The Corporate Social Responsibility and the Theory of the Firm

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Abstract

This paper investigates the extent to which the concept of corporate social responsibility (CSR) challenges the validity of the traditional firm model. Contrary to what have been suggested by some critics of CSR, CSR does not appear to have been accepted as an alternative to the traditional profit maximising objective. Rather, CSR appears to play an integral part in the development of new theories aiming to improve our understanding of how contemporary firms operate, survive and succeed.
1. Introduction

The idea that firms may assume and be expected to assume social responsibilities has been both celebrated and condemned during the entire 20th century. Corporate social responsibility (CSR) enjoys plenty of attention in the media and in academia and does now appear to be widely accepted as an integral part of doing business. The fact that there is very little common consensus of what CSR means and how it fits into the corporate objective function is therefore a cause for concern. The aim of this paper is to bring some light on this issue, using evidence from the CSR literature as it has evolved since the beginning of the 20th century. This paper addresses three important questions in this respect: firstly, how business’ approach to CSR has evolved from the beginning of the 20th century and into the 21st; secondly, whether our understanding of the vices and virtues of CSR actually has improved over this time; and thirdly, whether the acceptance of CSR has challenged or complemented the traditional model of the firm as a profit-maximising institution.

As argued here, while business’ approach to CSR has changed significantly, the debate of why or why not firms should assume CSR has remained virtually unchanged over the 20th century. The message from CSR advocates continues to be that CSR is a necessary part of a contemporary business’ operations because society demands it whereas CSR critics continue to argue that firms should maximise shareholder wealth, not social welfare, and that managers have no right, obligation or expertise in fighting social ills. Moreover, it seems evident that CSR has not been adopted as an alternative to the traditional profit-maximisation objective. Rather, CSR appears to have been adopted as taking a complimentary, or integral, part of the corporate objective function. Hence, the essence of the traditional model of the firm, with profit maximisation as the primary objective, still holds. In fact, it could be argued that contemporary firms are more profit-driven than the large firms of the 1950s (which have been described by historians (such as Heald, 1957) as taking a role more as social institutions than as profit-driven institutions). At the same time, CSR appears to be embedded in the contemporary firm’s operating environment to a much greater extent than evident in the 1950s. This observation of actual firm behaviour serves as evidence pointing towards a possible reconciliation of CSR critics and advocates. Another indication is observed in recent developments in CSR theory, where CSR and profit maximisation are often discussed as parts of the same process. Hence, the view on the role of the firm within society has not necessarily
changed. What has changed is the nature of, and our understanding of, the wealth maximising process.

This paper begins with a critique of how CSR is defined and interpreted in the literature and in the media and suggests the use of Carroll’s (1979) framework for defining and interpreting CSR as a more appropriate alternative. Secondly, a review of business’ approach to CSR, and the CSR debate, as it evolved over the 20th century and into the 21st is provided. Thirdly, the uniqueness of the contemporary firm is discussed, identifying some features suggested to challenge the traditional view of the firm and discussing how CSR has been incorporated into recently developed theories of how contemporary firms operate, survive and succeed. The conclusion presents some suggestions of how firms (and other institutions) may improve the approach CSR.

2. Understanding CSR

The CSR literature suffers greatly from an unfortunate lack of a consensus of what CSR actually means. Academics and practitioners have thus been free to define and interpret CSR as best fits their purpose, resulting in definitions and interpretations that are often biased by underlying value-judgements and ideologies. For example, McWilliams and Siegel (2001: 117) define CSR as “actions that appear to further some social good, beyond the interests of the firms and that which is required by law”. The World Business Council on Sustainable Development (2000: 8) defines CSR as "the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and society at large”.

Similar definitions are found throughout the contemporary literature, and are especially abundant on the websites of various non-commercial organisations (for example, the World Business Council on Sustainable Development, the UK Financial Services Authority, and Canadian Centre for Philanthropy). Although it may be a little severe to say that all these organisations have and promote the wrong understanding of CSR, it is perhaps permissible to argue that there is ambiguity in what is definition and what is interpretation, which in the case of CSR leads to some common problems.
The weakness of this type of definition is that it carries an underlying message that assuming social responsibility is a non-commercial activity. It is therefore hardly surprising that CSR, when defined as above, has aggravated capitalists through time. Friedman (1962; 1970), the most frequently cited critic of CSR, argued adamantly that CSR contests the traditional role of the firm within society, and claimed that the social responsibility of the firm is to make profits. He thereby interprets CSR as a contender to the traditional corporate objective of profit maximisation, and effectively defines CSR as actions that violate the profit-maximising objective.

