

# **Social Responsibility of Business Beyond Profits**

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# Firms Spend a Lot of Money on Corporate Social Responsibility... Why?

## Economics' View of CSR – “The Friedman Doctrine”

155 US firms reported corporate philanthropy totaling \$11.5 billion in 2007 – *Giving in Numbers, 2008*

“The manager is the agent of the individuals who own the corporation... and his primary responsibility is to them.”

“Insofar as his actions in accord with his ‘social responsibility’ reduce returns to stockholders, he is spending their money.”

“The stockholders... could separately spend their own money on the particular action if they wished to do so. The executive is exercising a distinct ‘social responsibility,’ rather than serving as an agent of the stockholders... only if he spends the money in a different way than they would have spent it.”

– *Milton Friedman, “The Social Responsibility of Business is to Increase Profits.” 1970*



Indirect Profit Maximization  
*Differentiation – Porter & Kramer, 2002*

Offset Private Shareholder Contribution  
*“Warm Glow” – Zivin & Small, 2005*

Manager Discharges Own Social Responsibility  
*Harmless to shareholder – Baron, 2007*

Management Should Work for Society at Large  
*Survey – Garriga & Mele, 2004*

# Firms Spend a Lot of Money on Corporate Social Responsibility... Why?

Economics' View of CSR – “The Friedman Doctrine”

Would a manager acting purely in  
*shareholders' interest*  
ever undertake CSR that left them  
*less money?*

# Firms Generate Profits AND Externalities

## – Shareholders Feel Both, Society Only the Latter

### Formal Model

**Empirical Inspiration:** Absentee managed plants in the US emit more toxins, on average, than other plants – *Grant, Jones & Trautner 2010*

→ *Firm impacts on public goods, from which managers and owners derive benefit, influence the social behavior of the firm*

Shareholders enjoy **consumption** AND **private benefit from public goods**

- E.g. Shareholders enjoy wine AND well-balanced greenhouse gases

Firm **generates profits** AND a **negative externality**

- E.g. The firm emits CO<sub>2</sub> for every widget produce

**First, the manager *maximizes shareholder utility* by...**

1. Choosing an optimal production quantity
2. Contributing to the public good (E.g. The firm plants trees)
3. Distributing remaining profits to shareholders

**Then each shareholder *maximizes her own utility* by...**

1. Contributing to the public good (E.g. She donates to the Sierra Club)
2. Consuming remaining dividends (E.g. She buys and drinks a fine Cabernet)

# Managers Contribute more Public Goods than Decentralized Shareholders Would and Shareholders are Happier

## Proposition 2 (Centralized Provisioning)

**Lemma 1:** *When shareholder contributions are interior, manager contributions per shareholder crowd out private contributions one for one.*

Similar neutrality results well known in public economics (Bergstrom, *et al.* '86)  
Taken alone this suggests no benefit from manager contributions to the public good: firm contributions are exactly offset by reductions from shareholders

# Managers Contribute more Public Goods than Decentralized Shareholders Would and Shareholders are Happier

## Proposition 2 (Centralized Provisioning)

**Lemma 1:** *When **shareholder contributions are interior**, manager contributions per shareholder crowd out private contributions one for one.*

Similar neutrality results well known in public economics (Bergstrom, *et al.* '86)

**But when incentives are aligned the assumption of the lemma is FALSE...**

**Intuition:** Every shareholder is playing a prisoners' dilemma – each wishes to shirk if the other contributes. Manager can act as a commitment device.

