Corporate Social Responsibility:
The role of law and markets and the case of developing countries

Antonio Vives*

A. Introduction

Is the only goal of the corporation that of maximizing profit? Can the corporation engage in non-profit maximizing activities? Can responsibility be mandated and controlled by laws and regulations? Will the corporation be responsible if left to its own devices? Is it responsible for the corporation to go beyond the law? What is the effectiveness of the market in fostering responsibility? Are there differences needed in corporate behavior in developing countries? These are some of the questions that this paper seeks to address.

This paper present a pragmatic view on the role of law and markets in fostering corporate social responsibility, recognizing the constraints, demands and pressures facing corporate managers to put profits at the top of the list of priorities, but also recognizing the potential that corporations have to contribute to society's welfare, within the rules and freedoms that society imposes and gives to corporations. The position taken in this paper is neither the radical view that the corporation is free to pursue profit maximization, regardless of impact on society, nor the equally radical view that the corporation must resolve society's problems and substitute for government failures. The analysis is based on the advantages and limitations of the law and the markets in fostering corporate responsibility. The paper does not intend to present an apology for corporate responsibility.

The paper first discusses what is and what is not a responsibility of the corporation, considering its role in today's society and the scope of action afforded by laws and regulations to then consider the complementary role that markets can play in fostering responsibility and some perverse messages that those same markets send. In the process, the situation of law and markets in developing countries is discussed. As the situation in developed countries has a significant impact on the views and corporate behavior in developing countries, we discuss first the case of developed countries in order to frame the discussion that follows for developing countries. A final section concludes with a plea for good judgment, avoiding extreme positions.

B. What do we mean by corporate social responsibility?

Management guru Peter Drucker said: "*If you find an executive that wants to takes on social responsibilities, fire him. Fast*" (quoted in Bakan[1]). If he means an executive that

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* Manager, Sustainable Development Department, Inter-American Development Bank.
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[1] Bakan, Joel, "The Corporation: The Pathological Pursuit of Profits", Free Press, New York, 2004, pag. 35.

wants to take on the role of the government and/or NGOs, we agree with him. It is very unlikely that managers will have expertise or comparative advantage in the solution of social problems and it is not the purpose of the corporation. This quote does illustrate the confusion that exists with the term social responsibility. May non-experts take the literal meaning of each word: corporations have social responsibilities, i.e. "corporations are responsible for solving society's problems", instead of the compact meaning of "corporations cannot do whatever they want with society" or "corporations are responsible for the impact of their actions on society".

There is a significant confusion in the private sector, public sector and civil society as to what is the meaning of Corporate Social Responsibility, or CSR as it is widely known. As the concept has evolved from philanthropy, many continue to make it synonymous with philanthropy. The convenience of the acronym has a lot of interested parties talking about CSR as if it were a universal, uniform, well-defined, standard concept. Every party has its own definition, many times not articulated, and used to advance or detract the concept. This failure in the communication has led to significant controversy and confusion, even polarizing positions. This is not say that the discrepancies between many parties are not real, but these discrepancies are exacerbated by a lack of an explicit understanding on which of the many ideas embodied in the acronym CSR, the parties are talking about.

The terms "Social" and "Responsibility" are many times misinterpreted. For some "social" mean that the responsibility refers to social issues, i.e. health, education, security and the like, i.e. issues generally under the responsibility of governments. For others, more correctly, "social" is a shortcut for society, including the planet, including the environment, i.e. the ambit of action of the corporation. For some "responsibility" stands for accountability for the corporation's actions, for others for a sense of duty towards society, and for others for good judgment (the golden rule: "do unto others as you would like done unto you").

In terms of what actions are included, most people interpret these terms to mean that the corporation has a responsibility towards society, and some interpret it to mean that corporation has a responsibility to do something about the problems that affect society, while others interpret it to mean that the corporation must take responsibility for its activities as they affect society. Most international NGOs and social activists hold the first view, while the latter is the view of business leaders, like the World Business Council for Sustainable Development. These views have very, very different implications.

In the first case, the corporation is attributed responsibilities that go beyond the purpose for which it was created, like getting involved in the welfare of the population, covering some of the failures of governments. Many of these activities are the responsibility of the citizens themselves and of their local or national governments. Needless to say, most representatives of the private sector do not agree that these are the functions of the corporation and reject the whole concept of CSR. In the second case, the corporation as a legal "person" is responsible for the impact of its activities, and these activities must be carried out with respect towards those affected.

This paper is about the latter interpretation of CSR, over which there should be less controversy[2]. Nevertheless, as we will see in the discussion later on, there are some that claim that even this responsibility is limited and that the corporation should only exercise it if it can be shown that it leads to higher profits. For the purpose of this paper, "Corporate Social Responsibility" means "Corporation must be responsible towards society and the environment for the impact of their actions". This is not to say that the case is closed. There is significant divergence as to what being responsible for the impact of their actions means and the concept of what constitutes responsible behavior changes from context to context, from culture to culture and, within context and culture, changes over time. A few years ago society did not consider that food companies had any responsibility over the obesity of its customers; it was a matter of genetics or irresponsibility in the part of the consumer. Today, in advanced societies, some responsibility is being attributed to the food producers and some are reacting by producing healthier products and educating the consumer. Nobody would claim today that fast food companies, in developed countries, think that indifference to these issues will not affect the bottom line. Today, everybody agrees that a pharmaceutical firm should produce drugs that cure the ailment they are prescribed for, but not everybody would agree that it is the responsibility of pharmaceuticals to produce cheap drugs for the poor. Highly desirable, yes, but is it their responsibility?: probably not. In some contexts it might be wise for them to do so, as consumers may react to this and an improved reputation and consumer recognition might enhance the competitiveness of the firm.

As the nature and extent of the impacts of the corporation's activities are not well defined in all cases, there can still be significant discrepancies among stakeholders as to the corporation's responsibility. Furthermore, many of those stakeholders may demand or act as if the corporation had responsibility for some actions (for instance producing cheap drugs of the poor or enhancing the quality of life in the community) even if the corporation may consider them outside of their responsibility or that are not the result of the impact of their activities. The corporation may rightly claim that these are not their problem, but ignoring these demands may be costly. These considerations show that even the narrow case of CSR as responsibility for the impacts of their actions (or lack of action!) is not a clear-cut case and there can still be significant controversy.

Under the all encompassing and abused name of Corporate Social Responsibility, corporations carry out may actions, some legit, some pure public relations. Critics of the idea look at some philanthropy done in the name of the corporation and argue that it is

[2] Some authors prefer to use the term "Sustainability" which holds a vision that all activities of the corporation must be done to assure that future generations will be able to enjoy a quality of life at least as good as the one we now enjoy. The concept is broader than CSR and its practical implementation more complicated as it involves uncertain tradeoffs. Should we leave nature untouched or can we "consume" some of it if in exchange we leave, for example, better infrastructure? It is a concept better suited to guide the actions of society as a whole, including corporations, governments and civil society. For a discussion see Holliday, C.O., Schmidheiny, S. and Watts, P., "Walking the Talk: The Business Case for Sustainable Development", Greenleaf Publishing, Sheffield, 2002

not the responsibility of the corporation as an entity, but rather it belongs to the individual managers or shareholders to do it with their own money, not with monies that are not theirs, that belong collectively to the shareholders. This philanthropy may be done to enhance the image of a given manager, although it may also enhance the image and reputation of the corporation. Extreme critics would not even like it even if it enhances the image of the corporation, preferring to do it with activities that are more directly related to the business of the corporation. At best they tolerate what some call "strategic philanthropy"[3], i.e. philanthropy that contributes to profits. It must be clear to the reader that there a continuum of actions in the spectrum, some of which can be called misappropriation of common resources for the private good, but some of which benefit both society and the long term value of the corporation. Is the donation of a school building to the community by a pharmaceutical firm responsible or irresponsible? It depends. In a developed country, most likely it is irresponsible. In an underdeveloped area or country, it may be justified if it leads to better-educated consumers, although it would a stretch. Proponents of strategic philanthropy would prefer to see the resources used, say, in educating the consumers in better health practices, particularly using their products. The ones better placed to make those decisions are the managers, subject to the oversight of the market, including shareholders, as we will discuss below. We need to look at the actions and the circumstances not just the name of the action. But let us not trash all actions for which someone gives the name of Corporate Social Responsibility, just because some people may understand something different. Do not "throw the baby with the bathwater".