Ultimately, a good and usable definition of CSR, especially when used when developing theory, is one that does not interpret what the responsibilities of the firm should be. A good definition should be acceptable by academics and practitioners of any discipline and political conviction, and should work under any model of the firm – also the traditional purely commercial model. Such a definition was proposed by Carroll (1979). Carroll (1979: 500) defines CSR as encompassing “the economic, legal, ethical, and discretionary expectations that society has of an organization at a given point in time”. This is a good definition because it defines CSR as what it is: something fluid and ever-changing, and in fact a gauge of the business-society relationship itself.

Carroll (1979) identifies four main types of responsibilities that society may expect business to assume, or that business may expect they have a right and duty to assume (as becomes apparent, there may be a conflict between what business assumes and what society wants). The most basic of these, in an evolutionary sense, is the economic responsibility the firm holds towards its shareholders, and the legal responsibility the firm holds towards society. Firms may also assume ethical and discretionary responsibilities towards society. Ethical responsibilities reflect societal norms and values that are not codified in law, and discretionary responsibilities reflect issues for which society sends no clear message. Carroll emphasises that these responsibilities are not mutually exclusive. Accepting that these responsibilities may be interrelated, and that positive synergies may exist between some of them, might enable more constructive dialogue between proponents and opponents of CSR. Jensen (2002), whose contribution to the CSR literature is discussed later in this paper, provides a step in this direction.
3. The Traditional Firm and CSR

The contemporary firm has evolved from the traditional industrial capitalist firm, which emerged with the industrial revolution in the late 19th century. The traditional firm existed with the sole objective of maximising shareholder wealth subject to some (but arguably not many) constraints. The traditional firm, as described by Luthans, Hodgetts and Thompson (1990), abided by the law when forced to but was expected to behave as ruthlessly as possible in pursuit of profits – all in the name of social welfare as per Adam Smith’s model of the market economy. Although things might have changed since, the broader outline of what a contemporary firm is supposed to do is not so different. The main change is perhaps in the development of explicit theories to explain how the traditional firm operates. The managers of the firm are agents acting on behalf of and in the best interests of owners. Since owners are assumed to be wealth-maximisers, managers are contractually bound to maximize the wealth of owners. The decisions that managers make should follow a seemingly simple process where they accept projects that are expected to increase wealth and reject projects that are expected to decrease wealth. This should ensure resources are distributed according to how they are valued by society, which in turn will ensure maximum allocative efficiency and therefore welfare. The traditional model of the firm is perhaps simplistic, but whether it is actually outdated or not is debatable. The emergence of CSR, and also socially responsible investing (SRI), has been interpreted both as a challenge to and as an extension of the traditional model of the firm.

2.1 The Background to the Traditional Firm

Contemporary business philosophy and the perception of what responsibilities business is expected to assume has evolved with society from the beginning of modern civilisation, although the traditional model of the firm appears to have emerged mainly with the industrial economy in the 1800s. A brief overview of the history of business ethics demonstrates that the responsibilities business is expected to assume have differed significantly through time. For example, in medieval times the Catholic Church held pervasive authority on the ethics of all facets of society, and the basic commercial objective of wealth creation was considered immoral. Early mercantilism was brought about by a combination of growth in international trade, a decline in the power and control of the Catholic Church and a cultural change towards
the new Protestant movement. Finally, Adam Smith popularised the idea of the market economy, providing the basis for the traditional capitalist view of the firm (for brief historical reviews of business philosophy, see for example Carroll, 1981; Luthans et al., 1990; Moore, 1950).