### Example Prisoners' Dilemma

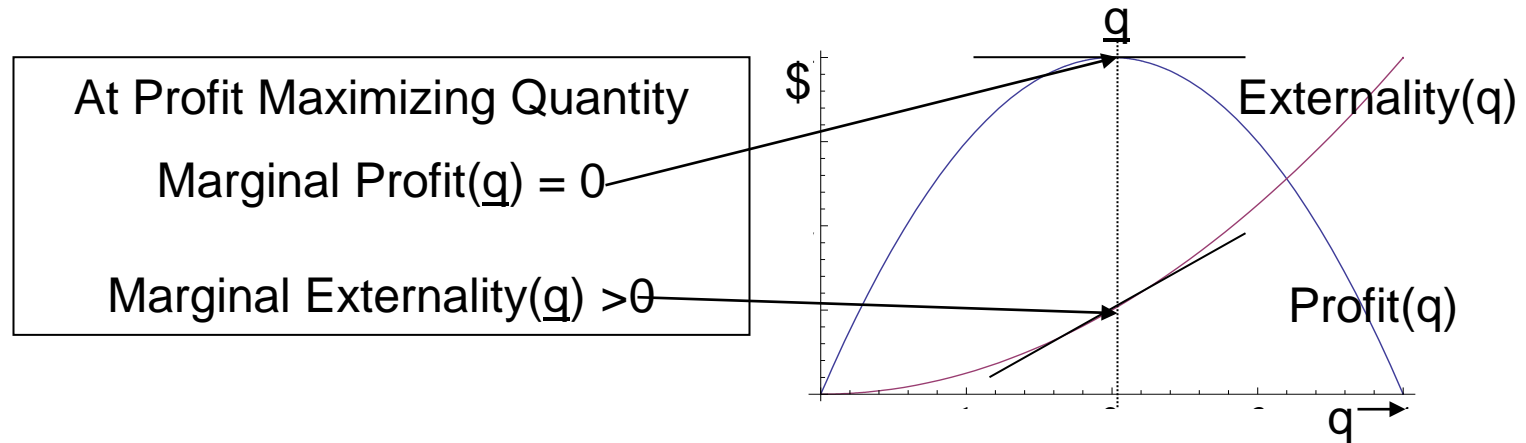
		$\beta_2 = 0$	$\beta_2 = 2$
$u(c,g) = \frac{3}{2}c+g$	$\beta_1 = 0$	(6,6)	(8,5)
Dividend = \$4	$\beta_1 = 2$	(5,8)	(7,7)

**Proposition 2:** *(i) Shareholders delegate all public goods contributions to the manager. (ii) The manager contributes more than if shareholders contributed individually and shareholders are better off.*

**Societal Impact:** Free-rider problem only resolved for shareholders, but better than decentralized and improves as the number of shareholders increases

