



EUI Working Papers

ECO 2008/37

Economics and Corporate Social Responsibility

Markus Kitzmueller

**EUROPEAN UNIVERSITY INSTITUTE
DEPARTMENT OF ECONOMICS**

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ISSN 1725-6704

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Printed in Italy
European University Institute
Badia Fiesolana
I – 50014 San Domenico di Fiesole (FI)
Italy

<http://www.eui.eu/>
<http://cadmus.eui.eu/>

Economics and Corporate Social Responsibility*

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Working Paper October 2008

Abstract

Corporate Social Responsibility (CSR) is an important economic phenomenon with broad implications for firms, employees, consumers, investors, governments and NGOs alike. This paper collects, structures and combines scattered pieces of economic theory and empirical evidence in novel ways that shed light on various fundamental economic questions related to CSR. The main conjecture presents individual preferences as the ultimate driving force behind any form of CSR. In the presence of social stakeholder preferences, firms may use strategic CSR to maximize profits, while not-for-profit CSR may satisfy shareholders' social ambitions. Only if managers take CSR beyond strategic levels or shareholder preferences, does CSR constitute moral hazard. Incentives and mechanisms underlying for-profit CSR will be outlined in greater detail. Six frameworks for the analysis of strategic CSR are proposed and analyzed. Finally, some empirical issues related to measurement and estimation of CSR are briefly discussed.

JEL: D21, D6, H11, L21, L22, M14

Keywords: Corporate Social Responsibility, Public Goods Provision, Preferences, Strategic CSR

*I wish to thank Pascal Courty for helpful comments and suggestions. This work greatly benefitted from discussions with faculty and students at the EUI and The University of Chicago GSB.

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Contents

1	Introduction	2
2	What is CSR? From Definition to Analysis	4
2.1	A "Neo-Classical" Dichotomy	4
3	From Whether to Why? Economic Theory and the Evolutionary Understanding of CSR	7
3.1	Milton Friedman and CSR	7
3.2	A new Set of Preferences	9
3.3	Six Strategies behind <i>strategic</i> CSR	11
3.3.1	The Labor Economics of CSR (<i>Contract Theoretic approaches to CSR</i>)	11
3.3.2	CSR and Product Markets (<i>Socially Responsible Consumption</i>)	12
3.3.3	CSR and Financial Markets (<i>Socially Responsible Investment</i>)	14
3.3.4	CSR and Private Politics (<i>Social Activism</i>)	15
3.3.5	CSR and Public Politics (<i>Regulation</i>)	16
3.3.6	Isomorphism	17
4	Some Empirical Issues	18
5	Concluding Remarks	19

1 Introduction

Corporate Social Responsibility (CSR) constitutes an economic phenomenon of significant importance. Numerous surveys find that a substantial share of consumers has preferences for social or environmental performance of firms and that managers now consider CSR practices as an essential building block of firm strategy. The rise of Socially Responsible Investment (SRI) and respective "ethical" indices (e.g. KLD Domini 400 Social Index, Dow Jones Sustainability Index, or the FTSE4Good Index) suggests that investors base their investment decisions not only on financial, but also on social and environmental performance criteria. Hence, CSR is referred to as *one of the social pressures firms have absorbed*¹ and considered to *have become a mainstream activity of firms*². Many national and international firms, among which most of the Fortune 100, strive to achieve social and environmental standards such as the Corporate Giving Standard³ or ISO14001, and the number of related certifications in OECD (high income) countries as well as in emerging markets is constantly growing⁴. At the same time, the Public carefully observes corporations and their involvement with social ills, environmental degradation or financial contagion, while political decision makers try to find out where their responsibility and ability to regulate firm behaviour ends and Corporate Social Responsibility begins. In this context, Scherer and Palazzo (2008) note that *paradoxically, today, business firms are not just considered the bad guys, causing environmental disasters, financial scandals, and social ills. They are at the same time considered the solution of global regulation and public goods problems*, thereby underlining that CSR opens up a wide array of economic questions and puzzles.

Consequently, the focus of research into CSR recently started to shift from *whether* CSR should exist to *how* it affects the economy, stressing the need of analytical machinery to better understand the

¹ John Ruggie (Harvard University) in the Economist (January 17) 2008 special report on CSR.

² See The Economist (January 19, 2008): *Just good business - A special report on corporate social responsibility* and The Economist Intelligence Unit (2005) Global Survey asking 136 senior executives and 65 institutional investors to assess the importance of CSR.

³ issued by the Committee Encouraging Corporate Philanthropy (CECP) in 2007 ("Corporate Giving in Numbers 2007").

⁴ See OECD Working Papers on International Investment No 2005/3 (Baskin and Gordon 2005).

mechanisms underlying CSR⁵. Economics, among other social sciences such as sociology, political science or management studies⁶, actively contributes to the study of CSR. Therefore, the objective of this paper is to identify, structure and assess the qualification of economic tools applied to theoretic and empirical aspects of CSR.

More precisely, CSR entails a set of implications that opens up discussion of the predominant neoclassical firm paradigm and asks for novel application of existing or the design of new economic tools. Well established areas of economic research that contribute to the analysis of CSR include public economics, information economics, contract theory and industrial organization. CSR often is intimately connected with the provision of public goods by or the origin of externalities (social or environmental) within firms. As public goods and externalities entail market failure, government provision through direct production or regulation may be most efficient. This concept became generally known as Friedman's classical dichotomy. If firms still decide to engage in costly social behaviour beyond regulatory levels, i.e. CSR, then why would they voluntarily incur these costs? The attempt to answer this question leads to the firm's classical objective - maximizing shareholder value - and its dependence on the nature of shareholders' and stakeholders' preferences. Actual as well as future shareholders (investors) can be profit (money) oriented or have social and environmental preferences. The same is true for consumers, while workers may be extrinsically and/or intrinsically motivated. Economics offers analytical tools able to shed light on individual behaviour and contracting between economic agents in product and labor markets, in the presence of social preferences as well as aggravating circumstances such as asymmetric information or collective action problems. The importance of information about CSR with quality/content, ranging from advertising to third party certification is well documented. On the one hand, 25% of all Global Fortune 500 and nearly 10% of all S&P100 companies report in detail on their CSR activities and seek legitimization from governments (among which the UK, Japan, Australia, Canada, France, The Netherlands, South Africa and all Scandinavian countries), international organizations (such as the Japanese Development Bank, OECD or the Worldbank among others), Non-Profits and private Auditors⁷. On the other hand, a recent US survey by Fleishman-Hillard and the National Consumers League finds that technology is changing the landscape in which consumers gather and communicate information about CSR. In detail, 52% of all respondents seek information about a company's CSR record all the time or sometimes, while internet access in general has created a *more informed, more empowered consumer...searching for an unfiltered view of news and information*. Given these trends, the conclusion is that firms seek to build social or environmental reputation subject to the workings and channels of the market for information about CSR.

Last but not least, Industrial Organization may enhance the understanding of CSR by explaining how the underlying "social pressures" affect market structure (downstream as well as upstream), competition (CSR might act as product differentiation, entry barrier etc.) and total welfare. In order to gain a more complete picture, this paper aims to clarify *what* is known and *where* Economics has arrived in modeling CSR. To that end, various relevant strands of literature in economics and partly management studies (including but not limited to the above mentioned) are reviewed and linked to empirical evidence at hand.

The remainder is organized as follows: Section 2 defines CSR and discusses the classical dichotomy between the public and private sectors in light of CSR. Section 3 identifies and structures the contribution of economic theory to the field so far. Subsections 3.1 and 3.2 motivate and outline the role of preferences in the emergence of CSR, and conclude that the major form of CSR is strategic in nature and fully consistent with profit maximization. Subsection 3.3 gives a structured overview of distinctive theoretic explanations of strategic CSR in light of respective empirical evidence. Section 4 touches upon some empirical issues related to CSR and section 5 concludes.

⁵This "next question" about CSR has been emphasized by John Ruggie of Harvard University's JFK School of Government among other leading scholars in the field.

⁶For a comprehensive investigation of the status of CSR research within the management literature see Lockett, Moon and Visser (2006).