It should be clear by now that the social responsibility concept involves a long-term view of the impacts of all the activities of the corporation, as many of these impacts will take time to be felt, both the positive and negative impacts. It is precisely the sort term horizon that most managers have that conspires against corporations being responsible. We will discuss this key issue in the next section.

Also, we are not advocating that the firm is responsible for the public welfare, or that it has, among its responsibilities, that of solving social problems. Far from it. The firm has responsibilities towards its shareholders, but these responsibilities are fulfilled if the firm is also concerned about the impact of their activities on society and behaves in a responsible manner.

The preceding discussion tried to narrow the concept of CSR, but this concept may have to be expanded for application in developing countries. Some of these countries are characterized by weak regulations, weak governments, particularly at the local level, with government failing to provide basic services. Under these circumstances, the corporation may find that it is in theirs and their stockholders' best long-term interest to, not only be a good citizen, but also to contribute to the provision of some basic services. For instance, it may be in their best interest to ensure the quality of water or of primary education in order to either avoid worker migration or to have a pool of able and healthy workers. Most people in developed countries would not consider this to be part of a responsible

[3] Michael E. Porter and Mark R. Kramer, "The Competitive Advantage of Corporate Philanthropy." Harvard Business Review, December 2002

corporation. Nevertheless even an early critic of CSR, the 1976 Nobel Prize in Economics Milton Friedman, acknowledged these cases even for developed countries, in his famous New York Times article where he stated that

> "*…it may well be in the long run interest of the corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government. That may make it easier to attract desirable employees, it may reduce the wage bill or lessen losses from pilferage and sabotage or have other worthwhile effects*". [4]

In the case of developing countries, this may be a common occurrence and may even need to be broader in the face, say, of government failure to provide basic services. Friedman does object, though, to calling this "social responsibility". We do not think that semantics should get in the way. If managers, exercising their good judgment believe that this will benefit the corporation, so be it.

Can we then rely on the goodness of the corporation to be responsible? Can we rely on the efficiency of government to protect the interests of the public? Can we rely on the workings of the market, and if so how? We will discuss these issues in the remainder of the paper.

C. Purpose of the Corporation

The business of business is business. This well known quote of Milton Friedman, published in 1962[5], has been used by those who believe that the only responsibility of the private corporation is to increase profits for its owners or shareholders, in order to oppose activities that are not directly related to pursuit of profits[6]. Managers tend to see the corporation as having only one "stakeholder": the shareholder and even that this one has a narrow view of profits.[7] This behavior is justified on the basis of business and economics school theories of "maximization of shareholder wealth" as the objective of the firm and is further biased by the attention given to the variations in stock market prices, which tend to over-react to events related to the corporation, in particular to reported earnings. And this has been further exacerbated by miss-designed stock options that, with the good intention of aligning the objectives of management with those of the firm, do so based on short term increases in stock prices, which is not and should not be the sole objective of the firm. The "going concern" concept of accounting principles does not match the sort term view of personal profit maximization of some managers and

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[4] Milton Friedman, "The Social Responsibility of Business is to increase its Profits", New York Times, September 14, 1970.

[5] See Friedman, M., 'Capitalism and Freedom", University of Chicago Press, Chicago, 1962.

[6] And the special survey of The Economist on CSR added: "*The proper business of business is business. No apology required*". The Good Company: A survey of corporate social responsibility, January 22, 2005.

[7] Here it may be convenient to distinguish between owner/managers, managers on behalf of clearly identified owners (maybe of a family-owned firm) and managers acting on behalf of a multitude of anonymous shareholders. The first two types of managers may not be as detached form the broader responsibilities of the firm as the last ones, where the "agency problem" (the potential discrepancy in the decisions taken by managers and those that would be taken by the owners) may be more acute.

the perverse incentives provided by stock options and bonuses based on short term performance.

Creation and destruction of market value

In the case of stock market prices reacting to reported earnings and even in the case of firms whose shares are not traded, current generally accepted accounting principles conspire against a broad and long term view of the firm's activities. These accounting principles are based on recognition of expenses actually incurred and income actually received, over the reporting period, usually a short-term horizon. Also, they do not and cannot recognize values that cannot be measured in an objective way. In many cases the accounting principles have a conservative bias, recognizing as an expense some outlays that could be capitalized, i.e deferred for future expensing, as they will yield future benefits. Current accounting principles do not recognize, for instance investments in human capital, in intellectual property, in creating brand value and reputation (unless acquired in a merger or acquisition), which may be some of the most valuable assets[8]. These principles do not recognize the consumption of natural capital (the negative or positive impact on the environment), which may not have a tangible financial cost for the firm in the short run, but may have it in the long run and certainly has, sooner or later, a cost for society [9]. Supposedly, the stock market valuation does include these items, but we argue that if it does, does so in a fickle way, with a short-term orientation, not providing the right incentives for management to act in the most convenient, long-term interest of the firm. There is no need to elaborate or repeat the recent examples of firms where short-term maximization of market value by managers, for their benefit, led to irresponsible and illegal behavior, with the consequent **destruction** of market value for shareholders.

We are not saying here that reliance on the stock price and on reported earnings are not good guides for management behavior. But we will argue that they are not enough and in many cases may lead to irresponsible behavior and a destruction of the value. Neither are we advocating a different accounting or pricing system, but we will argue for a broader conception of the corporation based on the concepts of corporate social responsibility. As we will see below these concepts require us to take a broader view of the firms activities and include other stakeholders in the decision process, like employees, customers, suppliers, community, governments, civil society and the environment where the firm gets its resources and disposes of its unwanted items [10]. These stakeholders must be part and parcel of concerns of the firm, not only the providers of capital, who even

[8] The market value of firms like Coca Cola and IBM is overwhelmingly related to intangibles like brand value and reputation.

[9] The most common example these days is the case of Greenhouse Gas emissions. In most cases, corporations do not face the costs to society of those emission as the cost, say of oil or coal, does not include the future damage to the environment in their prices. Cost of labor, technology, raw materials and the like are included, but the costs of increased concentrations of CO_2 in the atmosphere are not. An accountant would say that these costs are not quantifiable, and are better ignored. This creates perverse incentives to use more of the mispriced resources.

