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Navigating Corporate Social Responsibility

By Ben Bates

When business school graduates enter the workforce today, they quickly discover that they have traded introductory economics courses for a world increasingly confused about the purpose and responsibilities of corporations. Just last August, the Business Roundtable (BRT) issued a widely publicized statement reversing decades of prior statements on corporate responsibility.[1] High-powered CEOs—including Jamie Dimon of JP Morgan Chase and Co., Mary Barra of General Motors Company, and Jeff Bezos of Amazon—unanimously proclaimed their commitment to "deliver value to all of [their stakeholders]," not just to their shareholders.[2]

The Business Roundtable's sudden reversal on corporate governance doctrine, confusing enough on its own, unleashed a flood of perplexingly contradictory reactions. Martin Lipton—a founding partner of the law firm Wachtell, Lipton, Rosen, & Katz and specialist in mergers and acquisitions—along with two other attorneys from his firm, wrote that the BRT's statement was a "milestone" in the "evolution of corporate governance."[3] On the other hand, Nobel laureate Joseph E. Stiglitz openly questioned whether the statement was "merely a publicity stunt."[4] Harvard Law School professors Lucian Bebchuk and Roberto Tallarita even went as far as calling the Roundtable's declaration an "illusory promise" that might "impose substantial costs on shareholders, stakeholders, and society at large."[5]

With the debate on corporate responsibility far from settled, future business leaders will need to defend their decisions to critics with a variety of ideological perspectives. In order to successfully navigate today's corporate landscape, graduating business students should understand the basics of both the shareholder and stakeholder primacy theories of corporate responsibility. They must also understand when a company should take responsibility for its stakeholders and when it should not.

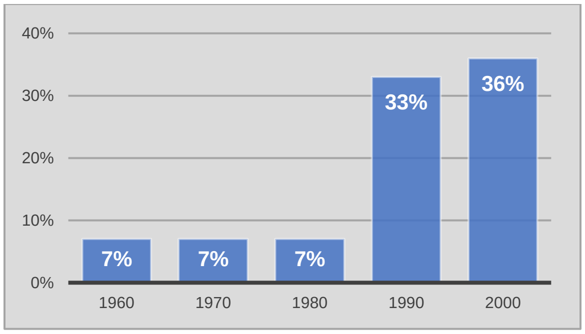
Shareholder Primacy

Milton Friedman, a Nobel Prize-winning American economist, was an early champion of the theory of shareholder primacy. Friedman based his case for shareholder primacy on the idea that shareholders employ directors and executives as agents to run the shareholders' business. He argued that under this framework, corporate directors and executives have the responsibility to act in their "employers'" best interests, which usually means "[making] as much money as possible while conforming to the basic rules of the society."[6]

Friedman criticized the idea that business leaders should use corporate profits to pursue social agendas. He viewed corporate leaders spending shareholders' money on social projects without their input as a modern form of "taxation without representation." Instead, Friedman insisted that shareholders should be allowed to decide how to spend their own money.[7]

Current proponents of shareholder primacy Lucian Bebchuk and Roberto Tallarita have expanded Friedman's arguments by pointing out that the shareholder primacy theory encourages managerial accountability. They warn that relaxing the clear profit objective of shareholder primacy "[insulates] corporate leaders from shareholder pressures and [makes] them less accountable."[8]

Figure 1: Dow Jones Index Companies that List Shareholder Value Maximization as an Objective

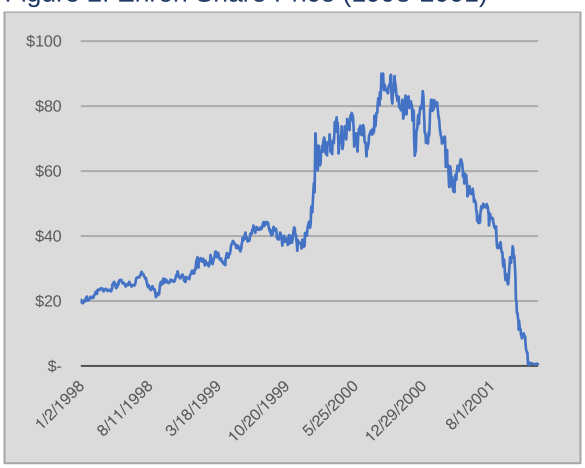


Source: Hart and Zingales, "It's time."[9]

Stakeholder Primacy

Based on Milton Friedman's and others' arguments, shareholder primacy quickly became entrenched as the reigning corporate governance philosophy in the United States (see Figure 1). However, business failures and vocal critics gradually began to chip away at the theory's dominance.

Figure 2: Enron Share Price (1998-2001)



Source: Douglas Linder, "Enron Stock Price."[10]

For example, Enron, a multibillion-dollar energy company, spectacularly collapsed in 2001 and cast a dark shadow over the shareholder-obsessed business community (see Figure 2). Enron's fall was caused in part by a mindless pursuit of short-term profits, which cast doubt on the wisdom of enshrining profit maximization as a firm's sole objective.[11]

Additionally, Oliver Hart, a Harvard economist, and Luigi Zingales, a finance professor at the University of Chicago, recently pointed out that Milton Friedman's case for shareholder primacy was based on a flawed assumption. Friedman assumed that there would be "no loss of efficiency" if shareholders, rather than corporations, spent money on social projects.[12] Hart and Zingales identified cases where this assumption breaks down, noting, for example, that "undoing pollution is more expensive than curbing it to begin with."[13]