⁷The joint effort to establish a common framework for corporate Social Auditing, Accounting and Reporting (SAAR) led to several big joint public-private ventures such as the Global Reporting Initiative (GRI) or Institute of Social and Ethical Accountability (ISEA).

2 What is CSR? From Definition to Analysis

Before entering economic analysis, the stage has to be set by defining Corporate Social Responsibility. In practice, a variety of definitions of CSR exists. The *European Commission* (2002)⁸ defines Corporate Social Responsibility as "a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis". The *Worldbank* states: "CSR is the commitment of businesses to behave ethically and to contribute to sustainable economic development by working with all relevant stakeholders to improve their lives in ways that are good for business, the sustainable development agenda, and society at large".⁹ A notion similar to "voluntary behaviour" can be found in definitions of CSR that refer to either "beyond compliance" such as those used by Vogel (2005) or McWilliams and Siegel (2001), who characterize CSR as "the fulfillment of responsibilities beyond those dictated by markets or laws", or to "self regulation" as suggested by Calveras et al. (2006) among others. These attempts to define CSR reveal two basic conceptual features: First, CSR manifests itself in some observable and measurable behaviour or output. The literature frequently refers to this outcome dimension as Corporate Social or Environmental Performance (CSP or CEP). Second, the social or environmental performance or output of firms exceeds levels set by obligatory regulations or standards enforced by laws¹⁰. In essence, CSR is *corporate social or environmental behaviour that goes beyond the legal (regulatory) requirements of the relevant market(s) and/or economy(s)*.

This definition is independent of any conjecture about the motivations underlying CSR¹¹, thereby constituting a strong fundament for economic theory to address incentives and mechanisms beneath CSR. In order to capture its complete economic relevance, this view of CSR is in line with Baron (2001) in that CSR can be market driven or "strategic" as opposed to McWilliams and Siegel (2001), who equate CSR only with social or environmental performance "beyond market forces".

2.1 A "Neo-Classical" Dichotomy

As CSR is intimately related to firm behaviour and output within the realms of regulation and government involvement, a valid point of departure might be to reevaluate those characteristics of goods or behaviour (collective action) that are at the core of the classical dichotomy¹² between state and market, therefore defining the border between government and corporate responsibilities. In general, the realization of CSR either is a good (or reduction of a bad) with at least some public good characteristic, or a positive (reduction of a negative) externality. Relevant works that relate CSR exclusively with public good provision include Bagnoli and Watts (2003) and Besley and Ghatak (2007), who explicitly define CSR as the *corporate provision of public goods or curtailment of public bads (negative externalities)*. When CSR takes the form of an environmental public good produced alongside a private good such as in Kotchen (2006), it certainly exhibits non rivalry and non excludability to some extent. However, CSR might share just one of the two properties of a classic public good, as is the case with recognition of human and worker rights in employment relationships. Here, CSR is non rival among workers in a firm, but clearly excludable, as it just benefits the subset of those agents employed by the respective corporation. In short, firms often produce a (partly) public good or an externality jointly with private (consumption)

⁸ Commission of the European Communities: "Communication from the Commission concerning corporate social responsibility: A business contribution to sustainable development", July 2002, COM (2002) 347 Final, p.5.

⁹ For yet another definition of CSR along these lines see the *OECD's* 182 codes of conduct.

¹⁰ Earlier attempts to develop a clear concept and establish the boundaries between definition and analysis of CSR include Locke (2002) and Mc Williams, Siegel and Wright (2006) among others. Locke (2002) structures models of CSR along two dimensions: Motivation (instrumental versus ethical) and Beneficiaries (shareholders versus stakeholders). He finds that there is significant divergence of opinion over key issues such as the role of management (contractual versus beyond contractual obligations), the relation to profits (Is CSR profit enhancing?) or the scope of responsibility (direct versus indirect effects of conduct of business).

¹¹ While Baron (2001) takes the (normative) view that "both motivation and performance are required for actions to receive the *CSR label*", I propose that linking a particular motivation to the respective performance is required for the action to receive the *correct CSR label* (e.g. strategic or altruistic).

¹² Milton Friedman

goods, either in connection with the production process of private goods (e.g. less polluting technology or safe/healthy working conditions) or linked to the private good/service itself (e.g. less polluting cars or energy saving light bulbs). This perspective on CSR relates directly to earlier work by J.M. Buchanan (1999), who referred to this joint provision of a public and private good as an "impure public good", and relevant insights such as those derived by Bergstrom, Blume and Varian (BBV 1986) in their seminal paper on the private provision of public goods can be readily translated into the CSR framework. For example, BBV (1986) focused on the interaction between public and private (individual) provision of the public good and the effect on overall levels of provision, and concluded that public provision crowds out its private counterpart almost perfectly. Along these lines Kotchen (2006) compares joint corporate provision of private and public goods in "green markets"¹³ and separate provision of either, leading him to the similar conclusion that the very same crowding out takes place between corporate provision and individual (what BBV called "private") provision and may even lead to an overall reduction in the level of the public good. In this context, CSR can be interpreted as a shift of public good provision between competing supply channels. More precisely, Besley and Ghatak (BG 2001) notice that public goods provision has dramatically shifted from public to mixed or complete private ownership in recent years, while Rose-Ackerman (1996) phrases the problem as the *blurring of the analytically motivated division between for-profit, nonprofit and public sectors in reality*. To explain these observations, BG (2001) suggest that in the presence of incomplete contracts, optimal ownership is not a question of public versus private provision but simply should involve the party that values the created benefits most. Another interesting rationale provided by Besley and Ghatak (2007) identifies economies of scope to be the decisive variable in determining efficiency of impure public goods. The conclusion states that if economies of scope are absent, tasks should be segregated into specialized organizations (governments provide public goods and firms private ones), while otherwise CSR is an efficient way of delivering public goods. Both findings are of immediate importance to those authorities involved in the mechanism design of public good provision.

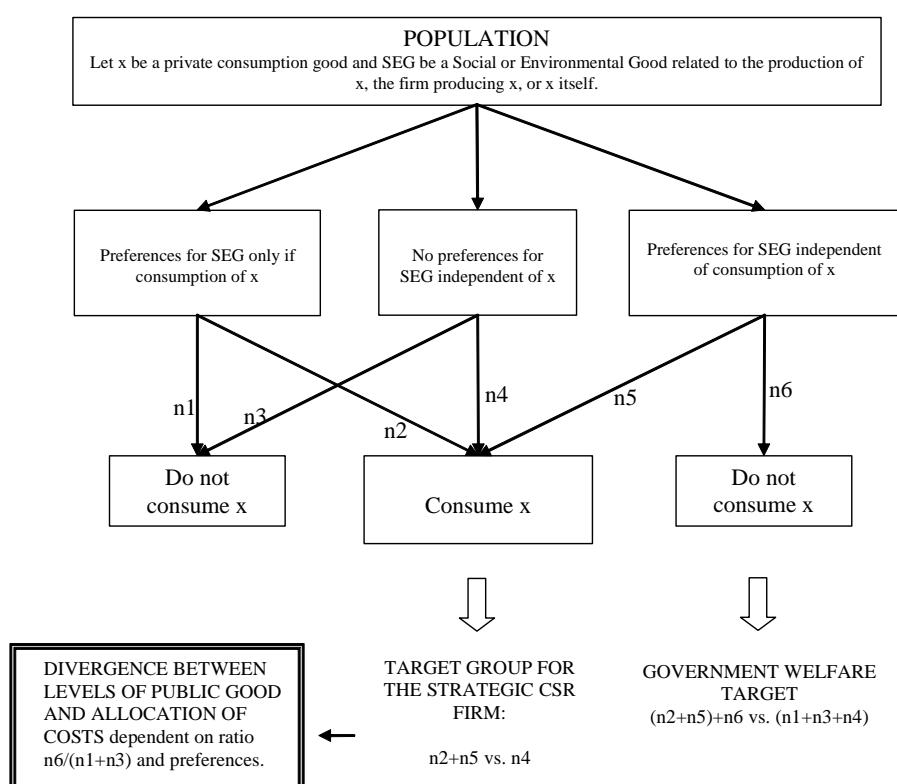
A simple thought experiment may illuminate CSR related welfare analysis. It will identify a basic trade off between government and market provision of social or environmental good by sketching the production of welfare in the presence of various preferences of consumers and non-consumers. Comparative statics (see Graph 1 next page) reveal a potential for (1) divergence between public good levels supplied by government and CSR, or, *ceteris paribus*, (2) differing allocation of costs of the public good. Assume for a moment that firms only take into account preferences of those groups that are relevant for their profits (e.g. consumer preferences). This most likely will be a subgroup of society at large. Then, if the public good is *intrinsically bundled* with the firm (BG 2007), the government can assure its provision only via uniform regulation and various trade offs may arise. If the government is first best (full information and benevolence)¹⁴, it can achieve optimal public goods levels, which might come at a cost for firms or subgroups of consumers. It is possible that consumers with no preference for the public good (neutral consumers) pay higher prices for the private good (up to their maximum valuation) while those with respective preferences (ethical consumers) pay relatively less. If firms serving neutral consumers are regulated and neutral consumers are not willing to pay the increased price for the private good anymore, these firms suffer losses. A similar issue might arise even when the government can produce the public good itself. If the policy vehicle is a uniform head tax, it is the structure of the respective "target group" of firms and governments as well as differences between the two that determine optimality of public versus corporate provision. In general, CSR can be efficient due to the distributional advantages of product variety and pricing vis-a-vis uniform government policies. If ethical consumers are a minority, governments might not regulate at all and CSR constitutes a pareto improvement. If ethical consumers form a majority, governments might overprovide the public good. Then comparative welfare again depends on the ratio between neutral and ethical consumers as well as consumers and non-consumers, however,