[10] For instance, the Constitution of Germany states: "*Property imposes duties. Its use should also serve the public weal*" Article 14, literal 2.

though critical, are not the only ones that make the firm a long term viable entity. This is not to say that stakeholders have rights, in the same way that shareholders have rights to the residual value of the firm, but it means that they cannot be ignored.[11]

What type of firm will it be if it had plenty of capital (provided by shareholders) and no employees to produce the products or no customers to buy them, or lack the proper environment where to get inputs and operate? Recall that not all markets are as perfect as those of capital in the most developed countries. The firm does not pay for the value of clean air, or for the negative consequences of climate change due to carbon emissions, or the full-cost price for the water it uses, and in some cases, for the value of labor it uses (in a very imperfect market for labor) or for the negative impact that it has on the surrounding community. There are many instances of mispricing of inputs, and even inputs that the firm uses but does not even account for. Some compensation to the earth and to society may be due.

Legal theories of the firm and profit maximization

This discussion goes to the heart of the different conceptions of the purpose of the corporation. There are at least two legal theories of the firm. On one side is the contracts theory that sees the corporation primarily as a set of property or contractual relations and on the other side the entity theory that recognizes the corporation as a concession from society with its attendant rights but also obligations. In the first case, the theory sees the corporation as a collection of private contracts between shareholders, managers and others. In this view, the primacy is the contract with shareholders, which allows and conditions all others. From this, the theory states that the corporation should only be governed in the interests of the property owners or the contracting parties.[12] It is up to the bargaining power of each of the parties to the contracts to defend their interests; the corporation should defend the interests of the shareholders. And under the assumption that shareholders being rational human beings would want more wealth than less and will never be satiated, the conclusion is reached that the objective of the firm is to maximize shareholders wealth.

In the second case, there is a recognition that the corporation operates within society, that it needs the resources that the planet and society can provide in order to carry out its activities and its needs society to buy its products and services. The corporation does not operate in isolation. As such it has responsibilities towards society. This theory recognizes the complexity of the relationships and assumes that many of the "contracts" of the "contract theory" may not be explicit, for instance with the surrounding community, with the people that breath the air released in the factories and so on. It would also recognize that there could be an extreme asymmetry of power between the

[11] "*The ultimate responsibility always points to the rights of the owners; managers are proxies for those owners and have an obligation to meet the business needs of the corporation. Managerially, stakeholder theory is primarily a tool for managers to accurately and thoroughly consider threats and opportunities to the business*". Sasse, Craig, M. and Ryan T. Trahan, "Rethinking the new corporate philanthropy", Business Horizons, 50, 2007, pag. 34.
[12] Parker, Christine, "The Open Corporation: Effective Self-regulation and Democracy", Cambridge University Press, Cambridge, 2002, pgs. 3-7

corporation and the explicit and implicit contracting parties, particularly as the corporation gets bigger and more global. It recognizes that the state has a role to play in the regulation of these relationships as it has granted the corporation the right to operate with limited liability and/or separate legal personality.

The former theory is based on the assumption that the firm is omnipotent and provides goods and services needed by society and we should all be thankful and not ask for anything more. The later assumes that the corporation activities are based on a "license to operate" from society. All contracting parties, whether explicit or implicit have a stake on the activities of the corporation, are stakeholders, including the ones with primacy of rights, the shareholders.[13]

While the firm may be private in the sense that it is owned by private individuals, directly or indirectly, it does not mean that it operates exclusive within the realm of those individuals. As it operates in the public space, it does have public responsibilities. Contrary to what some authors state, stakeholders do not pretend to have "a pseudo-ownership interest in the corporation"[14] but they do have a stake in the activities of the firm and can exercise their rights within a competitive, democratic and free system, if provided all the necessary information to make informed decisions, in particular they can refuse to buy the products and services. It is not that the corporation has to work for the public good, but if it wants to work for its own good, it better consider the impact of its activities on the public good.

Many critics of CSR assert that the business enterprise is an important social good for four reasons: job creation, production of goods and services, creation of wealth and as a private social instrument for the moral and material support of other activities of civil society[15]. These critics argue that this is the social responsibility of the corporation and it does not have any other responsibilities to society.

The economic theory of the firm, mostly based on the legal theory of contracts, has influenced many business and economic students. This theory, in order to be presented in an understandable way, develops a simple model that for its simplicity requires heroic assumptions: information flows freely and it is fully reflected in the prices of goods and services, there is perfect competition in markets, labor markets function with no friction, wages reflect the marginal contribution of labor, and so on. There is no need to dwell on the gap between these assumptions and the real world; even in the most advance societies they do not hold. The conclusion of the model is that profit must be maximized to enhance the welfare of society. In a purely competitive environment, with no externalities[16], with perfect markets and where the individual always prefers more money

[13] For a comprehensive critique of the theory of shareholder value, see Aglietta, Michel and Antoine Reberioux, "Corporate Governance Adrift: A Critique of Shareholder Value", Edward Elgar, 2005.
[14] Henry G. Manne, "Milton Friedman Was Right: Corporate social responsibility is bunk". Wall Street Journal, November 24, 2006.
[15] Novak, Michael, "The Future of the Corporation", American Enterprise Institute, 1996.
[16] Externalities are said to exist when the price of the product does not reflect all costs that society incurs to make it available to consumers or when at least some of the benefits associated with the consumption of the good or service can be captured by others that pay nothing for it. Pollution is a negative externality.

to less, the pursuit of profit will make everybody work harder, resources will be better used, only the most efficient firms will survive and everybody will be better off. Take care of profit and the rest will take care of itself. Profits are literally the last line, the bottom line of the income statement, and it is the net of all revenues and expenses, summarizing everything that went on in the business. This profit belongs to the owners, or shareholders in the case of a corporation, and they are all that matters, they put capital at risk that allows getting other financial, labor and material resources. Profits are "the bottom line" of business.

These newly minted economists and MBAs go into the world with this model of the world, knowing the assumptions are not valid, but are told that somehow the results of the model are valid even if the individual assumptions are not. Alford and Naughton take a broader view of the role of business in society:

> "*…A purely financial description of the firm is appealing in that it is quantifiable and allows for the creation of both simple decision making rules and complex mathematical analysis of the financial structure of business, but this description is inevitably abstract and disconnected from the real world of business …*".[17]

Based on the preceding discussion we can assert that profits are one of the major responsibilities of the corporation. If a legitimate corporation is not profitable it will eventually cease to exist and will not be able to perform any role in society, including the important one of providing employment. But this is not to say that the sole purpose of the corporation is that of maximizing profits for shareholders. In fact, "*…no corporate statute has ever stated that the sole purpose of corporations is maximizing profits for shareholders…*" [18]. Corporations must also consider the impacts of their activities on the other stakeholders, minimizing and compensating the negative impacts and enhancing the positive ones. These considerations may enhance the favor of customers and society in general, and help to minimize and control risks, which may lead to better profits.

Could and should the firm behave responsibly only if there is a link with profits? In the next section we discuss this question in the context of the role of law in the regulation of socially responsible activities.

D. Responsibility, law and ethics

Corporations are artificial creations, *persona ficta.*[19] In Spanish-speaking countries the most common form of corporation is called a "sociedad anónima", an anonymous

[17] H.E Alford and M.J. Naughton, "Beyond the Shareholder Model of the Firm". Chapter 2 of Cortright, S.A. and Naughton, M.J., editors, Rethinking the Purpose of Business, University of Notre Dame Press, (2002), pag. 28.
[18] See Elhauge, Einer, "Corporate Managers' Operational Discretion to Sacrifice Corporate Profits in the Public Interest", paper in Hay, Bruce L., Stavins, R.N., and Vietor, Richard, H.K., editors, "Environmental Protection and the Social Responsibility of Firms: Perspectives from Law, Economics and Business", Resources for the Future, Washington, 2005, pag. 23.
[19] Stone, Christopher D., "Where the Law Ends: The Social Control of Corporate Behavior", Waveland Press, Prospect Heights, 1991, pag. 3.

society, implying in its name that it does not have responsibility as a person, you do not know who it is, in the same way that we attribute a work to Anonymous, when we do not the author. Can these artificial creations have responsibilities or it is only real persons that can have them? Being anonymous, how can their behavior be controlled?