# If Shareholders Feel Externalities at All, Firms will Produce Less Than the Profit Maximizing Quantity

## Proposition 3 (Production Abatement)



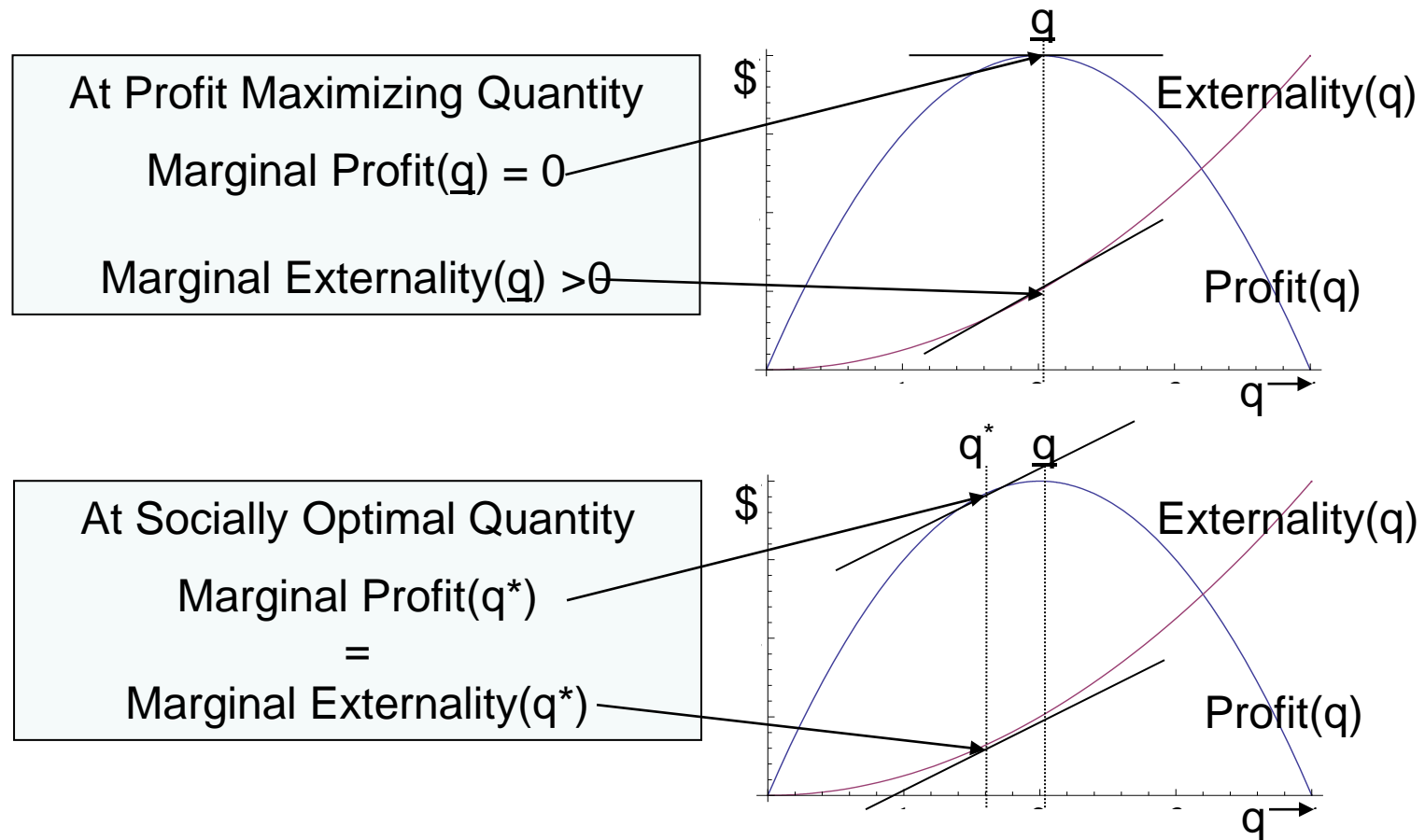
Let a firm produce the profit maximizing quantity. Decreasing production slightly would create a first order gain in shareholder welfare due to increased public good but no first order loss in profits. Thus, some  $q < \underline{q}$  is optimal.

**Proposition 3:** *When incentives are fully aligned, the manager will produce less than the profit maximizing quantity*

But how much will the manager abate production?

# If Shareholders Feel Externalities at All, Firms will Produce Less Than the Profit Maximizing Quantity

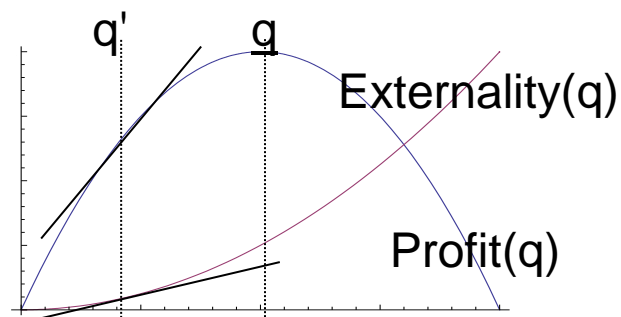
## Proposition 3 (Production Abatement)



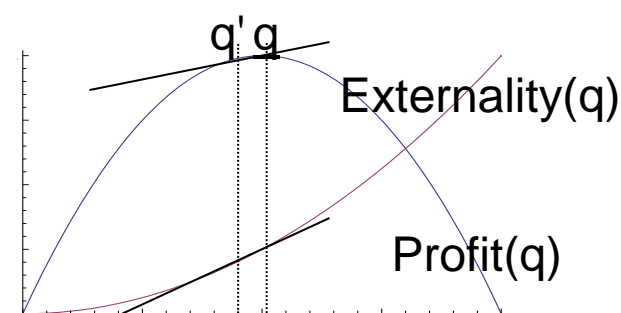
A social planner would equalize marginal profit and externality