¹³The definition of a "green" market is based on technologies with joint production of a private good and an environmental public good, i.e. a kind of "green" impure public good.

¹⁴If there is government failure, the case for CSR might be substantially stronger, however, here it is shown that even under perfect government there exists a trade off between public and corporate provision of public goods and a niche for CSR.

neutral consumers and non-consumers pay taxes for something they do not care about. In this example (Graph 1) the result crucially depends on the potential effect of "free riding" under CSR by subgroup n6.

In sum, CSR might be suboptimal from a total welfare perspective as it just takes account of consumer preferences (partial welfare), while public provision of the public good can reach first best levels but might be inefficient from a *distribution of welfare* point of view, as it accounts (in some way) for all preferences, but makes neutral (non) consumers pay. In other words, markets may be optimal within a subset of society and sometimes pareto improve total welfare, while governments may get total welfare right, but optimal allocation wrong. Given certain conditions, it is this trade off that must be taken into account when choosing the optimal provision strategy of firm related public goods or policy outcomes according to distributional preferences.



Graph 1: CSR and the Potential Trade Off between Levels of Public Good and Allocation of Welfare

However, while analyzing CSR through a "public goods lens" offers important insights into welfare implications and efficiency of CSR and allows for a comparison and normative choice between competing supply channels, it only partly sheds light on the motivations behind CSR (e.g. Bagnoli and Watts (2003) or Kotchen (2006) assume consumer preferences at the bottom of CSR). To get a more complete picture of what might cause firms to be socially or environmentally responsible beyond legal requirements, the next section develops a categorization of CSR along motivational lines and across theoretical frameworks. CSR can be subclassified as either "strategic", market driven CSR, which is perfectly compatible with profit maximization and Milton Friedman's view of the "socially responsible firm", or as not-for-profit CSR that comes at a net monetary cost for shareholders. However, foregone profits¹⁵ and costs implied by CSR need

¹⁵Note that Reinhardt, Stavins and Vietor (2008) define CSR in this spirit as "sacrificing profits in the social interest".

not be at odds with the principle of shareholder value maximization and do not automatically constitute moral hazard (between management/agent and owner/principle) if shareholders have respective intrinsic (social or environmental) preferences that substitute for utility derived from extrinsic (monetary) sources. I.e. any explanation of CSR (strategic or not) builds upon the recent advancement of new concepts of individual behaviour in economics and the related departure of economic theory from the classical homo oeconomicus assumption¹⁶. In fact, CSR and the related departure from the neoclassical firm paradigm is closely linked to the extension of traditional individual rational choice theory towards a broader set of attitudes, preferences and calculations.

3 From Whether to Why? Economic Theory and the Evolutionary Understanding of CSR

Initial research into CSR was dominated by the question of whether firms do have any social responsibility other than employing people, producing goods or services and maximizing profits. However, firms increasingly engaged into CSR activities that, at first sight, seemed to be outside the original, neoclassical boundaries. Hence, research shifted focus to why firms actually do CSR. Both questions, *whether* and *why* CSR, are intimately related to each other and will be jointly addressed in the following subsections.

3.1 Milton Friedman and CSR

Should firms engage into CSR, and if so, why (not)? In this respect, Milton Friedman (1970) examined the *doctrine of the social responsibility of business* and rightly concluded that *the only responsibility of business is to maximize profits*, i.e. shareholder value, while goods or curtailment of bads (externalities) based on public preferences or social objectives should be provided by governments endowed with democratic legitimation and the power to correct market inefficiencies¹⁷. This view suggested that CSR was a manifestation of moral hazard towards shareholders and not only inefficient, but also inconsistent with the neoclassical firm's profit orientation. But, rather than putting the discussion about CSR to a halt, Friedman's thoughts provoked the search for an economic justification of CSR in line with neoclassical economics. The breakthrough came with the idea that CSR may actually be a necessary part of strategy for a profit maximizing firm. In other words, profit maximization can be a motivation for CSR.

But how may CSR be integrated into the objective function of the profit maximizing firm? The answer to this question builds upon the existence of preferences that are beyond those of the classical homo oeconomicus. Stakeholders such as consumers or employees and/or shareholders often are socially or, in general, intrinsically motivated, a fact that profit maximizing firms cannot ignore as it directly affects demand in product markets and/or supply in labor markets. These preferences might also potentially affect firms indirectly through governments or regulators translating voter preferences into market interventions. In sum, social stakeholder preferences translate into some sort of action or behaviour relevant to corporate profits¹⁸, therefore qualifying CSR as part of a profit maximizing strategy. CSR induced by demand side pressures or as a hedge against the risk of future regulation has been termed "strategic CSR" by D. Baron (2001), while McWilliams and Siegel (2001) refer to the same underlying profit orientation of CSR as a "theory of the firm perspective".

If shareholders (or private firm owners) have preferences allowing them to derive intrinsic utility equivalent to extrinsic, monetary utility, any resulting social or environmental corporate performance constitutes a non-strategic form of CSR that is equally consistent with Friedman's view of the firm. Here, the objective of the firm reflects the preferences of its owner(s) and therefore might involve a reduction of profits or even net losses without breaking the rule of shareholder value maximization (i.e. no moral hazard). Obviously, if ownership and management are fused into one and the same person, as is the

¹⁶ See Section 3.2 for a detailed discussion.

¹⁷ such as Free Riding or Collective Action Problems.

¹⁸ Think of firms that expect consumers to buy preferably green or fair trade products, investors to prefer shares in low polluting companies or governments (responsible to voters) regulating in favor of environmentally friendly technologies and against breaches to human rights.

case for "social entrepreneurs" (Baron 2005), the absence of moral hazard is substituted by simple and coherent individual utility maximization.

So Friedman's concept of CSR being equal to profit maximization has been basically confirmed and enriched by taking account of a new set of stakeholder and shareholder preferences. The result is a bipolar conception of CSR being either *strategic* (profit oriented due to social stakeholder preferences) or *not for profit* (social shareholder preferences) with varying implications for the financial performance of a firm (see Graph below).