Corporate regulation

In an ideal world managers will have high ethical principles and law and regulations would not be needed, leaving corporations free to adapt their activities and make the necessary trade-offs to achieve maximum gains for all. In this ideal world, the market would act as the regulator, guiding the firms to the actions that society considers most desirable. As is, markets are far from perfect and not all managers have high ethical principles. In most case, the public does not have the capacity and knowledge to exercise their preferences so as to reward responsible corporations and punish irresponsible ones. Worse of all, as we mentioned above, the market may send the wrong signals. Earl Warren, former Chief Justice of the US Supreme court remarked that:

> "*Not only does law in civilized society presuppose ethical commitment, it presupposes the existence of a broad area of business conduct controlled only by ethical norms and not subject to the law at all ……………. Many areas of corporate behavior are simply beyond the ability of the law to control, and we must rely on managers' ethical decision-making to achieve societal objectives*" [20]

According to this view, ethics covers a broader range of behavior than the law, and ethical considerations are indispensable to complement the deficiencies of the law to assure responsible behavior [21]. "*Although the law is a necessary condition for creating responsible behavior, it is not a sufficient condition*" [22]. Can and should we design laws that control all possible misbehavior? Most likely the answer to both questions is no, unless we want to cripple the capacity of the corporation to go about its business. Laws simply cannot include every aspect and possible scenario necessary for individual or company behavior, as there is always an underlying assumption regarding a certain level of ethical and moral behavior. Moreover, creating overly complex and difficult regulatory structures actually inhibits companies from operating at optimal levels and impedes their ability to identify the most effective measures and methods for compliance. Such an approach is even less realistic in the case of developing countries, which tend to have limitations in terms of enforcement. Nevertheless, there are some aspects of responsible behavior than can and must be regulated.

The traditional approach to regulation is that of command and control, whereby an undesirable behavior is detected and laws and regulations are passed that seek to prohibit

[20] Cited in Hess, David, "Corporate Social Responsibility and the Law", Chapter 8 in Allouche, Jose, "Corporate Social Responsibility," Volume 1: Concepts, Accountability and Reporting. Palgrave Macmillan, New York, 2006. pag. 154.

[21] Even the bitterly critical survey of CSR by The Economist, op.cit. admitted: "*Sometimes the aims of the business and rational self-interest will clash with ethics, and when they do, those aims and interests must give way*", pag. 20.

[22] Hess, op. cit., pag. 155.

or control the behavior. While in some cases this approach is effective, in many cases is inefficient and may lead to undesirable behavior. In cases where the costs of the misbehavior are perceived by society to be large and where there is a clear relationship between the behavior and the consequence, command and control regulation may be effective and sometimes may be the best way. For instance, cases of market failure like the cases of pollution, toxic ingredients, slave and child labor, among many cases, can and must be regulated.

In other cases, regulations may be harder to design and/or enforce. For instance, the case of working conditions for labor. Some minimal behavior may be mandated, but there are many aspects than cannot be mandated. For instance, maximum working hours, minimum age, rest periods, lighting, quality of air and the like may be regulated, but the richness of the work performed, the capacity for advancement, for example, may not be regulated. Even if regulated, the corporation may find other ways to undermine them if the cost benefit is favorable, as we will discuss below.

Command and control regulations do achieve some of the presumed objectives but their implementation presents many difficulties. For instance, as they have to apply to all cases covered, which may be very different, and cannot be tailor-made for every case, regulations will be tend to be inefficient, and will tend to cover the common elements to all cases, which may be minimal. To counter this, the regulator will have the tendency to over regulate, including unnecessarily complex rules that are too difficult or costly to implement.[23]

These regulations will need strong enforcement procedures and institutions and may be suited for countries or areas with a high institutional development, including the ethical manpower to enforce them. They also run the risk that the creativity of the corporation is directed to avoiding the negative effects of regulation instead of looking for better solutions to the problems at hand. Under the regulatory scheme there is also the tendency to try to solve every problem by throwing a regulation at each one of them, increasing the costs of compliance, and probably eliciting selective compliance.

Also, these regulations will tend to elicit reactive behavior in the part of the corporation, some of which are counterproductive. The most common one is strict compliance with the letter of law, forgetting the spirit of the law, much less doing some reasonable or ethical actions if not mandated by the law. Not only will the regulation tend to be a race to the bottom, but so will compliance.   Then there is the problem of capture of the regulator, depending on the relative power of both parties. In the case of large corporations, grouped in industry associations, this power can be significant. Depending on the balance of power, and sometimes on the political inclination of the regulator, he/she may be co-opted to design favorable regulations or enforce them lightly

The corporation, used to minimizing costs and maximizing revenues, will comply with regulations according to their cost benefit. Will first evaluate the probability of being caught, the amount of the fine if caught and, in less institutionally developed countries,

[23] Parker, op. cit., pg. 8-12.

will evaluate the ways out of the fine, all of this balanced against the "benefits" of non-compliance. Some corporations will continue selling products that may be fatal because the cost of settling the lawsuits may be cheaper than a recall or taking the product off the market (needless to say, this is cynical irresponsibility, but played within the rules of the game). Regulation may not be enough. It will be the market for responsibility that will tip the balance of this cost benefit equation, when customers penalize the corporation with their wallets. We will discuss the potential role of the market later on.

This is not to say that there should no be regulations, but that the regulations should limited to the cases that are effective and efficient and where they can be suitably enforced. If society were to rely on the law to control all possible situations in corporate behavior, the laws and regulations would end up severely limiting the activities of the corporation, whereby society would lose a significant part of the benefits of business. Private initiative is a very powerful incentive that, as much as possible, should not be curtailed. A balance must be struck between crippling the initiative and freedom of the corporation and protecting the welfare of society.

To achieve this balance, command and control regulation is supplemented by self-regulation, international hard and soft regulation and the workings of the markets.

The most common response of industry to command and control regulations is that of self-regulation, i.e. the issuance of codes of conduct, both at the individual level and the aggregate industry level and the institution of compliance programs within the firm [24]. These self-regulations can be the result of legitimate attempts by corporations and industries to self-police their behavior and put peer pressure on each other. Many times these are attempts to pre-empt more costly regulation by governments or mitigate negative reactions from society. The following quote from a lawyer advising corporations on the discussion of pending legislation in the US Congress in early 2007 is illustrative of the reaction:

> *"Corporations should consider the extent to which they wish to become part of the legislative process. Otherwise, they may find themselves subject to compulsory CSR guidelines and left with no say or meaningful input into their own CSR programs".*[25]

The key to the value of self-regulation is the credibility of the enforcement and the willingness to be exposed to the scrutiny of stakeholders, in particular the media and civil society, through independent monitoring, certification, auditing and public reporting. There are myriads of instances of self-regulation that we do not have the space to cover. The interested reader is referred to several compendia of these codes.[26]

[24] For a comprehensive discussion of the implementation of practical strategies for self-regulation, see Parker, op. cit. For a summary of the issues, see Hess, op. cit.
[25] Michael E. Levine, "Legislating Corporate Social Responsibility", Greenbiz.com, April 2007.
[26] Abrahams, Desiree, "Regulating Corporations: A Resource Guide", United Nations Research Institute for Social Development, 2004.