The capitalist ideas of the market economy were adopted wholeheartedly and unreservedly during the 19th century. The emergence of the traditional firm was fuelled by a change in societal values towards self-regulation and enterprise, condemning the autocratic power that the state and the Church had previously held over business, and significantly changing attitudes towards commercialism (Carroll, 1981). There were few regulatory or moral constraints, and firms were free to pursue profits and economic expansion. The ruthlessness in business conduct in regard to the poor treatment of workers, customers and suppliers has been blamed partly on the acceptance of what was later termed Theory X. It has been suggested that at this time business assumed absolutely no responsibility for society (Luthans et al., 1990). Firms started merging into large business trusts during the period between 1890 and 1933, which led to these firms gaining substantial monopoly power used to drive out competitors. This resulted in a great economic instability which ultimately led to a falling trust in Adam Smith’s ‘laissez-faire’ theorem and the virtues of the ‘invisible hand’ (Luthans et al., 1990). Finally, after the great depression, the idea that government intervention could play an important role in economic stabilisation was developed and implemented.

The arrival of government intervention brought new legal constraints to the traditional firm. Several new laws were passed in the US (and elsewhere) to impede undesirable conduct such as anti-trust activity, monopolistic behaviour, and false advertising. Later came legislation to regulate specific industries. This does not indicate any significant change of motivation on the part of corporations, however. The improved business conduct that resulted from these changes is suggested to have resulted from the legal constraints, and not from humanistic motivations. Corporations were not yet expected to take part in community affairs or concern themselves with social issues. Fair treatment of labour was generally taken care of by the growing position of labour unions, whose existence in time became protected by law. Later, labour unions became accepted by governments and businesses as fruitful institutions which took care of many of the social responsibilities that otherwise could have been forced onto businesses themselves (Luthans et al., 1990).
The increasing role of the government as a regulator continued into the 1970s, at which point regulation reached a new level as the public became much more aware of social issues, demanding new legislation to restrain acts of inequality and discrimination based on race, gender, religion or ethnic background, as well as the negative externalities of consumption and production (Carroll, 1981; Freeman, 1984; Krumsiek, 1997; Luthans et al., 1990).

2.2 CSR Before 1970

Heald (1957), who provides a review of CSR within the context of the traditional firm, argues that examples of the integration of social responsibilities in business started to emerge during the 1880s and 1890s. The new large corporations were the first to voluntarily assume social responsibilities and take on philanthropic roles by means of charitable giving and financial support for employee activities such as the YMCA. The increased attention to CSR provided by the financial capitalists significantly improved the welfare of certain constituents of society, especially in terms of workers’ welfare. There was an increase in the interest and attention on the part of management to safety and sanitary conditions in its plants and to payments for accidents, retirement and death. Heald (1957: 377) suggests this was a direct result of labour unionism, public opinion and political pressures, and implied “an obligation on the part of management for the health and welfare of those most directly affected by its operation”.

The larger size of these companies forced their management to recognise that their success depended on the approval of the general public. One example is Theodore N. Vail, leader of the Bell System in the US, who identified that his company assumed many of the characteristics of a public utility and therefore that government intervention was inevitable. Vail therefore welcomed this regulation and attempted to “humanize the corporation in the eyes of the public”. So successful were his attempts that he was later ranked as one of the first U.S. leaders to “appreciate the problems of public relations in a farsighted way and to find a basis for their long term adjustment” (Long, 1937, quoted by Heald, 1957: 378). This is perhaps one of the first instances of proactive behaviour in a CSR context.

Heald (1957) suggests that the first World War added to the general tendency of businesses taking on social responsibilities. The massive social assistance programs, developed during the war, remained on the agenda of large corporations after the war ended,
indicating business’ acceptance of these new social responsibilities. “Service” was the new buzz-word, indicating a growing appreciation of stakeholder relations. Of course, business professionals differed in their interpretations of the word “service” and in their views on how far the firm should take its social responsibilities. For example, Owen D. Young of the General Electric Company, argued that large companies have an obligation beyond profit making, and that corporations should strive to become “good citizens”, and that service had precedence over profit. Henry Ford agreed with the notion of firms holding certain responsibilities, but differed with Young in that he stressed that firms must meet their economic obligation first, and then their other obligations. His reasons were largely grounded in capitalistic ideology, and his interpretation of ‘service’ was to increase welfare by increasing production and providing work and goods to the public (Heald, 1957).