		SHAREHOLDER/OWNER PREFERENCES	
		Social/Environmental	Purely Monetary
STAKEHOLDER PREFERENCES	Social/Environmental	<p>Not For Profit CSR</p> <p>Mixed Effect on Profits</p>	<p>Strategic CSR</p> <p>Profit Maximization</p>
	Purely Monetary	<p>Not For Profit CSR</p> <p>Negative Effect on Profits</p>	<p>No CSR</p> <p>Profit Maximization</p>

Graph 2: Typology of CSR

From the perspective of the firm, strategic CSR has a strong *reactive* notion as it is induced by an outside party such as consumers, activists or potential employees, while not for profit CSR can be considered *active* as the initiative to foster social good actively derives from intrinsic motivation inside the firm.

After having established consistency between strategic CSR and the profit maximizing firm, optimality conditions for CSR have been searched for along the lines of the discussion in section 1 ("public goods lens"). Besley and Ghatak (2007) show that CSR might Pareto improve social welfare as compared to complete government provision of public goods. The logic behind this argument runs as follows: Given that consumers use firms' strategic CSR efforts as close substitutes for private, voluntary contributions to public goods such as donations, an increase in strategic CSR should crowd out public supply of public goods, or vice versa, as established by BBV (1986). Then, it follows that for CSR to be optimal in terms of welfare, firms must be at least as efficient as governments in providing certain public goods. This might be the case in the presence of government failure or simple comparative advantage of markets vis-a-vis governments or NGOs (economies of scope).

Further analysis will identify a more detailed framework and distinguish the respective economic channels that lead to CSR. The analysis will include separate treatment of product markets (i.e. the firm-consumer relationship), financial markets (i.e. the firm-investor relationship) as well as interaction between activists, governments and firms among others. However, before doing so, the following subsection will discuss the crucial role of individual preferences in the economic analysis of CSR in more detail.

3.2 A new Set of Preferences

It was again Milton Friedman, who explicitly pointed out that to understand any form of social responsibility it is essential to notice that *society is a collection of individuals and of the various groups they voluntarily form*. This means that any attempt to investigate organizational (including firm) behaviour needs to look at incentives, preferences and motivations of individual share- and stakeholders. Stiglitz (1993 and 2002) talks about new concepts to be taken into account when modeling individual behaviour. Gary Becker (1993) proposes an *Economic Way of Looking at Behaviour*, stressing the importance of a richer class of attitudes, preferences and calculations for individual choice theory. What both Friedman and Becker have in mind is a new class of psychological and sociological ideas that recently entered microeconomic theory in general and the individual agent's utility function in particular. More precisely, standard motivational assumptions have been expanded and a literature on intrinsic (non-pecuniary including social) aspects of motivation has emerged.

As the Behavioural Economics literature¹⁹ is rather extensive and a comprehensive review certainly lies beyond the scope of this paper, only a few selected contributions that are believed to improve the understanding of CSR will be analyzed.

Akerlof and Kranton (2000 and 2005) specifically recognize the importance of identity in deriving utility, while Benabou and Tirole (2003 and 2006) as well as Besley and Ghatak (2005) more generally assume that agents have preferences for money, social/public goods and reputation. A first important insight deriving from this assumption is that intrinsic motivation can act as a substitute for extrinsic monetary incentives. This has interesting and novel implications for pricing through the potential increase in consumers' willingness to pay, and for determining incentives in employment contracts given the classical information asymmetry between principal and agent. Relevant theoretic findings include Benabou and Tirole (2006), who find that extrinsic incentives can crowd out prosocial behaviour via a feedback loop to reputational signaling concerns. The reputational concern reflects the possibility that increased monetary incentives might negatively affect the agent's utility as observers are tempted to conclude greediness rather than social responsibility when observing prosocial actions. This signal extraction problem arises because agents are heterogeneous in their valuation of social good and reputation and this information is strictly private. This sort of considerations could influence not only employees, consumers or private donors, but also social entrepreneurs. Baron (2005) defines a social entrepreneur as "one who is willing to create a CSR firm at a financial loss". (The opposite would be the private entrepreneur, "who creates a firm if and only if its market value exceeds the capital required to create it" (= a monetary participation constraint)). In sum, CSR here expands the "social" individual's opportunity set to do good by the option to create a CSR firm. A non-trivial implication proposed by Baron builds upon reputational concerns in the sense that if citizens reward social behaviour not only in the market place (strategic CSR) but also in a more societal environment, then also managers working in large companies will carry CSR beyond its strategic level (of maximized market value). Although this behaviour might be optimal from the managers' point of view, it constitutes moral hazard if shareholders are purely profit oriented. Summing up, agents are motivated by a mixture of extrinsic (classical) and intrinsic factors, therefore potential non-intended (counterintuitive) effects should be taken into account when designing optimal incentives.

Yet another role this new set of preferences could play leads back to the above outlined welfare analysis of corporate provision of public goods. It has been proposed that stakeholders use CSR to do social good in line with their intrinsic motivation, and the key question that follows, this time with respect to alternative private ways of doing social "good", asks why this "corporate channel" of fulfilling ones need to do public good is used at all if there are alternatives of direct social contribution. Again, from a welfare perspective, there should be some comparative advantage of CSR, something that makes it more efficient than individual supply. In an important paper, Andreoni (1989) compares different ways to contribute to a social good and asks whether they constitute perfect or rather imperfect substitutes. Although the initial version compares public and private (direct) provision of public goods,

¹⁹For an overview of the key ideas and contributions underlying Behavioural Economics see *Behavioural Economics: Past, Present and Future* (Camerer and Loewenstein (2002)).

the same analysis can be extended to compare various ways of private provision such as corporate and individual social responsibility. If there exists a "warm glow" effect of individual (direct) altruistic giving, then investment into a CSR firm, government provision of a public good and direct donations are imperfect substitutes that imperfectly crowd out each other. In other words, a socially responsible consumer might not derive the same utility from buying a "social product" and from donating money to charitable organizations directly. For a more detailed investigation of motives for charitable donations see Andreoni (1990), Buraschi and Cornelli (2003) or Croson and Shang (2005). A special analysis of how government incentives affect individual donations is performed by Pittel and Rübhelke (2004). Special attention is paid to the effects of granting tax deductibles on private public good provision when income tax schemes are progressive. Potential outcomes in terms of welfare and level of donations first crucially depend upon deductible ceilings, progressiveness of tax rates as well as preferences of agents, and second Pareto improvements might result at the expense of some agents utility. However, these analyses are unable to explain why individuals allocate a share of their "endowment to do social good" to CSR. A reasonable conjecture might be that people must or want to consume certain private goods, but derive disutility from being connected to any socially stigmatized behaviour or direct negative externality related to their purchase and/or use of the good or service (e.g. firms using child labor or acting environmentally hazardous during the production process)²⁰. Such motivation might appeal to both consumers endowed with social preferences independent of their consumption pattern and those consumers, who only have social conscience considerations in relation with their consumption of relevant private goods²¹. In both cases, but especially in the second one, CSR might be the preferred/optimal way of maximizing individual utility subject to social/environmental concerns²². However, this conjecture has yet to be tested empirically.

Finally, CSR often has been connected with advertisement or public relations of firms, thereby suggesting that CSR eventually could change preferences and ultimately individual behaviour over time. While the management literature has approached these issues via the concept of Corporate Social Marketing (Kotler and Lee 2004), economists have been more cautious when it comes to endogenous preferences. When it comes to preference formation, Becker (1993) concluded that "attitudes and values of adults are ... influenced by their childhood experiences". Bowles (1998) builds the bridge from Becker's "family environment" to markets and other economic institutions influencing the evolution of values, preferences and motivations. Simon (1991) was among the first to argue that agency problems may be best overcome by attempting to change and ideally align preferences of workers and principals. At the same time, empirical evidence from the General Social Survey (1991)²³ suggests that workers strongly identify with their organization (i.e. employer's preferences). In theory, this finding can be a result of matching (selection), reducing cognitive dissonance (psychology) or induced convergence of preferences (endogenous preferences). Given these alternatives, CSR could be either interpreted as a signal leading to matching or alternatively used to "streamline" agents' preferences over time. While the latter suggestion lacks theoretic or empirical treatment²⁴, the former potential matching (selection) role of CSR has been analyzed in more detail. The major result of this research is the notion of reduced agency cost due to matching motivated agents and principals as put forward in Besley and Ghatak (2005). Their focus is on the *mission oriented sector* (NGOs, public administrations, not for profit in general), and they show that matched preferences, in their words *motivation*, allow for a reduction of high powered incentives (bonus payments) without any loss of efficiency. In reality, however, the border between profit and mission orientation is increasingly getting blurred, i.e. many firms adopt missions (various CSR activities) in

²⁰Note that these social or environmental goods do not always directly/physically affect consumers, but rather are feeding through to individual utility indirectly via intrinsic, reputational concerns.