With the weakness of the command and control regulation discussed above and the acceleration of multi-country operations by many corporations, there has been a need for more globalized regulations, both for multinational companies on cross-country operations and for purely national companies on a host of issues of common interest in most countries. With multi-country operations, the corporation can engage in regulatory arbitrage, i.e placing operations where regulation is weakest or where it can be overridden by regulatory capture, particularly in developing countries. This cross-border activity can escape the reach of national regulations. "*The global reach of transnational corporations is not matched by a coherent global system of accountability*" [27]. This growing power of the multinational corporation is exercised both in seeking favorable treatment in international trade treaties and in resisting attempts at international regulation.[28]

Multilateral and Civil Regulation

As a result there are a large number of soft regulations, some more binding than others. Roughly speaking we can categorize these global regulations into Multilateral and Civil Regulations. The first ones are normally the result of international treaties or conventions developed by multilateral bodies like United Nations agencies, which when ratified by member countries become international law applicable in those countries[29]. Many of these regulations cover the activities of corporations, either implicitly or explicitly, when the language refers to the application to "non-state actors". Examples of these regulations are the International Labor Organization, ILO, Declaration on Fundamental Principles and Rights at Work and the many anti-corruption conventions[30]. There are other multilateral regulations that are not ratified by countries and hence are of voluntary application. Examples are the Guidelines for Multinational Enterprises and the Principles of Corporate Governance, both developed by the Organization for Economic Cooperation and Development, OECD, and the 10 principles of the Global Compact, developed by the United Nations, but not as treaty or convention. The fact that these regulations are non-binding does not mean that they can be ignored, as stakeholders can demand compliance and future binding regulations may build upon them.

Another category of regulations is that of Civil Regulations, which are codes of behavior developed by non-governmental entities and as such are non-binding and of voluntary compliance. "*Civil regulation represents an effort to fill the governance gap between the law and the market*" [31]. These include among others, codes of conduct, reporting

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[27] UN Secretary General, 1996, quoted by Tully, Stephen, editor, "International Documents on Corporate Responsibility", Edward Elgar, Cheltenham, 2006, pag. *xx*.

[28] Significant efforts were expended in the successful blocking of the approval of the U.N. Sub-Commission on the Promotion and Protection of Human Rights resolution 2003/16 on Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights.

[29] See Medjad, Karim, "In Search of the Hard Law: Judicial Activism and International Corporate Social Responsibility", Chapter 9 in Allouche, op cit.

[30] See the website of Transparency International or U4 Anti-corruption Resource Center (www.u4.no).

[31] Vogel, D., "The Market for Virtue: The Potential and Limits of Corporate Social Responsibility", Brookings Institute, Washington, 2005, pag. 9.

guidelines, factory monitoring guidelines and certification criteria. Examples are the Clean Clothes Campaign Code of Labor Practices, applying to labor issues in the garment industry, and the Collevecchio Declaration on Financial Institutions and Sustainability developed by over one hundred advocacy groups and the Equator Principles on sustainable practices in project finance, developed by the International Finance Corporation with major international banks. These non-binding regulations are used by civil society organizations to pressure corporations into compliance with social responsibility principles [32].

> *"Resort to guidance offered by international standards is accordingly the most defensible position. International norms enjoy the authority of universal consensus by the international community including persuasive moral weight free from parochial national law. Reputable companies cannot fail to observe the origins of international agreements even where voluntary…………..It could be suggested that several instruments, even if applicable to corporations do not constitute law per se. However it is characteristic of the international lawmaking process that formally non-legally binding materials (so called "soft law") subsequently undergoes a process of "hardening"".* [33]

One of the latest attempts at soft-regulating CSR practices is the European Parliament Resolution urging the European Commission to extend legal obligations in relation to corporate accountability, such as directors' duties, foreign direct liability and environmental and social reporting [34].

A good illustration of the complications of command and control regulation and of soft regulation is the attempt by the International Standards Organization, ISO, which develops hard standards for materials, engineering processes and the like, to develop a standard for Corporate Social Responsibility. In the process of development it was decided that a certifiable standard was not feasible, given the myriad of possible interpretations and the difficulty of regulating behavior and in the end decided to develop non-compulsory guidelines. In their own words,

> "*There is a range of many different opinions as to the right approach ranging from strict legislation at one end to complete freedom at the other. We are looking for a golden middle way that promotes respect and responsibility based on known reference documents without stifling creativity and development*" [35].

Regulation, responsibility and business value

[32] For a very comprehensive, yet not exhaustive, compendium of international instruments and treaties affecting corporate responsibility, see Tully, op. cit and Abrahams, op. cit.
[33] Tully, op. cit., pg. *xx.*
[34] Resolution PE 387.010, of 13 March 2007.
[35] Work is expected to be completed by 2008 as ISO 26000 and the latest developments can be seen in the working group website www.iso.org/sr.

Given the limitations and inefficiencies of devising laws and regulations of business behavior, it does not seem necessary to ask the question: **Should** corporations go beyond the law? If the law ends up being at a rather minimum level, because of the need to preserve business flexibility, the significant lobbying by corporations and their industry associations, and because of the costs of overregulation, it should not be necessary to ask them to go beyond the law, but they should offer to do so, voluntarily. This is the essence of Corporate Social Responsibility: a win-win situation whereby the corporation does not have to bear the costs of overregulation and in return performs its activities in a responsible manner. Both sides of this equation, less regulation, more responsibility, can enhance society's welfare. Granted, not all managers play by these rules, and it is here that the market must step in, as we discuss later on.

Yes, corporations should go beyond the law. The question now is: **Can** corporations, legally, go beyond what is required by law or would they be damaging the interests of shareholders if they did? Again a quote from Milton Friedman can illustrate: "*…a manager that spends money on environmental protection beyond what the law requires is wrongly spending shareholders money*"[36]. It is not that we are picking on Mr. Friedman, it is that his views are shared by many, many managers. These managers would be wrongly spending shareholders money if and only if the corporation controlled the market and the government, i.e a monopoly in an institutionally underdeveloped country. Why bother about the environment under these conditions?

There should be little discussion that managers can and should go beyond the law if such activities can be proven to lead to profits, or as we prefer to state it, when they increase the value of the corporation[37]. The apparently subtle difference between profits and business value is the source of significant misunderstanding as to what constitutes legitimate activities for the corporation. By firm value we do not mean current reported profits or the price of shares, we mean the long-term value of the corporation. Here are two very important differences in the characteristics of what are considered responsible activities. One is the time horizon over which benefits from these activities is considered and the other is the valuation of these benefits. Some will take a very stringent position, influenced by accounting or by stock market valuations and will only consider as legitimate those activities that can be quantified and shown to affect reported earnings or the stock price over short periods of time (recall the impact on stock options and the short time horizons of most managers). For us, the definition of the impact on the value of the firm must consider a considerable longer period and include even those activities whose impact cannot be quantified, like the impact on reputation. In economic terms, we refer to this as the present value of all future earnings (including the impact of intangible assets), discounted at a rate the takes into account the lower level of risk that some of these activities will bring (for instance, investments in reduction of potential environmental liabilities) [38].

[36] Quoted in Hess, op. cit., pag. 155.

