regulation, is that strategic interactions potentially prevent governments from reaching or maintaining a socially optimal agreement (see, e.g. Mäler and de Zeeuw, 1998). For instance, it is internationally recognized that global warming is of major concern, but the global society has not yet reached agreements that will significantly reduce CO$_2$ emissions. The problem is that when an agreement is reached, the cost associated with CO$_2$ reductions gives one individual government incentives to break the agreement, without jeopardizing global CO$_2$ reductions seriously. Such public good issues can be related to the classic *tragedy of the commons* (Hardin, 1968). Provision of a public good suffers from free-rider effects, unless property rights are well defined (Coase,

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1 I appreciate that laws are not behind in general; take for instance the current discussions on human cloning. Policy makers have put this topic on their agendas, while the technique is not available yet.
There are numerous examples of how strategic interactions between firms, governments, and firms and governments might compromise optimal regulation (see Heijnen, 2007). If regulation is not optimal, it often leads to effects which economists label externalities; costs or benefits resulting from an economic transaction that parties “external” to the transaction receive. A typical example of an externality is pollution due to production. A third reason that explains failure of achieving optimal regulation is simply that developing and maintaining legislation is costly, see e.g. Dixit (2004).

“We live in a world where it is more serious to break trade rules than it is to violate human rights,” said Warren Allmand, (President of International Center for Human Rights and Democratic Development). Whether or not one agrees that in some instances society fails to implement optimal regulation, the fact is that increased globalization has fueled the public debate on the “fairness of society”. Consequently, the debate has led a growing number of corporations to engage in self-regulation (Becchetti et al., 2005; Beltratti, 2005). We increasingly witness voluntary overcompliance in terms of environmental and social policies, and an improvement of corporate stakeholder relations in general. A popular label for this type of behavior is “corporate social responsibility”. There are several alternative descriptions of corporate social responsibility, such as, corporate citizenship, voluntary overcompliance, self-regulation, internalization of externalities. McWilliams and Siegel (2001), regard corporate social responsibility as a set of actions on the part of a firm that advance the promotion of some social good beyond the immediate interests of the firm and/or shareholders. That is, socially responsible activities of firms are those that exceed compliance with social or environmental regulations. Morrison Paul and Siegel (2006) argue that these are employed to create the perception or reality that these corporations are advancing a social good or goal. There exist many definitions and labels, but the general idea is clear: to do more than just staying within legal boundaries, even if this possibly compromises corporate profits.

For many people it is an attractive idea that “being socially responsible” is the best thing a firm can do. However, there is little literature that thoroughly investigates this from an economic perspective. Attempts have been made to put corporate social responsibility in an economic framework. Baron (2001) links corporate social responsibility to modern political theory and the role of civil society. In this thesis, we try to make the connection between corporate social responsibility and basic

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2 To this extent, trade in CO2 permits is a theoretically optimal implementation of international agreements, since it assigns property rights to environmental pollution.

resource allocation theory and adopt Geoffrey Heal’s definition of corporate social responsibility:

“Corporate social responsibility involves taking actions which reduce the extent of externalized costs or avoid distributional conflicts.” (Heal, 2005, p. 393.)

This thesis tries to fill some gaps in the literature on the economics of corporate social responsibility. The focus of this thesis is not so much on why and how firms behave socially responsible. We take societal preferences and public debates as given. We are interested in the consequences of corporate social responsibility for corporate financial performance, the real implications and the relation to optimal allocation of production factors. We question whether Friedman’s argument is insensitive to possible discrepancies between regulations and social preferences, such as externalities. We also try to answer whether socially responsible behavior is actually valued by economic agents. Furthermore, we are interested in how corporate social responsibility relates to increased globalization. Since shareholders play such an important role in corporate policy and corporate governance, the emphasis is on the relation of corporate social responsibility with financial markets.

1.1 Corporate social responsibility

Although firm behavior is taken as a given throughout the thesis, in this section we give a few explanations for why firms might engage in corporate social responsibility. This list is loosely based on Heal (2005).

Preempting future regulations

Regulations are not static and firms might have strategic reasons to preempt the introduction of new government regulation. In a model of voluntary pollution control, Maxwell et al. (2000) discuss how an increased threat of government regulation induces firms to voluntary reduce emissions before the new laws are actually passed. In their model, they show that without voluntary control, the new regulation laws will potentially be more strict. Firms therefore have an incentive to self-regulate. Analogue to staying ahead of the competition, firms might want to stay ahead of the government.
Liability management

Liability management is an important aspect of corporate governance. In this context, corporate social responsibility can be seen as a way to avoid environmental scandals, consumer boycotts, or law suits. In 1995, a media campaign by Greenpeace against the disposal of the oil storage tanker Brent Spar, caused a huge environmental scandal. Although Royal Dutch Shell had carried out an environmental impact assessment in full accordance with existing legislation, and firmly believed that their actions were in the best interests of the environment, they had severely underestimated the strength of public opinion. Since then, Shell has been one of the pioneering companies to engage in corporate social responsibility, adopting the popular slogan “People, Planet and Profit”. Related to such scandals are consumer boycotts. Friedman (1985, 1999) reports that consumers start boycotts more and more frequently. One of the reasons for consumer boycotts is dissatisfaction with corporate policy after receiving information on how goods are produced. Finally, law suits such as those against the tobacco industry have shown that scandals do not only hurt brand equity, but can induce large costs in the form of penalties.