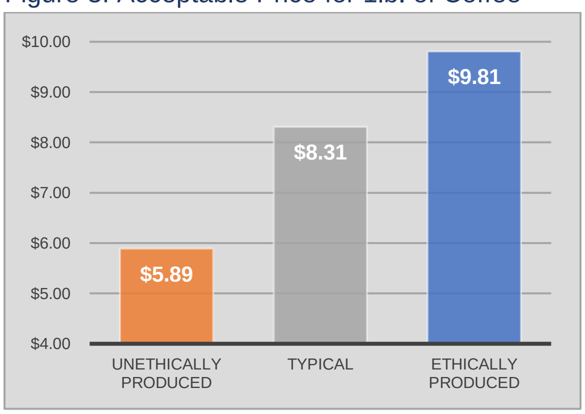
Hart and Zingales's work supports a stakeholder primacy approach to corporate governance, which holds that businesses should maximize collective welfare by focusing on the needs of a variety of stakeholders. This view gradually gained popularity within the United States business community until it was unanimously endorsed by Business Roundtable CEOs in August 2019.[14]

When to Focus on Stakeholders

A growing body of evidence suggests that businesses often produce superior returns for their shareholders when they treat other stakeholders well, including employees, suppliers, customers, and members of the communities in which the businesses operate. For future business leaders, this means that many stakeholder-focused strategies are advisable *regardless* of the ideology used to evaluate them.

In an article published in the MIT Sloan Management Review titled "Does It Pay to Be Good?," Remi Trudel and June Cotte from the University of Western Ontario's Richard Ivey School of Business presented research showing that customers are willing to pay more for coffee produced by a company that engages in fair trade practices.[15] They also showed that, inversely, customers punish companies that participate in unfair or unsustainable production methods (see Figure 3).[16]

Figure 3: Acceptable Price for 1lb. of Coffee



Source: Trudel and Cotte, "Does It Pay?"[17]

In addition to increasing customer willingness to pay, companies that treat stakeholders well lower their risk of facing costly litigation. In today's climate, even the perception that a company has mistreated a key stakeholder can trigger expensive legal proceedings. For example, in the past 18 months, Amazon and Uber both paid millions of dollars to settle lawsuits over alleged employee mistreatment.[18] In Amazon's case, attorney fees alone totaled nearly $3.7 million.[19] By consistently and openly protecting employees and other stakeholders, tomorrow's business leaders can reduce their corporations' legal costs and increase returns to shareholders.

Figure 4 lists a series of questions that corporate leaders can use to evaluate stakeholder-focused policies. If leaders can answer "Yes" to any of these questions with regards to a specific policy, then they can likely defend that policy from both a shareholder and stakeholder primacy perspective.

Figure 4: Questions for Evaluating Policies

1. Will this policy increase our customers' **willingness to pay**?
2. Will it decrease the **probability of expensive** litigation?
3. Will it increase community visibility and **grow our customer base**?
4. Will it build **trust and cooperation** with our suppliers?

When *Not* to Focus on Stakeholders

Unfortunately, not all corporate programs designed to provide value to stakeholders increase shareholder returns. For example, in addition to showing that customers will pay more for ethically produced goods, Trudel and Cotte's study showed that customers will *not* pay more for goods produced by *extra* ethical companies.[20] In other words, they discovered that "once a certain threshold is attained, additional ethical acts . . . will not change consumers' willingness to pay."[21] ("Ethical acts" in this case referred specifically to environmentally conscious production techniques.)[22]

This reality is problematic for situations in which corporate action would benefit society as a whole but decrease shareholder profits. Some proponents of stakeholder primacy might trust business leaders to put society first in these scenarios; however, Lucian Bebchuk and Roberto Tallarita have argued that business leaders will not prioritize social projects if they do not pay.[23]

In a study published after the Business Roundtable endorsed stakeholder primacy, Bebchuk and Tallarita revealed empirical evidence that, in negotiations, "corporate leaders have bargained for benefits to shareholders as well as for themselves but have made little use of their bargaining power to secure protections for stakeholders."[24] Even worse, Bebchuk and Tallarita produced these results using data from states with constituency statues, which protect business leaders who take non-shareholder interests into account in business decisions.[25]

Rather than simply relying on corporate benevolence to protect stakeholders, Bebchuk and Tallarita recommend implementing "policy reforms" and "regulatory intervention."[26] This approach places an important responsibility on current and future business leaders. Leaders who are aware of business incentives and who care about societal welfare need to be active in promoting reforms that "[address] corporate externalities and [protect] corporate stakeholders."[27] By actively promoting positive policy adjustments, these leaders will accomplish more to protect stakeholders than they ever could by relying solely on self-interested managers.

Conclusion

Today, academics and business leaders often hold deeply polarized and conflicting views on corporate responsibility. While some individuals maintain that corporations exist solely to increase shareholder wealth, others argue that companies should use their considerable influence to protect the welfare of a variety of stakeholders.

In spite of this confusing array of credentialed voices, new entrants into the corporate world can still learn to deftly navigate tough decisions about corporate social responsibility. By gaining a sound understanding of both the shareholder and stakeholder primacy theories of corporate governance, future leaders can learn to identify situations where corporations should or should not prioritize stakeholder welfare. This will prepare them to powerfully advocate for effective corporate programs and meaningful policy reform, leading the economy into a new age of fair and sustainable advancement.

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