²¹I would like to thank Mathew Gentzkow for a clarifying discussion of this point. For an overview see again Graph 1.

²²On the one hand, a person having a strong preference for social or environmental good and donating a lot of money to charity might not want to send a contradictive signal via her consumption behavior and therefore demand CSR products. On the other hand, somebody that does not per se care about social or environmental good but about reputation in general (given that the public or a relevant societal subgroup has social preferences) might deem social or environmental performance by producers of her consumption goods as very important for her own utility (pure signaling).

²³The General Social Survey is a national US survey of demographic and attitudinal variables with a sample size of about 3000. It asks employees about their job satisfaction and work organization in general.

²⁴to the best of my knowledge.

their quest to maximize profits. Would this interpretation of CSR then lead to similar conclusions about incentive payment or preference distribution among workers in and across firms with varying degrees of CSR engagement?

It can be seen that a lot of open questions need to be answered when it comes to the mechanics of intrinsic motivation and social preferences within the human mind. However, further discussion of CSR focuses on the economics of the firm's interaction with various stakeholders and treats the existence of intrinsic preferences as exogenously given.

3.3 Six Strategies behind *strategic CSR*

This section identifies six relevant theoretic frameworks within which strategic CSR can arise, and links them to empirical evidence at hand.

1. Labor Markets,
2. Product Markets,
3. Financial Markets,
4. Private Activism,
5. Public Policy, and
6. Isomorphism.

3.3.1 The Labor Economics of CSR (*Contract Theoretic approaches to CSR*)

CSR might affect interaction between employers and employees and alter classical labor market outcomes. Bowles, Gintis and Osborne (2001) address the role of preferences in an employer-employee (Principal-Agent) relationship. Their main idea is that employees might have general preferences such as sense of personal efficacy or rate of time preference that are able to compensate for monetary incentives and therefore allow the employer to induce effort *at lower cost incentive enhancing*. The conclusions suggest an important role of preferences in determining the cost of labor services and affecting earnings of employees and employers alike. In this spirit, Besley and Ghatak (2005) establish a theoretic framework to analyze the role and interaction of monetary and non monetary incentives in labor contracts within the non-profit sector. They refer to not for profit organizations as being *mission oriented* and conjecture that such organizations, (e.g. hospitals or universities) frequently are staffed by intrinsically motivated agents²⁵. The main conclusion from their moral hazard model with heterogenous principals and agents is that pecuniary, extrinsic incentives such as bonus payments and the agents' intrinsic motivation can act as substitutes. In other words, a match between a mission oriented principal and an intrinsically motivated agent allows for reduced contractual bonus payments and still induces the standard second best effort level. In case of more than two types, a better match implies a higher substitution effect between money and motivation.

As opposed to Friedman's concern that CSR is a form of moral hazard, Brekke and Nyborg (2004) based on Brekke et al. (2003) show that CSR can actually reduce moral hazard in the labor market context. More precisely, CSR serves as a screening device for firms that want to attract morally motivated agents. This interpretation builds upon the above outlined main insight of Besley and Ghatak (2005) and is subject to the same substitutability of motivation and high powered incentives.

Another labor market context that involves CSR and corporate governance is explored by Cespa and Cestone (2007). They conjecture that inefficient managers can and will use CSR, i.e. the execution of stakeholder protection and relations, as an effective entrenchment strategy to protect their jobs. Their discussion of the effect of corporate governance institutions on firm value leads to the conclusion that

²⁵Think of a doctor or professor, who has a non-pecuniary interest in the hospital's or university's success, i.e. saving lives or educating students.

institutionalized stakeholder relations close this "insurance" channel for inefficient managers and increase managerial turnover and firm value. This finding also provides a rationale for the existence of special institutions such as ethical indices or social auditors and increased interaction between social activists and institutional shareholders in general. A similar approach to CSR is taken by Baron (2006b), who links managerial incentives (contracts) with socially responsible consumers. He addresses the interplay of consumer preferences, the ability of managers, managerial incentive design and social expenditures. The main focus is on the interplay between social expenditure and financial performance of firms. Both are jointly determined, i.e. causality can go both ways, and the major explanatory variable is whether consumers do have social preferences or not. After introducing managers' ability it is concluded that higher demand for social goods empowers the profit incentives by managers and compensation for managers is positively correlated with social expenditure (i.e. managers are encouraged to spend socially as demand and hence profits will then be maximized). When times are good and consumers value CSR, a positive correlation emerges between CSR and financial performance and the level of both, CSR and profits, is increasing in managers' ability. In bad times, however, shareholders are not supporting social expenditure (for profits) anymore and the correlation becomes negative.

Baron's work gives a first idea of the importance of consumer preferences in the determination of CSR efforts, which will be treated within the following subsection.

3.3.2 CSR and Product Markets (*Socially Responsible Consumption*)

Consumers and their social preferences may translate into demand for CSR and induce profit maximizers to supply levels of CSR dependent on their competitive environment. If there is competition in the private goods market, CSR can either act as product differentiation, or even trigger competition with respect to the level of CSR itself.

The first question to ask is whether the assumption that consumers really care about CSR is justified. There is substantial empirical evidence that this is the case. Consumer surveys reveal that consumers' assessment of firms and products as well as their final consumption decisions depend on firms' CSR records. The Millennium Poll on CSR²⁶, the largest global survey of public expectations of corporations conducted in 1999, documented that over 25,000 individuals across 23 countries on six continents revealed that their assessment of firms depends on its CSR record. Two out of three people want companies to go beyond profit maximization and contribute to broader society goals. Worldwide, one third of interviewees said they form impressions of a company based on business fundamentals such as financial factors, company size, business strategy or management, while 40 per cent mention brand quality or corporate image or reputation. A majority (almost 60 per cent) mention factors related to a company's broader responsibilities - labor practices, business ethics, responsibility to society at large, or environmental impacts to be important determinants of their opinion about a firm. This perception also translates into action as nearly half of American consumers say their perception of a company led them to consider rewarding or punishing a company by purchasing or not purchasing its products or services, or by speaking up for or against an organization. Around the world, 40% of the 25,000 respondents have thought in the past year about punishing a specific company perceived as not socially responsible. Other consumer surveys such as the one conducted by MORI²⁷ in the UK in 2003 confirm this picture by finding that 70% of consumers are willing to pay more for a product that they perceive as ethically superior. Cotte and Trudel (2008) find the equivalent to loss aversion in consumers' willingness to pay for ethical products. According to their findings consumers are willing to pay a premium for ethical products and buy unethical goods at a comparatively steeper discount.

So both consumption and willingness to pay may be influenced by CSR. Given that firms compete for consumers with such preferences, CSR may be correlated with the degree of competition in the market. Bagnoli and Watts (2003) model competitive product markets with homogeneous, socially responsible consumers. They conclude that competition for these consumers, who are willing to pay a premium

²⁶ EnviroNics International, Ltd., The Prince of Wales Business Leaders and The Conference Board. (1999). "Millennium Poll on Corporate Social Responsibility: Executive briefing". Toronto, Canada.

²⁷ IPSOS MORI has been merged in 2005 and is now the second largest research company in the UK. Further information can be found under <http://www.ipsos-mori.com/about/index.shtml>.

for impure public goods (remember CSR defined as the corporate provision of public goods alongside private goods), leads to private provision of public goods (=CSR) as a by-product and at levels that vary inversely with the degree of competitiveness in the private goods market²⁸. A more competitive environment in terms of prices (Bertrand competition as compared to Cournot) reduces a firm's mark up and its ability to use this mark up to increase CSR. This leads to reduced competitiveness in terms of product differentiation via CSR, and hence to reduced overall CSR activity. In sum, there exists a trade off between efficient provision of the private good and efficient provision of the public good, i.e. although both Bertrand and Cournot competition entail lower than efficient levels of CSR, but levels of CSR are higher under Cournot competition. A similar analysis of strategic CSR in a Cournot oligopoly by Manasakis et al. (2007) suggests that all firms hire socially responsible managers due to Stackelberg leadership motives. This increases equilibrium output and, dependent on consumers preferences, managers' decisions in favor of CSR increase or decrease profits.