In sum, Heald (1957) describes a contemporary conception of CSR which originated with the financial capitalists of the late 1800s, and gained support through the social issues that arose during the great depression of the 1930s. He creates an impression of CSR still largely gaining support through the 1940s and 1950s. Nevertheless, the adoption of CSR has consistently met with criticism, partly because CSR was interpreted as a contender to the traditional model of the firm and the traditional ideal of how the business-society relationship should work.

2.3 Early CSR Debate

The integration of social responsibilities in business that emerged with the financial capitalists spurred a fierce debate on whether or not CSR should be included in the corporate objective function. The earliest reference to such criticism appears to be Ghent, who in 1902 criticised this new trend for its similarity to the economic feudalism of the Middle Ages, and who argued that CSR was being used as a tool for forestalling public criticism and regulation rather than from an actual concern for social issues (as reported by Heald, 1957). Similar but more specific arguments have since been provided by Levitt (1958), Friedman (1962; 1970) and recently Jensen (2002). Ghent did admit, however, that the idea of businesses taking some responsibility for society could be fruitful, but that the implementation of the idea thus far was imperfect (Heald, 1957). Levitt (1958) was more explicit in his criticism, arguing that managers must be clear about the motives of CSR.
Marshall (1970: 20) suggests Theodore Levitt represents “one of the first and most severe voices of criticism of the corporate responsibility to be heard in business circles”. His 1958 paper, “The dangers of social responsibility”, presents passionate criticism of CSR, with arguments well rooted in the political ideologies of individualism, democracy and capitalism. Levitt (1958) is strong in his critical examination of how CSR is, and should be, incorporated into management’s responsibilities.

Levitt (1958) suggests CSR to be a “fashion accessory” of self-interested businessmen, whose priorities are not so much the health of the businesses they are paid to manage, or the welfare of society, as the pursuit of their own objectives as individuals, be it in terms of personal political agendas or self-realisation. In spite of suggesting self-interest to be the main objective behind CSR, Levitt (1958) also provides an argument for CSR as a profitable strategy. The problem is the practice of ‘dressing up’ conventional profit-making objectives as philanthropic, when they clearly would not be pursued if they were not profitable. In other words, the only ethical approach to CSR, according to Levitt (1958), is to pursue CSR when profitable, but to also admit that profit is the real objective behind any socially responsible activities.

Levitt (1958) further warns against the dangers of pursuing ambiguous corporate objectives, such as those implied by CSR, rather than the well-defined traditional objective of profit maximisation. He argues that as soon as the corporate objective function includes CSR, this leaves managers with the luxury of making value judgements on which social issues to pursue and which not to pursue. In effect the multiple objective function reduces to the single objective of maximising the manager’s utility. This is exactly what was later argued by Friedman (1962; 1970) and recently by Jensen (2002). In other words, this issue appears unresolved to this day. Jensen’s criticism is discussed in greater detail later in this paper.

The strongest part of Levitt’s (1958) argument is perhaps his adamant reminder that the responsibilities of the public and private sectors ought to be kept separate. Levitt (1958) emphasises that, in order to produce a society built on ideas of democracy and freedom it is imperative to create and maintain a pluralistic, rather than monolithic, system. Put simply, the functions and responsibilities of business and governments are separate and they need to be kept separate. Levitt (1958) argues that it is undemocratic and therefore unethical for managers to assume any authority on how social issues should be dealt with. Managers hold
no right to assume such a role and have no expertise in dealing with these issues, and they are therefore not likely to succeed in such a role. Hence, any attempt by managers to take on other roles besides that of the profit-maker is bound to fail. On the larger scale, if a separation of private and public sector responsibilities and functions is not maintained, the consequences will, according to Levitt (1958), be dire. He warns of companies assuming a role in society similar to the medieval Church; describing this scenario as the beginning of a fascist regime where business moulds society rather than the other way around.

Friedman (1962) is widely regarded as the originator of, or at least the main spokesperson for, the arguments that Levitt (1958) provided four years earlier. Friedman (1962) gives little specific acknowledgement to others throughout this book, so it is difficult to determine exactly from where the ideas expressed in it originate. He does however make an acknowledgement in the preface of his book outlining some scholars who have contributed to forming the arguments he presents. The titles he mentions reveal that these are views deeply based in individualism.