Vertical product differentiation

In marketing, product differentiation refers to the alteration of a product to make it more attractive to the target market. Vertical product differentiation is most often associated with producing similar goods with distinct qualities. Bjørner et al. (2004) show that a sufficiently large group of consumers is willing to pay a bit extra for a product, if it has been produced in an environmental friendly way. Also, the market for “fair trade” goods is expanding. Importers of these goods certify that producers, often from developing countries, are given a “fair” wage. This type of demand creates a niche market. To this extent, corporate social responsibility can be a form of vertical product differentiation.

Improving stakeholder relationships

Engaging in corporate social responsibility can also be motivated to create an improvement in human relations and employee productivity. For instance, the theory of compensating wage differentials (see e.g. Rosen, 1974) implies that improved labor conditions can reduce employee costs. This theory states that in equilibrium employees are willing to accept a lower wage in exchange for e.g. better safety conditions. Moreover, working for a “responsible” company can exhibit positive
externalities in the form of increased productivity, as employees might be better motivated to do their job. Furthermore, good stakeholder relationships can serve as “social credit” - thereby facilitating business operations.

Lowering the cost of capital

Related to social responsibility is socially responsible investment. In 2003, nearly one out of every eight dollars under professional management was subject to some form of social or environmental screening. Some shareholders do not merely care about cash flows, but also about how these cash-flows are generated. Rating agencies like Kinder Lyndenburg Domini (KLD) and Ethical Investment Research Service (EIRIS) have come up with large lists of issues they consider when assessing corporate social responsibility. For example, KLD analyzes charitable giving, relations with indigenous people, the compensation of top management, employment of women, minorities and disabled, the retirement benefit program, the firms liabilities for hazardous waste, use of recycled materials and alternative fuels, etc. (See Mattingly and Berman, 2006). How well a company scores on these issues is then taken into account when shareholders select their portfolio. By limiting the set of available investment opportunities, socially responsible investors are implicitly willing to accept a lower rate of return.

Intrinsic motivation

Finally, managers might have their own moral obligations against certain ways of doing business. A fairly well-known example of such a manager is Ray Anderson, chairman of Interface, a manufacturer of modular carpet for commercial and residential applications. He is known for his progressive stance on corporate social responsibility and sustainability. Since 1995, he has reduced Interface’s waste by a third, and plans to make the company sustainable by 2020. Anderson radically changed his way of doing business in 1994 after reading “The Ecology of Commerce” by Paul Hawken.

1.2 The economics of corporate social responsibility

Engaging in corporate social responsibility implies that firms restrain their own conduct, i.e. they limit their set of production possibilities. This implies that the benefits of corporate social responsibility come at a cost. In an economic equilibrium,
the benefits should at least outweigh the costs. From the previous section we can deduce that the economic rationale of engaging in corporate social responsibility boils down to identifying who reaps the benefits of socially responsible behavior and who is willing to bear the associated cost. The costs are usually more easily identified and measured compared to the benefits, though.

For instance, if corporate social responsibility is motivated through vertical product differentiation, consumers bear the costs by paying a higher price. If corporate social responsibility is motivated through socially responsible investment, than the investors are bearing the costs through reduced returns. Such indirect payments can be linked to hedonic price mechanisms, i.e. the price of a product can be split up in a sum of payments for various characteristics of the product. Note that because of altruism, it does not always have to be the case that the agent who receives the benefits also “pays” for corporate social responsibility. If corporate social responsibility is motivated in light of improving employee relationships, employees might bear the costs in terms of a lower wage, but it could also be the “fair trade” consumers or socially responsible investors that are bearing the costs.

In this thesis, we focus on the economics of corporate social responsibility. We try to answer questions such as whether investors bear the cost of corporate social responsibility, are hedonistic price mechanisms associated with corporate social responsibility able to optimally allocate resources, what are the consequences of socially responsible behavior for financial performance, how corporate social responsibility affects location decisions, etcetera. We are interested in the implications of corporate social responsibility for the real economy and the relation to optimal allocation. The remainder of this chapter presents an outline of the thesis.