If firms (Bertrand) compete in markets populated by heterogenous consumers, i.e. consumers with and without preferences for the joint corporate provision of a private and public good, Besley and Ghatak (2007) find that there exists a unique separating equilibrium, where firms make zero profits. The level of CSR is equivalent to the one under pure private provision of the public good by consumers and therefore second best only. The analysis in this framework allows validation of a whole array of standard results from the screening and public goods literature. The maximum sustainable level of CSR is achieved when the incentive compatibility constraint of caring consumers binds, while an exogenous increase of public good supply (e.g. by a government) perfectly crowds out competitive provision of CSR. In the absence of government failure, governments are able to implement the first best level of public good (Lindahl-Samuelson) and have a comparative advantage vis-a-vis firms, which cannot be perfectly monitored. However, as soon as governments fail, CSR might generate a Pareto improvement, while CSR and provision by non-profits are identical unless one or the other has a technological advantage in producing the public good. Finally, a small uniform regulation would leave the level of CSR unchanged and redistribute contributions from social to neutral consumers, while large regulatory intervention can raise supply of the public good to its first best level given that neutral consumers are willing to pay higher prices for the private good. These findings can be interpreted as justifying CSR as an economically optimal, sustainable way of providing public goods if governments fail²⁹, NGOs do not have a comparative advantage (i.e. lower production costs) over firms, and consumers are able to monitor firms to some extent.

Yet another approach towards modeling supply of CSR due to consumer demand has been proposed by Arora and Gangopadhyay (1995). They model CSR as firm self regulation, i.e. voluntary overcompliance with environmental regulation, and assume that although consumers all value environmental quality, they vary in their willingness to pay a price premium for CSR, which is positively dependent on their income levels³⁰. Firms play a two stage duopoly game and first decide about CSR (clean technology), and then compete a la Bertrand. The subgame perfect equilibrium entails firms differentiating themselves via catering to different sets of consumers. Choosing technology acts as product positioning similar to the choice of product quality, and CSR is positively correlated with the income levels of either all consumer segments or of the lowest income segment. Similar to Besley and Ghatak (2007), the comparative statics allow for an analysis of government policy. The main finding here is that if a minimum standard is imposed and actually binds on the "worse" firm (lower CSR), the better firm will overmeet the standard. CSR subsidies can have the same effect as standards, while taxes always reduce output (here: number of consumers served) and CSR efforts by all firms.

Finally, product characteristics are often difficult to observe and subject to information asymmetry between consumers and firms. In this context, Siegel and Vitaliano (2006) test and confirm the hypothesis that *firms selling experience or credence goods* are more likely to be socially responsible than firms selling

²⁸Competitiveness is reflected through both number of firms and firm entry.

²⁹Government failure could be either inferior technology (i.e. higher production costs), distributional preferences for neutral or social consumers or opportunistic politicians.

³⁰The conjecture that higher income leads to lower disutility from paying price premia for CSR suggest some Maslow type argument at the bottom of social/environmental preference formation and may explain why CSR is originating in the developed world (high income countries).

search goods. This lends support to the conjecture that consumers consider CSR as a signal about attributes and general quality³¹ of the private good. Here, firms use CSR to differentiate their product, advertise it, and build brand loyalty. The advertising dimension of CSR is especially strong when social efforts are unrelated to business conduct. In Navarro (1988) corporate donations to charity are identified as advertisement and CSR is meant to transmit a positive signal about firm quality/type . However, according to Becker-Olsen and Hill (2005) this signal might not necessarily be positive, as consumers are able to identify *low fit* CSR as advertisement and tend to negatively perceive such CSR efforts as greediness of firms rather than genuine interest into social or environmental concerns.

3.3.3 CSR and Financial Markets (*Socially Responsible Investment*)

Also investors care about CSR, and firms, which compete for equity investment on stock markets, will have to take that into account. Geczy, Stambaugh and Levin (2005) among others, put forward strong evidence of the increasing importance of CSR on financial markets. A new form of investment, so called Socially Responsible Investment (SRI), has come into being. SRI is defined by the Social Investment Forum (SIF) as *an investment process that considers the social and environmental consequences of investments, both positive and negative, within the context of rigorous financial analysis*. Social investors today include both private and institutional ones (in the US over 50% of investors take investment decision based on social criteria³²). Large pension funds allocate their investment based on CSR reports and ratings (such as those provided by GMI³³ in the US or KLD³⁴) and organizations such as the Council on Institutional Investors (CII) or the Association of British Insurers (ABI), which control approximately \$1.5 trillion and \$1 trillion, respectively, have each issued statements that corporate social responsibility is a key factor of long-term financial success (SIF, 2001). More precisely, the US Social Investment Forum³⁵ reports 10.8% of total investment under professional management in 2007 to be socially responsible (see Table 1), i.e. using one or more of the three core socially responsible investing strategies—screening, shareholder advocacy, and community investing. In Europe the European Sustainable and Responsible Investment Forum (EuroSIF) identifies €336 billion in assets to be SRI. In October 2006, Fortune Magazine similarly reported³⁶ that US \$2.3 trillion out of US \$24 trillion of assets under management in the US are invested in firms that rate highly on some measure of social responsibility. The trend points upward in most financial markets, e.g. in the US SRI assets grew 4% faster than total assets and over 258% in absolute terms between 1995 and 2005.

Year	SRI/US (trillion US\$)	Total US Investment (trillion US\$)	SRI Growth (%)	Total Investment Growth (%)
1995	0.639	7	-	-
2007	2.710	25.100	324.1	258.6

Table 1: Socially Responsible Investment³⁷ in the US since 1995 (source: US Social Investment

³¹in line with Milgrom and Roberts (1986)

³²See the 2001 Opinion Research Corporation Poll (sponsored by MMA-Praxis).

³³Governance Metrics International produces in depth ratings on CSR and governance on 2000 companies worldwide. Its client base includes Atate Street Bank, TIAA-CREF and ABP, the largest pension fund in Europe.

³⁴Kinder, Lydenberg and Domini is a firm rating the social performance of firms . A social index based on the Russell 1000 Index, which covers more than 90% of US stock market capitalization, is constructed.

³⁵The US Social Investment Forum is the national trading body for Socially Responsible Investment (SRI). The figures are taken from the Forum's *2005 SRI Trends in the US* report.

³⁶based on a survey by AccountAbility and CSR network

³⁷SRI refers to investment under professional management and chosen after applying at least one of the following social investment strategies: Screening (i.e. the practice of including or excluding publicly traded securities from investment portfolios or mutual funds based on social and/or environmental criteria), Shareholder Advocacy or Community Investing (i.e. financing that generates resources and opportunities for economically disadvantaged people in urban and rural communities in the U.S. and abroad that are underserved by traditional financial institutions). Therefore SRI serves as an indicator for the level of firm engagement into CSR.