[37] Elhauge correctly points out that only those activities that voluntarily go beyond the law *in some socially desirable way* can be called corporate social responsibility. Elhauge, op. cit., pag. 16.

[38] See Michael C. Jensen, "Value Maximization and Stakeholder Theory", Harvard Business School Working Knowledge, July 24, 2000.

Going beyond the law and business value

While there should no discussion that managers can go beyond the law if the responsible activities lead to profits, there is more controversy as to what activities do lead to profits. For example, the firm may invest in environmental protection. Under the traditional approach this will be seen merely as an expense (recall the previous Friedman quote on environmental "expenses") that will reduce the value of the corporation, unless there is an increase in revenues or a reduction of risk. This increase in value may come from avoided future expenses, be it in the form of avoided actual costs or reduced litigation or in a better preference by the market of the corporation products or even in the unquantifiable increase in reputation and goodwill. In this case, we prefer to use the word investment instead of expense. As the market may not recognize those activities if they do not have an impact on reported earnings or the stock price, it is incumbent upon the firm to ethically inform the market of those activities. Managers must inform the markets of these activities and the expected benefits, quantifiable or not. And the information is not for the purpose of influencing stock prices, it is truly to ethically inform the market.

This approach to responsible activities also has the virtue of applying to corporations whose shares are not traded in the markets, either because they are privately held or because the stock market is not well developed. For instance, in Latin America stock market valuations may not be reliable as there are less than 1,600 corporations with listed stocks, of these less than 100 trade frequently and in all the major stock markets, the bulk of trading volume is in less than 10 stocks. Millions of other businesses do not trade in any exchange. Under these conditions we cannot rely on stock market valuations to guide responsible behavior[39].

But one question still remains: Can the corporation go beyond the law, even if it **does not** lead to an increase in value?[40]

> "*Despite contrary assertions by advocates of a profit-maximization duty, the law has never barred corporations form sacrificing corporate profits to further public-interest goals that are not required by law*" [41]

To support the ideas that the law does not cover all ethical activities, and that the activities of the corporation may not all be profit maximizing, it may be illustrative to consider the American Law Institute's Principles of Corporate Governance[42]:

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[39] There have been some attempts at promoting responsible behavior in stock markets in developing countries, mostly concentrated on issues of corporate governance. See for example the "Novo Mercado" in Brazil, at www.bovespa.com.br.

[40] The remainder of this section draws on Elhauge, op. cit. and the comments on that paper by Donohue, John J., "Does Greater Managerial Freedom to Sacrifice Profits lead to Higher Social Welfare?", and Roe, Mark J., "On Sacrificing Profits in the Public Interest", in Hay et. al. op. cit.

[41] Elhauge, op cit., pag. 23.

[42] American Law Institute, "Principles of Corporate Governance: Analysis and Recommendations", 1994.

> *"Even if corporate profit and shareholders gain are not thereby enhanced, the corporation, in the conduct of its business: ……. (2) May take into account ethical considerations that are reasonably regarded as appropriate responsible conduct of business; and (3) May devote a reasonable amount of resources to public welfare, humanitarian, educational and philanthropic purposes."* [43]

While admitting that this is merely an opinion and it is not legally binding, a majority of U.S. States corporate constituency statutes explicitly allow managers to consider non-shareholders interests including stakeholders like employees, customers, suppliers, creditors and society at large[44]. It must also be said that this discretion is not unlimited and the interest of the corporation must be the overriding consideration, but without the need of having to prove that they lead to increased profits. Needless to say, none of this means those managers have the duty or obligation to engage in these activities, they have the option. Fortunately there are control mechanisms in the corporation and in the market that would prevent managers from abusing this discretion. Either the Board of Directors, or the shareholders meeting or the market for corporate control (to be discussed later) would exercise some restraint.

> *"Federal law also seems to recognize a discretion to sacrifice profits to further public-interest objectives because rule 14a-8 (of the Securities and Exchange Commission) allows shareholders proposals on social responsibility issues* ***significantly related to the corporation business****, (emphasis added) even if not motivated by profit-maximizing concerns…. ……..includes proposals whose significance in relation to corporate business is ethical rather than financial."*[45]

That these activities that may be profit sacrificing must be significantly related to the corporation business also means that they cannot be done for the purpose of personal gain of the managers or related parties. This last is the case of many philanthropic activities done mostly for enhancing the reputation of some managers. Although the corporation may benefit from the exposure, many times the motivating factor is alien to the business. This reinforces the concept expressed before that even philanthropy should be done in areas related to the corporation business.

In light of the difficulties of interpretation and the variety of opinions, it is not surprising that courts would prefer to leave decisions to the good judgment of managers. Roe, in his comment on Elhauge, summarizes the argument thus:

> *"Gaps in rules exist and will persist because regulators are not omniscient. If corporate players could fill these gaps voluntarily, even while sacrificing profits, the public interest could be furthered. Corporate law allows managers to do so*

[43] Cited in Elhauge, op. cit., pag. 24.
[44] Nevertheless, the state of Delaware where a large number of firms are incorporated still holds a shareholder wealth maximization position in its statutes.
[45] Elhauge, op. cit., pag. 27.

(1) indirectly, through the business judgment rule, and (2) directly and explicitly, once we wind through the doctrinal maze" [46]

One author, to avoid having to have this discussion suggest changing the business corporation act, or the commercial codes in civil law countries, to add that the interests of the corporation and of the shareholders should be pursued "*….but not at the expense of the environment, human rights, the public safety, the communities in which the corporation operates or the dignity of its employees*" [47]. If this were politically feasible, if would solve a lot of problems but most likely the discussion would shift to what actions are done at the expense of those affected parties and to what extent have they been affected. We would still have to rely on good judgment.

In summary, the case for the corporation engaging in social responsibility activities, if they contribute to enhance the value of the firm is beyond discussion. What has been the source of discussion is the meaning of "enhancing the value of the firm". For some purists, it would mean only activities that increase reported profits in the financial statements or the price of the shares in a quantifiable and direct way. Our position is that this is too stringent an interpretation and the goal should be activities that enhance the long-term value of the firm, whether quantifiable with current accounting practices of economic measurement tools or not, in the best judgment of the manager. The discussion has pointed out that, within discretion, managers can also engage in socially responsible behavior that does not contribute to the value of the firm, and may even be profit sacrificing, provided that is in for the benefit of society, not personal, and is significantly related to the corporation business.

From the preceding discussion we conclude that profits are not a necessary condition for engaging in responsible behavior. Nevertheless, as business managers may not agree with the preceding arguments and do have a bias towards profit maximization, responsibility may be better accepted if it is couched in terms of enhancing current and/or future profits, value or competitive position, i.e if the business case for corporate responsibility can be made it will be easier for managers to engage in responsible behavior.

E. Law and regulation in developing countries

While every developing country has different legal structures, even different legal systems, it will impossible to generalize. As an example we can use the countries of Latin America that at least share the same legal system, civil law. In general corporate law is composed of the civil code, the commercial code and some special laws on business societies and on capital market laws for those corporations issuing securities. None of these instruments contains regulations as to the purpose of the societies or the firm, leaving any details to the bylaws establishing the firm. Where there are some references to the responsibilities of management, they tend to be vague and limited to the prescription of managing the affairs of the firm with honesty and within the law. There

[46] Roe, op. cit. pg.88
[47] Robert Hinkley, "How Corporate Law Inhibits Social Responsibility", Business Ethics, Jan-Feb. 2002.

does not seem to be any obligation to maximize profits. Nevertheless the influence of US legislation, of US business and economics schools and of US multinational corporations may bias the behavior of local managers. So long as they operate within the bylaws of the firm and the constraints related to their performance contracts, managers are legally free to pursue the management of the firm as they see fit. Shareholders are the ones that either developed the bylaws of the firm upon incorporation or they bought into it knowing the existing bylaws. There do not seem to be legal constraints to engage in activities that pursue the social welfare, obviously exercising good business judgment.