# If Shareholders would Spend ANYTHING on Public Good, Then Firms Produce SOCIALLY OPTIMALLY

## Proposition 5 (Socially Efficient Production)



Increase production, offset externality & increase dividend



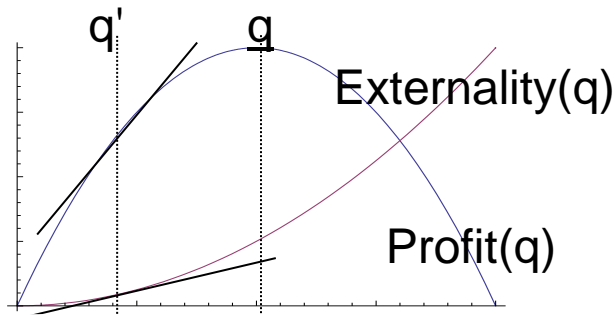
If shareholders are contributing, then reduce production instead

**Fundability Condition:** We say the public good is (strictly) *fundable* iff shareholders (strictly) prefer the manager to contribute to the public good when production is optimally abated. Otherwise the public good is *unfundable*.

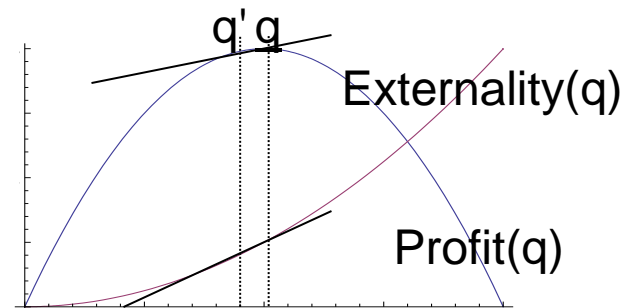
**Proposition 5:** The manager chooses the socially optimal quantity iff the public good is fundable; otherwise the firm overproduces. He provisions strictly positive amounts of the public good iff public good is strictly fundable.

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**Policy Impact:** Quantity regulation cannot improve public goods levels\*

But governments mandate that firms implement technology to reduce externalities like pollution or subsidize such research...

# Reducing a Firm's Marginal Cost Helps Society just as Much Reducing the Firm's Marginal Externality

## Proposition 6: Technology Neutrality

Suppose the government can subsidize technology to make production either **Cheaper** (lower marginal production cost for all quantities) **OR** **Cleaner** (lower marginal cleanup cost for all quantities by same amount)

### Intuition:

1. Fundability implies marginal profit = marginal externality under the optimal output
2. Equivalent to choosing quantity to maximize “profits” when profit = revenue - cost
  - Cleaner technology is equivalent to a reduction in marginal costs
  - Cheaper technology is equivalent to an increase in marginal revenues
  - Each of these changes has the same net effect on “profits”
3. Next, manager chooses between consumption and public goods provision
  - Since relative price unaffected by technological change bundle is unchanged

**Proposition 6:** *Suppose Fundability holds. Then firm output is identical under the cleaner or cheaper technology. Furthermore, total public goods are identical under the two technology improvements.*

**Policy Impact:** Society benefits more from investment in cost saving technologies if they are cheaper than externality abating technologies

E.g. Investing in cheaper oil refining may reduce pollution more than in cleaner refining

# Incentive Alignment Does Not Yield Friedman's World but a Better One for Shareholders and Society Alike

## Conclusion

### Novel Rationale for CSR:

- Profit maximization is not masquerading as social responsibility
- No behavioral motives or agency problems are required

### Perfect Contracting:

- Pure profit based management contracts are not in shareholders' best interests
- Broader society benefits too, though not by any design of the firm

### Empirical Predictions:

- Widely held firms are more socially responsible
  - Benefit from centralized provisioning increases
- As marginal public goods utility / marginal consumption utility increases so should firm CSR activities
  - SRI fund, philanthropist insider investment should increase CSR

### Policy Implications:

- Production quantity regulation may only hurt society in many circumstances
- Cost-savings R&D may be socially more efficient than clean tech investment
- "Taking a company private" may adversely affect social performance
- Foreign held firms are less likely to behave nicely than locally held ones