1.3 Outline of this book

First, in chapter 2, we describe the mixed findings in the empirical literature on the relation between corporate social responsibility and financial performance. Economic theory suggests that corporate social responsibility comes at a cost. This means that, in theory, corporate social responsibility should negatively affect a firm’s financial performance, certainly not positive. Even if consumers, employees or stakeholders other than investors fully bear the associated cost, socially responsible firms can only do at least as good as their “irresponsible” peers. Moreover, who would want to invest in a heavily polluting firm with low returns? So an economic equilibrium suggests a trade-off between corporate social responsibility and
However, a huge strand of empirical work suggests that this is untrue, and in fact, many studies claim that corporate social responsibility is associated with superior financial performance (see Margolis and Walsh, 2001; Orlitzky et al., 2003). These survey articles show that the amount of empirical work on the relation between corporate social responsibility and financial performance is overwhelming, with a lot of conflicting conclusions. What can explain these mixed observations? Although the relation has been studied intensively and management literature provides some insights, a satisfactory economic theory lacks. Therefore, we analyze the relation between corporate social responsibility and financial performance using a Diamond (1967)-like general equilibrium stock market model. We find that the presumed conflicting results are in fact paradoxical. Gained with new insights we evaluate the existing empirical literature in light of our model and find that the empirical results on the relation between corporate social responsibility and financial performance are in fact very aligned. As such, chapter 2 can be viewed as a road map for interpreting the empirical literature.

In chapter 2 we also show that socially responsible investment can drive firms to self-regulation that leads to the socially optimal allocation. This is in line with the argument made by Jensen (2002) that firms should have one goal and that is to maximize its value and not simply maximize pure profits. However, if an investor disagrees with corporate policy, he can choose to sell his share (exit) or to try to change firm policy at shareholder meetings (voice). Unless there is some form of coordination, the small individual investor acknowledges that he cannot change firm behavior on its own and will prefer the “exit” strategy over “voice”. Thus, a socially responsible investor will simply invest in companies that adopt policies in line with his preferences. Therefore, even if negative externalities are incorporated in the firm value, as long as the company does not go bankrupt and makes a positive profit, firm shares are priced accordingly, and nothing precludes a firm from behaving “irresponsible”. In that sense, corporate governance of corporate social responsibility might be problematic - firms can always rely on internal funds to finance new projects and hence do not need approval of financiers. So it appears that the impact of the shareholders on corporate social responsibility is rather limited.

Scholtens (2006) discusses the potential impact of the credit channel on corporate social responsibility. Although equity financing can in principle drive socially responsible behavior, in practice, equity financing is only a small percentage of total new funding. Internal financing and bank loans are far more popular methods of raising funds. Bank loans are dominating external financing in the worlds
major economies (see e.g. Corbett and Jenkinson, 1994), so if banks have some form of social or environmental screening when financing projects, it is potentially a much more effective tool to ensure that projects are conducted in a socially responsible way. Chapter 3 goes into this issue by analyzing the performance of banks that adopted the Equator Principles. The Equator Principles are designed to assure sustainable development in project finance. We are interested whether the social, ethical, and environmental policies of the non-adopters significantly differ from the banks that did adopt the Equator Principles. We are also interested in differences in other bank characteristics between the adopters and non-adopters, such as financial performance, structure, and size. With an event study, we try to find out how shareholders value the adoption of the Equator Principles.

In chapter 4, we link corporate social responsibility to sustainable development and analyze the role for financial markets. As pointed out by John and Pecchenino (1994), if agents are short-lived and the environment is long-lived, this creates an intergenerational externality. Generally, when agents are short-lived, society acts myopic, i.e. they do not account for long-term effects of pollution. Future generations are then forced to bear the costs of the current generation. Intergenerational externalities associated with conservation of the environment are usually tackled by fiscal policy. Alternatively, socially responsible investment funds create a role for the stock market to deal with environmental externalities. We analyze the role of the stock market in a Diamond (1965) type overlapping generations model, in which agents choose between investing in “clean” bonds or “polluting” firms. We are interested the long-term prospects of the real economy.

In chapter 5 we try to find out whether developing countries have comparative advantages in terms of regulations and link this to corporate social responsibility of multinational enterprises. We use firm level data on large multinational enterprises to test whether firms with relatively low environmental standards are more often located in countries that are poor, corrupt or have weak environmental regulations. In a sense, we test the Pollution Haven Hypothesis, which states that Multinational Enterprises are transferring their dirty operations to countries with weak environmental regulation (see e.g. Mani and Wheeler, 1997). In this context, we specifically try to find out whether socially responsible multinational enterprises avoid locating their operations in countries with weak environmental regulation. Finally, in chapter 6, we conclude, give policy recommendations, and present directions for future research.