Davis (1973) presents a case for business holding a social contract with society, and therefore existing only on the legitimacy of society. Hence, firms that do not operate in accordance with societal values will eventually lose their legitimacy to exist and will fail to survive. If business exists on the legitimacy of society, it follows that business must look to the governing political climate, which should reflect the public opinion, in search of an answer to the CSR problem (or the approach to including CSR as a part of the corporate objective function). It may not be as simply dealt with as Friedman (1962) and Levitt (1958) propose. Moreover, the social-contract argument suggests that business’ approach to CSR must be flexible, since societal values differ across economies and change over time.

This said, the argument for separation of responsibilities of the private and public sector is strong. One of the fundamental rules of democracy is that the decision, on behalf of others, of what is right or wrong should not be made at the discretion of managers or anybody else but by a democratically elected government. It is the government’s responsibility to translate the opinions of the majority into policies and laws that reflect these, and no other entity has any moral authority over anybody else. Strictly speaking, any manager or individual who assumes authority on ethics is therefore acting in conflict with democratic ideals. Although
much of the developed world operates under democratic ideals, the levels of government intervention in the business sector differ across countries.

2.4 CSR After 1970

As the previous section implies, the post-World War II years were marked by great confusion in terms of what should be considered the responsibilities of business. It seemed the trend was for managers to increasingly focus on “the common good”. Not only did this conduct appear to contradict the traditional profit-maximising objective. There was no available theory on why the firm should focus on the common good, let alone how, and at what costs, such objectives should be pursued. As such, it appeared as though firms and their managers were assuming a new role within society, one which may well be likened to social institutions rather than facilities where resources are transferred into wealth.

There is a significant difference in how the literature describes CSR before and after the 1970s. Before the 1970s CSR is described as a virtue, driven mainly by the corporations themselves, with the objective of appealing to regulators and the public in the pursuit of goodwill, or alternatively to simply further personal political agendas (Levitt, 1958). The advent of societal change starting at the end of the 1960s and beginning of the 1970s appears to have shifted the drivers behind CSR away from the corporations and into the hands of the public, as stakeholder activism gained momentum. Hence, CSR changed from being mainly supply-driven to becoming significantly more demand-driven.

Krumsiek (1997) and Shepard, Betz and O’Connell (1997) both attribute this rise in stakeholder activism to heightened awareness of social issues in general, as individuals increasingly became aware of the consequences and externalities of consumption and production, both in the way these affect them directly or indirectly, and in their concern for how these may affect others. It is suggested that the catalyst for this change was the emergence of a new demographic in the U.S. population, a segment of the baby boomer generation dubbed the “cultural creatives”, suggested to be at the forefront of this heightened social awareness and social activism (Ray, 1997).

As a consequence of this change in the cultural and political climate, the last three decades have seen many instances of companies being forced to pay some of the social costs
associated with their operations as a direct result of stakeholder activism. All of these cases are examples of externalities to some extent becoming ‘internalised’ as the social costs of business operations have become private costs borne by the corporations. These are however only the explicit costs of socially undesirable behaviour. Implicit costs, including loss of reputation and public goodwill, are also likely to be considerable and maybe even greater than the explicit costs, as is suggested by Zingales (2000), and add to the total cost of such behaviour.

The public demand for CSR that developed in the 1970s lead to a particularly interesting trend in the context of the theory of the firm. As consumers became increasingly concerned with the destination of their dollars spent investors became equally concerned with the destinations of their dollars invested, giving rise to SRI. This leads to the interesting question of whether investors gain utility from corporate social performance (CSP) as well as financial wealth. If they do, this has consequences for managers, because it means managers need to consider investors’ needs for CSP as well as financial wealth. While the recent growth in SRI alternatives marketed by fund managers should suffice as evidence that some investors gain utility from CSP, there is little evidence to suggest investors in general are willing to trade wealth for CSP. Hence, the traditional corporate objective of profit maximisation seems safe from an agency theory point of view. At least, this seems safer than substituting this objective for the objective of maximising CSP. That said, there is little conclusive evidence to suggest there is a trade-off between CSP and wealth.