Forum)

Having the above outlined typology of CSR (Graph 1) in mind, we know that investors (=potential shareholders) either have or don't have social preferences. Neutral investors just have their monetary return on investment in mind and, hence, just care about firm profits. It follows that such investors will use SRI as an investment strategy only if investment in respective firms qualifying as SRI actually translates into higher returns on investment. In terms of Corporate Financial Performance (CFP) this would imply that firms doing CSR are actually performing better financially. It is exactly this conjecture and the related questions of correlation and causality that have attracted a lot of attention in the scarce empirical literature on CSR. A comprehensive survey is provided by Margolis and Walsh (2003). Taking into account 127 published empirical studies between 1972 and 2002 they conclude that a majority of these studies find a statistically significant and positive correlation between CSP and CFP in both directions (i.e. causality is running from CFP to CSP and vice versa). Some regressions yield statistically non significant coefficients, and a negligible number of results suggests a negative relationship. However, it is emphasized that there exist sampling problems, concerns about the validity of CSP and CFP measures and instruments, omitted variable bias and the ultimate (and still unanswered) question of causality between CSP and CFP. A first attempt to address inconsistency and misspecification is the work by McWilliams and Siegel (2000). They regress firm financial performance on CSR and control for R&D investment. It follows that the upwards bias of the financial impact of CSR disappears and a neutral correlation emerges. This result is not particularly surprising as CSR very often entails the use of advanced technologies, therefore CSR and R&D might be strongly correlated (endogenous). In any case, further studies will have to clarify whether "greedy" investors should put their money into SRI and the underlying CSR effort qualifies as "strategic".

Alternatively, SRI can be a way for social investors to enforce their preferences through a demand channel similar to the one consumers use. The group of social investors, however, can be heterogeneous in the sense that there might be *those for whom corporate giving is a close substitute for personal giving and those, for whom it is a poor substitute* (Baron 2005). It seems logic that the former subgroup is more likely holding shares in CSR firms. Small and Zivin (2005) confirm this conjecture by focusing on the relationship between CSR, investment behaviour and firm valuation. They derive a "Modigliani Miller" theory of CSR, where the fraction of investors that prefers corporate philanthropy over private charitable giving (exactly the "key type" of investors identified above) drives CSR by firms attempting to maximize their valuation (share prices). A share constitutes a charity-investment bundle matching social and monetary preferences of investors with those of the firm's management. The main conclusion is that if all investors consider CSR and private charity as perfect substitutes, share prices and the aggregate level of philanthropy are unaffected by CSR. If they are imperfect substitutes, a strictly positive level of CSR maximizes share prices and hence the value of a corporation. A related natural experiment is provided by the correlation between corporate tax rates and the social performance of firms.

3.3.4 CSR and Private Politics (*Social Activism*)

The existence and success/impact of social or environmental activists is intimately related with information asymmetries between companies and the outside world. The rationale of Social Activism is that the threat of negative publicity (revelation of negative information) due to actions by an unsatisfied activist motivates CSR. As soon as the activist is credible and has the ability to damage a firm's reputation or cause substantial costs to the firm, the existence of such an activist is sufficient to integrate CSR as part of corporate strategy (D. Baron refers to this as *integrated strategy*). The logic is comparable to the one of "hedging" against future risk in financial markets, just here the firm insures itself against a potential campaign by an activist. Baron (2001) explicitly adds this threat by an activist, who is empowered with considerable support by the public, to the set of motivations for strategic CSR. CSR is referred to as corporate redistribution to social causes motivated by either profit maximization (1), altruism (2) or threats by an activist (3). However, it can be argued that the existence of activism qualifies CSR as an integral part of profit maximization, i.e. motivation 3 fuses in 1.

The main insights from the analysis of CSR and Social Activism can be summarized as follows: CSR

induced by private politics has two qualitatively different effects on firms in competitive markets. The first one is a direct cost effect for those firms that are targeted by an activist, i.e. costs are increasing due to CSR. This effect is even stronger for firms acting in a highly competitive environment (e.g. low product differentiation). In other words the degree of competition is positively correlated with the power of an activist boycott and strengthens the ex ante (threat) bargaining position of the activist. On the other hand, CSR can have a strategic effect that alters the competitive position of a firm. What is meant here is that CSR can take wind out of the sails of any potential activist and reduce the likelihood of being targeted in the future. This result roots in the assumption that in a way the activist also acts strategically and chooses "projects" that promise to be successful, i.e. weaker firms are easier targets. Finally, the existence of spill over effects from one firm to other firms or even the whole industry can act as an amplifier to activist power on the one hand, and motivation for (often observed) concerted non market action by firms in the same industry on the other (e.g. voluntary industry standards).

In a similar game theoretic (subgame perfect Nash equilibrium) setting, Baron (2006a) predicts market values of firms, prices, profits, contributions to activists and the level of corporate social performance in a model of product and capital markets with strategic consumers, investors and activists³⁸. Social pressure is arising endogenously in equilibrium. The new feature is that citizens can distinguish between strategic CSR (induced by social pressure) and truly altruistic CSR ("moral management", not for profit). If they actually do so, then in case the morally managed firm can signal its type and achieve a reputational advantage, social pressure will be directed towards self interested firms. If citizens are not distinguishing, morally motivated firms are more likely targeted. It shall be mentioned here that the distinction between strategic and not-for-profit CSR can be extremely difficult, subtle and based on perception rather than facts. Recent work done by Marketing scholars lends support to this proposition. Becker-Olsen and Hill (2005) find that consumers form their beliefs about CSR based on perceived fit and timing of related efforts, i.e. a high fit between CSR and the firm's area of expertise (business area) as well as proactive rather than reactive social initiatives tend to streamline consumers' beliefs, attitudes and intentions with those of the strategic firm.

Another interesting insight arises from the possibility to monetary support activists who differ in quality (Baron 2006a). It follows that high quality activists attract greater contributions and then are more likely to identify and target self interested firms, while the opposite holds for low quality activists. As far as market prices and values of firms are concerned, the (equilibrium) results are standard in the sense that (1) prices signal type and lead to consumer selection (altruistic firm, high price and social consumer versus profit maximizing firm, low price and neutral consumer) and (2) the distribution of shareholders' social preferences determines the value of firms because it determines the ability to attract equity investment. The contributions to the activists are similarly dependent on people's social preferences.

The impact of public interest advocacy and action either through activist groups or concerted consumer boycotts has also been analyzed from a marketing perspective (see Smith (2000) or Klein, Smith and John (2002)). Clearly, Marketing can be used to build reputation and avoid any form of activism that could harm business conduct. Recent innovations in Marketing techniques take consumer perceptions with respect to CSR into account and led to a stepwise development from Cause-Related to Social-Cause Marketing (Bloom et al. (2006)) to Corporate Social Marketing (Kotler and Lee (2004)). As negative reputation can harm a firm across all its activity areas through so called "halo effects", CSR can again act as a reputation insurance, an attribute shared with classical Marketing. In sum, consumer/activist perceptions translate into views and beliefs that form the basis for action. CSR done well can build reputation and insure the firm against boycotts or private activism.

3.3.5 CSR and Public Politics (*Regulation*)

CSR is defined as corporate social or environmental effort beyond legal requirements or regulations. So if being in accordance with laws does not qualify as CSR, how can public politics actually stimulate

³⁸The set up is close to a general equilibrium theoretic framework. the equilibrium concept used, however, is game theoretic in nature.

CSR? The answer involves a logic similar to the one behind private politics. It is the threat of future regulations and the adjustment costs they would entail that act as an incentive to hedge against such an event and build a strategic "buffer zone" via CSR (overcompliance). The threat stems from having a competitive disadvantage and high adjustment costs (due to e.g. new technologies) in face of an unexpected regulation. By doing CSR firms not only are safe in the event of regulation, but also might discourage government (public) intervention by signaling that markets can self-regulate its agents. Clearly, it is the classical dichotomy between public and private sectors that is at stake here.

Hence, it is again the public goods literature and its analysis of private versus public provision as well as related phenomena such as Crowding Out that serves as point of departure. Having Bergstrom, Blume and Varian (1986) in mind, one could ask whether CSR actually can crowd out public provision of public goods and to which extent the market itself (through inducing strategic CSR) can provide for the optimal level of public goods. A good understanding of the interaction between CSR and regulation then allows to address related policy issues such as the optimal level of regulation in the presence of CSR and the relationship between investment in CSR and firm performance (see the Editorial by D. Paton of a special issue of *Structural Change and Economic Dynamics* Vol.16 (2005) for an overview of contributions on the latter questions). Given knowledge about how to stimulate CSR, governments intending to provide a certain level of public goods could consider an alternative set of policy tools rather than regulation or taxation that are disturbing markets less.