In terms of regulation, in developing countries the element conditioning responsible behavior does not seem to be the need to temper regulations and their enforcement to allow for corporate flexibility, but rather deficiencies in setting and enforcing regulations. In general, the capacity to produce regulations tends to be weaker and even more reactive, to correct a problem rather than anticipate it, than in developed countries. This has the consequence that some areas that do require regulation may not be properly covered. For instance environmental and labor regulations would tend to be weak.

In developing countries there is a controversy regarding the extent of regulation needed. For some, regulations should be as stringent as those in developed countries, some go even as far as requiring those standards in free trade agreements[48]. For others regulations must be adapted to the conditions prevailing in the country, not only in terms of capacity to enforce but also in terms of the impact on overall welfare. Some damage to the environment may have to be tolerated if it leads to overall increases in the quality of life. The rules for child labor may have to be tempered in areas where doing otherwise may lead children to worse activities or where families cannot cope without the extra income. Lower ages may have to be tolerated in exchange for compulsory participation in schooling and health services.

> *"…….it is inappropriate to expect those in the developing world, where incomes are anywhere from one-tenth to one-hundredth of those of the United States or western Europe, to demand the same standards that we in the developed world enjoy today. Incorrectly assuming that they do would lead firms to spend too much money on environmental and other protections (strange as that may seem to some) and too little on wages and new job creation"*[49]

This a very complicated issue, as some countries may be tempted to lower standards, a race to the bottom, in order to attract foreign investment, for instance. Hopefully, the markets for responsibility, to be discussed below, can exercise some control over this.

Furthermore, the capacity to enforce the regulations seems to be the weakest point in developing countries, both in terms of technical expertise and in consistency and continuity of effort. In some countries the problem of regulator capture (ability to control the regulator) is acute, as the difference in income, access to resources and access to

[48] Sometimes more as protectionist measures than moralistic purposes.
[49] Portney, P.R., "Corporate Social Responsibility: An Economic and Public Policy Perspective", in Hay et. al. op. cit., pag. 124.

information is rather large between regulator and regulated. Also, as there is a scarcity of qualified personnel, regulators either come or expect to go to work for the regulated industry, losing independence. This may also happen in developed countries, although to a much lesser extent.

Under these conditions, there is an even greater need to supplement these deficiencies with a more proactive role of stakeholders, as will be discussed below. This is so in the case of developed countries because of regulatory restraint and in the case of developing countries because of regulatory failure.

These issues are even more important for developing countries given the broader role need for the corporation in society, not only in the production of goods, services, employment, taxes, etc., but also when covering government failures, like the provision of public services of basic health and education.

F. Markets for responsibility

Can markets stimulate responsible behavior? In general the answer is obviously yes, but the effectiveness of the market will depend on the existence of many conditions. The model of competitive markets assume that individuals and firms pursue their self interest, in the first case maximizing their utility and the second case maximizing profits, in both cases, without regard for others. All actors are assumed to have perfect information regarding demand, supply and prices, there are myriad of buyers and suppliers, and none of them is big enough to influence quantities or prices and the benefits and costs are borne exclusively by the buyers and sellers. The existence of these markets has significant benefits in efficient allocation of scarce resources, incentives for productivity and provides freedom of choice.

But, even if these conditions were met and markets were perfect, would they guarantee responsible behavior?: only if buyers and sellers were also concerned for the welfare of others and acted accordingly. If they were only concerned about themselves, individually, they would like for instance, cheap prices, even if it meant exploiting labor or destroying the environment, provided it did not affect them in a tangible way. Can the markets be moral and promote responsible behavior? [50] They can and the key question is how can markets be used to enhance responsible behavior.

One approach to the issue of corporate responsibility is to assume that markets are perfect and as such they should be left to their job and only if market failures were found would specific regulations be enacted to correct them. For some, departures from the perfectly competitive model are the rule, for others they are the exception[51]. Another approach is to start with the assumption that they are not perfect and design regulations to ensure a

[50] See a very entertaining and lucid debate between a liberal economist and a conservative journalist in Rebecca M. Blank and William McGurn, "Is the Market Moral? A dialogue on religion, economics and justice". Brookings Institution Press, 2004

[51] Two Nobel Prize winners in economics are on opposite sided of the argument: Milton Friedman and Joseph Stiglitz.

level of responsible behavior that is non-negotiable, basic, that all firms mush comply, but at a level that preserves the freedom of the firm to contribute to the efficient production of goods and services that society demands. And then rely on the markets to fill the gaps left by regulation. We favor this second approach, not only because observation of everyday life shows extensive market imperfections, but because we are also interested in responsibility in developing countries where there is no doubt that markets are mostly imperfect. In all cases, especially in developing countries, care must be taken not to substitute market failure[52] by government failure.

One of the grossest violations of perfect economic markets it that of prices not reflecting all costs. Markets need prices to clear, and all actors act on those prices. But a very important question is do markets price social and environmental costs properly[53]. The answers in most cases is no, they do not. Based on the accounting and economic principles mentioned above, prices in market transactions tend to include only incurred costs in the accounting sense and opportunity costs in the economic sense, but they will not include social and environmental costs that are not accounted for. For instance, the fact that wages are below what they would be in a competitive market for labor or the fact that production costs do not include the costs to society of pollution or the emission of greenhouse gases. How can we make corporations internalize these costs? One way is make all markets perfect, the market for labor, the market for air, and so on. While this is utopian, what can we do in the meantime? One way if to beef up government regulation to counteract these market failures, as discussed before, the other is to develop the market for responsibility.

To avoid stifling business with overregulation and to supplement fair government regulation we propose the actions of ten drivers in the **market for responsibility**[54] (which go beyond the more limited term of civil regulation), to counteract economic market failures. Some call this social regulation or regulation by society. We prefer the term “market” which puts a positive spin, not the negative connotation of “regulation”:

> *Enforcement of laws and regulations*: As pointed out before, laws and regulations may be necessary conditions but they are not sufficient. Institutions than enforce the regulations in a way that deter and correct irresponsible behavior are key.

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[52] Economists normally identify four types of market failure: Externalities, public goods, natural monopolies and imperfect information. Externalities were defined in footnote 15. Public goods are goods for which prices cannot properly be charged, for instance national defense. Natural monopolies are goods or services for which no competition is feasible or economically efficient (technology is contributing to the elimination of what one were considered natural monopolies, like electricity distribution). Imperfect information refers to the fact that market participants rarely have all the information needed for making decisions. In the discussion that follows we cover all these issues explicitly of implicitly, as they have the potential to stimulate irresponsible behavior.

[53] Even the defender of competitive markets, The Economist, admitted that *“…prices do not reflect true social costs and benefits…”* but goes on to say that “…*The question is whether false prices are causing big economic mistakes…*” Notice that the only mistakes that seem to matter are “economic” mistakes. The Economist, op. cit., pag. 16.

[54] We include a broader conception for this “market for virtue” than Vogel does.

Active civil society: To supplement the oversight of regulators and to induce responsible behavior that may have not been regulated, strong civil society institutions may be needed. These include institutions that developed standards of reporting and in general the activities of civil regulation, mentioned before.