This paper began by raising the question of whether or not the traditional firm survived the 20th century. Following the events set out above it appears the hypothesis that the traditional corporate objective function of wealth-maximisation is obsolete cannot be accepted. What may have changed, however, is the recipe for economic success. This has prompted the need for new theories of how firms operate, remain competitive and succeed. This issue is explored next.
3. The Contemporary Firm and Challenges to the Traditional Theory of the Firm

3.1 New Theories

The emergence of stakeholder activism in the 1970s appears to have been interpreted (by for example Jensen, 2002) as giving further support to the idea that business holds obligations to various groups in society, and must uphold these obligations in order to survive. Put another way, the idea of business holding a social contract with society, where the legitimacy of its existence rests on public assent (Davis, 1973), becomes relevant because it explains why such societal change must be reflected in the fundamental theories of the firm. Note that the adoption of this idea is not equivalent to the condemnation of the idea of wealth maximisation as a primary objective of the firm. Such misinterpretation appears to have been blamed most frequently on Friedman’s (1962; 1970) arguments against the adoption of CSR, since he in effect defines CSR as non-wealth maximising behaviour (Walters, 1977). In recent years many have argued that CSR may well harmonise with the wealth-maximisation objective, and even that CSR may in certain cases be a necessary (but not necessarily a sufficient) condition for wealth maximisation (Davis, 1973; Frooman, 1997; Jones, 1980; Moskowitz, 1972, 1997). Hence, positive synergies between economic and social responsibilities are implied.

The emergence of new theories, such as stakeholder theory, can be viewed as a manifestation of the changing theory of the firm in terms of how firms may succeed. More recent theories suggest that the firm is defined as more than just a facility where resources are combined to produce wealth, instead defining the firm as a complex system of relationships between constituents where the success of the firm depends on the quality of these relationships and how well they are managed by the firm (Zingales, 2000).

As has been discussed, the adoption of CSR as part of the corporate objective function has been heavily criticised. Beside the political arguments that CSR is anti-democratic, this criticism also pointed to the concept of CSR being too vague and subjective to serve as an objective for management (Friedman, 1962, 1970; Levitt, 1958). Jones (1980) suggests that this is not a valid argument against the concept of CSR but rather a statement recognising the need for a social issues management theory. Jones (1980) argues that, granted that corporate managers do have a responsibility to constituent groups other than shareholders, managers are
faced with five important questions: Who are these groups, how many of these groups must be served, which of their interests are most important, how can their interests be balanced, and how much corporate money should be allotted to serve these interests?

Freeman (1984) later developed what has later been termed stakeholder theory, which in effect presents an framework for addressing all but the last of Jones’ (1980) questions. Freeman (1984: vi) defines stakeholders as “any group or individual who can affect, or is affected by, the achievement of a corporation’s purpose. Stakeholders include employees, customers, suppliers, stockholders, banks, environmentalists, government and other groups who can help or hurt the corporation”. Freeman works from this basis, having defined and identified the possible stakeholders of the firms, and presents a method and reasoning for how and why relationships between the firm and these stakeholders may be managed. He thereby provides a new perspective on how firms may operate, where the focus is always on the interdependency between the firm and its environment. Freeman’s stakeholder theory may be regarded as an inevitable theoretical development that naturally evolved as the business environment became increasingly complex, challenging the validity and usability of many other theories which are based on the underlying theory of the traditional firm (Zingales, 2000).

Although stakeholder theory and the CSR debate developed independently of each other (Freeman (1984) merely mentions CSR and does not attribute much importance to CSR in the context of stakeholder management), stakeholder theory was quickly adopted as a theoretical foundation for a contemporary conceptualisation of CSR. The two concepts are almost inseparable in the more recent literature (see for instance McWilliams et al., 2001; Moore, 2001; Rowley & Berman, 2000; Ruf, Muralidhar, Janney, & Paul, 2001; Ullman, 1985; Waddock & Graves, 1997).

3.2 Some Implications and Extensions of Stakeholder Theory

Freeman’s (1984) ideas on stakeholder management have been developed further and provide important links between CSR and various theories of the firm. CSR theories may be said to have developed into two streams, namely the question of how CSR may be managed by the firm, which to a certain extent is addressed by social issues management theory, versus the question of why and when CSR is of any relevance to a firm’s success. The focus here is
on the latter. The most significant developments in the context of the relevance of CSR appear to be the idea of a link between CSR and valuable implicit contracts, further linking to transaction cost economics, and the resource-based view of the firm.