Calveras et al. (2006) study the interplay between activism, regulation and CSR and find that private (activism) and public politics (regulation) are imperfect substitutes. It follows that increased self regulation (i.e. CSR) can crowd out formal government regulation. It is emphasized that when society free rides on a small group of activist consumers, loose formal regulation (voted for by the majority of non activists) might lead to an inefficiently high externality level where activist consumers bear the related cost via high prices for socially responsible goods. This conclusion draws attention to another relevant correlation, namely between regulation and political orientation. The underlying assumption is that the agents' consumption strategy not only depends on the distribution of social preferences over the whole population, but also influences decision making as a voter. Consumers are also voters, and not only firms, but also governments will want to signal their type. As governments signal through legislation or regulation and firms through CSR, the interaction between regulation and CSR is an important subject of further investigation³⁹.

Empirical work has been done by Kagan, Gunningham and Thornton (2003), who address the effect of regulation on corporate environmental behaviour. Studying 14 pulp and paper producing mills across the US, Australia, Canada and New Zealand, they find that regulation cannot explain differences in environmental performance across firms. This conclusion stems from the fact that variation in behaviour is not found across different regulatory districts, but across firms in one district. They attribute this variance to "social license" pressures (induced by local communities and activists in the spirit of private politics) as well as to different corporate environmental management styles. In sum, regulation matters to a large extent, but variation in "beyond compliance" is subject to the antagonism between social pressure and economic feasibility. The potential impact of local communities' social pressures on local corporations constitutes the subject of the next subsection.

3.3.6 Isomorphism

While the relevant "social pressure groups" in the five previous cases were employees, consumers, investors, activists or governments, the incentive to do CSR here roots in isomorphic pressures within geographic communities or functional entities such as industries. It is the institutional environment and commonly (locally) accepted norms, views and values that might discipline firms into certain social behaviour. Institutional factors that are potentially shaping the nature and level of CSR in a community include cultural-cognitive forces, social-normative factors as well as regulative factors. The inclusion of regulative community factors complements the analysis of public politics by testing whether differences

³⁹In my working paper "Incentives and the Corporate Provision of Public Goods" I show that, when reputation is important for firms, CSR subsidies might not stimulate the supply of CSR in the economy.

in regulation on a community level imply different levels and nature of CSR by firms located in these communities. In other words, subsidiarity in regulation implies variation across regions (local entities), and therefore, comparing similar firms located in different regulatory environments can give hints about its correlation with CSR.

Marquis, Glynn and Davis (2007) identify, in an institutional theoretic setting, community isomorphism, i.e. the degree of conformity of corporate social performance in focus, form and level within a community, as a potential explanatory variable for empirical observations concerning CSR. Isomorphic pressures may also arise within industries, and may lead to industry wide self regulatory activities. Especially industries that are well organized and represented by a centralized lobby might be able to exert pressure on firm behaviour.

4 Some Empirical Issues

Although empirical evidence of CSR (SRI or the proliferation of related standards) and the underlying incentives to do it (stakeholder preferences) exists, the empirical literature on CSR is in an infant state and far from fully exploiting all theoretical propositions in the field. The first and foremost challenge to empirical analysis is to measure CSR in a commonly agreed, scientifically correct and homogenous way. Homogeneity is crucial in developing a level playing field that allows to assess whether competing results are truly competing and general conclusions are truly general. Codes of conduct, standards and monitoring systems that have arisen recently include SA8000 (1998) and ISO14000/1, both issued by the International Standards Organization, or the UN Global Compact initiative⁴⁰ (2000). These estimations of CSR share the common goal to give a picture of a particular firm's CSR efforts, but they vary in the underlying criteria, certification requirements (verification) and focus (even definition of CSR). However, as stakeholders use these measures and indices as baseline information about CSR practices, firms actually react to disclosure of information via such measures. Chatterji, Levine and Toffel (2007) examine the predictive validity of environmental ratings using the KLD rating that has been used by many others as a proxy for CSR. It is a first attempt to address the question of which metric is a good predictor of a firm's actual performance. This is of special interest to those (investors or consumers), who base their decisions upon such measurements of CSR. Similarly, Chatterji and Levine (2005) evaluate the role of non financial performance measures and stress not only the importance of reliable, valid and comparable metrics, but also the unique role managers should play in their development. The strategic perspective again stems from the fact that it is third parties that measure CSR and publish this information, which ultimately serves various key stakeholders as a basis for decision making. Hence, in order to manage risk, portfolio theory addresses direct financial risks, while a general CSR measurement framework is crucial for predicting perceived non-financial performance. Banker et al. (2000) empirically underline the long term correlation between non-financial performance measurement (such as product quality or customer satisfaction) and financial performance, which they translate into an important factor for designing managerial incentives.

Assuming validity of certain measures of CSR solves the dependent variable question. The natural next step is the identification of statistically significant independent variables explaining, determining or predicting CSR levels. The following partial results have been achieved: In the aforementioned study by Siegel and Vitaliano (2006) on CSR as a signal for product quality (of experience or credence goods), *no positive correlation between firm size and CSR* on the single cross section of data available was found. Both tested hypotheses (i.e. CSR and credence goods and CSR and firm scale effects) have been advanced by McWilliams and Siegel (2001 - hypothesis 2 and 10, p.120 and 124), who do a cost benefit analysis to determine the optimal, i.e. profit maximizing, level of CSR. The explanatory variables in this supply and demand model include firm size, level of diversification, R&D, advertising, consumer income, labor market conditions or stage in the industry life cycle. All hypotheses related to these variables still remain to be tested. Videras and Alberini (2000) test potential reasons why firms participate in

⁴⁰The UN Global Compact initiative attracted over 1500 companies worldwide since the year 2000 and commits them to uphold principles of human rights, environment and clean business practices.

voluntary environmental programs (EPA⁴¹ programs). The empirical analysis finds potential publicity and firm size to increase, and the previous environmental track record to negatively affect participation. More precisely, all firms participate more likely if possible publicity is positive - this is especially true for firms with high exposure to the public such as large corporations - and firms already involved into active communication with consumers use EPA programs to add credibility to their CSR efforts. Bad environmental performers are more likely to join if the program is directly related to the firms' pollution reductions, i.e. this suggests again the quest for credibility and publicity, while corporations with lower R&D expenditure are more likely to participate as they expect positive technology spill overs.

Another attempt to empirically investigate the determinants of CSR adds three new factors to the above mentioned variables. Focusing on S&P⁴² 500 firms, Ceton and Liston- Heyes (2005) include the *political context in which the firm operates*, its *involvement with secondary stakeholders* and *a firm's ISO 9000 status* in the multiple regression analysis. They find that firms (HQs) located in more conservative political communities (states) exhibit lower levels of CSP, while corporations that also fulfill weaker claims of less important stakeholder groups as well as ISO 9000 certified firms are more likely to get involved with CSP. While the first and potentially the third variable fit with the notion of strategic CSR (especially isomorphism and hedge against local regulation), targeting of secondary stakeholders does not directly reveal the demand side pressures as the strategic incentive at work.

5 Concluding Remarks

The message of this paper is that a fundamental understanding of CSR is emerging. Economically, CSR can be but not necessarily is just the result of (1) social preferences of entrepreneurs and shareholders, or (2) an immediate manifestation of managerial moral hazard towards profit oriented shareholders. Based on a new set of intrinsic (social or environmental) stakeholder preferences, CSR can be fully consistent with the profit maximizing strategy of any firm committed to shareholder value. Characterized as action beyond legal requirement, CSR qualifies as strategic behaviour if consumers, investors or employees have social preferences, and if these preferences translate into action with monetary effects for the firm (e.g. price premia can be charged or wages lowered). In addition, strategic consequences related to profits and competitiveness may arise (1) if activists and/or governments threaten to impose costs and, hence, competitive disadvantages on firms via boycotts, negative publicity or regulation, or (2) if communities and their values and norms were strong enough to weaken a non-aligned firm's position (isomorphism) and profitability.

Empirical evidence lends support to all of these incentives for strategic CSR, however, rigorous statistical analysis is still in an infant state and subject to various problems including measurement error, endogeneity and misspecification.

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⁴¹ Environmental Protection Agency

⁴² Standard&Poors

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