Developed financial markets: Financial markets can be drivers of responsible behavior but can also be deterrents. On the positive side, if banks, insurance companies and shareholders, for instance, are willing to lend at lower rates, charge lower premiums or pay higher prices for shares of responsible firms, they will be sending the right signals. And this need not be for altruistic reasons as responsible firms may be less risky, less subject to potential liabilities, or be able to capture new markets that are being opened for responsible products and services, that would make banks and firms more valuable. On the negative side is greed. Firms that devote resources to invest (invest, not spend) in responsibility with the hope of long-term gains may have short-term costs that make them a prey in the takeover market. With today's private equity insatiable appetite, any responsible firm that does not maximize the value of its shares is at risk of a takeover, going private, changing managers and taking the firm public again for huge gains by the raiders (the market for corporate control [55]). To some this introduces discipline in the markets. Unfortunately it may have the effect of stimulating irresponsible behavior [56]

Educated consumers and buyers: Consumers and buyers are the key actors in the markets for responsibility, as all firms have to sell goods and services and are subject to the desires of this group. Nevertheless, even if consumers and buyers wanted to reward responsible behavior they may not have access to information on the quality of the practices of firms. Most consumers say that they would buy and even pay a premium for responsible firm's products, but when asked if they did buy those products, most will tell you they do not know if the products bought were produced by responsible firms. Only in very special cases is that information available. This is the case of large firms selling massively into the market, which are under the scrutiny of civil society organizations and their cases are well publicized. Corporations like Nike, McDonalds or Wal-Mart are fully aware of the potential of consumer pressure, but a firm manufacturing brakes for railroads may escape scrutiny. Large buyers, which in turn are subject to consumer pressure, may exert pressure on their suppliers, even if these suppliers are unknown to civil society or consumers. This is case of the improvement in working conditions in sport goods manufacturing in developing countries due to the pressures of consumers and civil society on firms like Nike.

Activist media: Internet and the traditional media can be drivers of responsibility, educating and informing consumers and society at large of the practices of corporations. With the spreading of the Internet, the speed and scope of reporting

[55] Roe, op. cit., pag. 91.
[56] This comment is not intended to be an indictment on private equity, as there have been some takeovers intending to capitalize on the potential gains for corporate responsibility.

has increased dramatically and it is becoming a force in reporting and eliciting responsible behavior. Needless to say it can be misused and these media must also be subject to the monitoring and enforcement to prevent irresponsible practices.

Monitoring and reporting institutions: As in the media, specialized institutions that monitor and report, for instance working conditions, are important to detect, highlight and, most importantly, deter, irresponsible behavior. There are now a growing number of institutions that certify the responsible practices of producers, whose certification is needed to access many developed markets[57]. Again, these institutions must also behave responsibly as they are not exempt.

Activist employees: From the inside, without having to wait for the outside market to exert pressure, activist employees and middle management can induce and implement responsible practices, where they are most effective, from within.

Committed top management: As with employees, but in a separate category, top management can and must exercise a leadership position. It is extremely unlikely that a responsibility program will work without the support and commitment of top management. Needless to say they need not only the moral qualities but also the right incentives to behave responsibly. As was discussed above, there are significant market pressures that conspire against their responsible behavior.

Exposure to globalization and competition: Firms that are exposed to globalization may experience the pressures of international markets and of international civil society. In order to sell into some markets, particularly in Europe, it is becoming increasingly important to be and appear to be responsible, sometimes having to have certification from some independent monitoring institution. Global markets can act as driver of responsibility rewarding firms with better prices and access to other markets (for instance, Fair Trade coffee in European markets). Exposure to competition can also be a driver of responsibility. The extreme opposite case is that of a monopoly that even if regulated on responsibility issues, would have very little incentive to go beyond the law. If consumers have choices, through competition, they may exercise those choices and favor responsible products. But as in the case of financial markets described above, competition can also be detrimental for responsibility. If competition is strong and consumers do not have a direct impact (say in wholesalers or industrial products) or are not well informed, competition can lead managers to cut costs and reinforce the short-term vision of maximization of profits and reduce investment in responsibility that while increasing the value of the firm, may have short term costs, impacting the competitive position. On the other hand, exposure to competition can help to curb managers' excessive generosity to engage in social or philanthropic activities that are none of the corporation's business.

[57] Examples are the Forest Stewardship Council, FSC, in wood, Worldwide Responsible Apparel Production, WRAP, in the garment industry and Fair Trade in many products, for instance in coffee.

Needless to say, these markets for responsibility are rather underdeveloped, even in developed countries[58]. Some of the drivers mentioned above are more developed than others, but it is unlikely that in the real world they would be sufficiently developed elicit responsibility in the corporate world. If one considers the relatively underdeveloped situation of these markets in developed countries, there is little need for a detailed discussion of their situation in developing countries.

The imperfect markets that operate all over the world bring the benefits of economic efficiency but also bring unaccounted costs to society. A very difficult tradeoff must be achieved between these costs and benefits through the operation of government regulation and the market for corporate responsibility. This tradeoff in developing countries may lean even more towards the side of sacrificing economic efficiency in order the enhance the welfare of the less well-off, which may come back to benefit the company, through its operation in a more developed society.

G. Conclusion

From the preceding discussion it should be clear that the corporation can and must go beyond the law, as it is very likely that the law will not be able to cover all aspects of responsible behavior. And while these responsible actions should enhance the value of the firm, measured over the long run and including all costs and benefits, the firm may engage in activities where this relation is not clear, provided they are significantly related to the corporation's business.

How can the corporation be responsible if doing so involves voluntary measures? We are confronted by a series of imperfect tools to foster responsibility. Laws and regulations alone cannot fully control corporate behavior to the extent that society may like, and in any case it would be totally impractical, as the rules and regulations would have to be so constraining to encompass all possible cases, that they would impose extreme restrictions to the operation of corporations that society's welfare would be severely limited.

Complementary measures to a baseline level of compulsory and voluntary regulation would be the operation of the market, i.e. stakeholders exercising their rights, shareholders demanding responsible behavior of managers, increasing demand, and hence prices, of shares of responsible corporations, consumers to favor or shun products according to the responsibility of the corporation, better employees choosing to work and work harder for responsible firms, suppliers and financial institutions refusing to supply or charging prices reflecting the responsibility of the corporation and so on with other stakeholders. This market for responsibility is still imperfect and in many countries very underdeveloped.

The market may even send perverse signals, as in the case of the market for corporate control, where there is extreme pressure on managers to maximize earnings, worse, short term share price, lest they be bought out and expelled form their positions. Competition

[58] Most of the Vogel book cited above is devoted to showing the underdevelopment of this market.

policy, that has as its goal the promotion of society's welfare, stimulating competition to enhance economic efficiency, may promote the maximization of short term benefits, undermining the efforts of managers that are responsible, pursuing benefits for the corporation with a long term view. Needless to say, responsible managers, using the discretion afforded them, could counter many of these imperfections or restrictions, but they too face pressures for short-term results. A judicious blend of regulations and market forces, including responsible managers, can promote responsibility.

The line between law and market will be in a different place in every country and sector of the economy, depending on the relative development of each. Many times, particularly in developing countries, there will continue to be a gap between law and markets, a gap that stakeholders must try to fill by expanding the scope of either law or market or both. The relative ingredients will be dictated by the relative development of the rule of law and markets. As in any endeavor, good judgment, a scarce commodity, is key.