Ruf et al. (2001: 143) draw a direct link between CSR and stakeholder theory when suggesting that CSR is equivalent to “meeting the demands of multiple stakeholders”. Similarly, Waddock and Graves (1997) suggest that corporate social performance (CSP) actually measures the quality of a corporation’s stakeholder relations. Ruf et al. (2001: 145) also suggest a link between stakeholder theory and valuable implicit contracts, arguing that “Stakeholder theory posits that firms possess both explicit and implicit contracts with various constituents, and are responsible for honouring all contracts”. While explicit contracts are legally enforceable, implicit contracts are not. Implicit contracts are described as relational contracts, which “become self-enforcing when the present value of a firm’s gains from maintaining its reputation (and, therefore, future terms of trade) is greater than the loss if the firm reneges on its implied contracts”.

Ruf et al. (2001) thereby suggest that Freeman’s (1984) stakeholder theory can be complemented by both transaction cost economics and the resource based view of the firm. Transaction cost economics implies that “firms that satisfy stakeholder demands or accurately signal their willingness to cooperate can often avoid higher costs that result from more formalized contractual compliance mechanisms (e.g. government regulation, union contracts)” (Ruf et al., 2001: 143-144). Ruf et al. (2001) also argue that the concept of CSR may also be better understood from a resource-based perspective, focussing on the resources that firms use in the production of goods and services and how the uniqueness of these resources provides monopoly power and hence economic profit. A resource-based perspective of the firm implies that “firms view meeting stakeholder demands as a strategic investment, requiring commitments beyond the minimum necessary to satisfy stakeholders. By strategically investing in stakeholders’ demands, firms gain a competitive advantage by developing additional, complementary skills that competitors find it hard to imitate” (Ruf et al., 2001: 144). Hence, skill in stakeholder management may represent a valuable and unique resource to the firm.

The transaction cost and resource-based perspectives are not dissimilar. One talks about contracting costs and the other about the value of resources. A resource-based view is
possibly more general, because contracts are assets, but assets are not necessarily contracts. The important point is that resources include both tangible and intangible resources, and intangible resources include skills and reputation. CSR relates to intangible resources that may be valuable to the firm and hence its shareholders.

CSR is thus linked firstly to the firm’s ability to lower transaction costs by lowering contracting costs and secondly to capitalise on unique resources. These abilities are linked with the quality of the firm’s stakeholder relations, and the quality of a firm’s stakeholder relations is the very definition of CSP, according to Waddock and Graves (1997).

3.3 The Contemporary Firm – What has Changed?

The contemporary firm has been forced to adapt to a new environment of ever-increasing complexity, having to keep track of rapid changes in public expectations, and faced with an apparently unresolved problem of ambiguous corporate objectives. Consequently, the contemporary firm is different from the traditional firm in how it operates and how it may be expected to succeed in remaining competitive and generating wealth for shareholders whilst maintaining its legitimacy to operate within society.

Zingales (2000) explains how the contemporary firm differs from the traditional firm, and how such differences appear to have emerged. He explains that it is important to understand and appreciate this evolution because it needs to be reflected in all disciplines within the broad field of business studies. This includes issues such as defining a firm and what its objectives, rights and responsibilities are; in other words, defining business’ place within society. Zingales (2000) argues that if the underlying theory of the firm changes, then this forces the subsequent disciplinary theories to change in order to accommodate the new theory of the firm, otherwise we are left with theories that are no longer valid and that cannot be trusted for application in the contemporary real world.

Zingales (2000) describes a business environment that has undergone enormous change over the last 40 years, and a set of business theories that is trying hard to catch up. He argues that the traditional view of the firm was modelled on the traditional business corporation that emerged at the beginning of the twentieth century, describing the traditional firm as being predominantly asset-intensive and highly vertically integrated with a tight control over its
employees secured by a hierarchical system of authority. In contrast, the contemporary firm is held together with ‘a looser form of collaboration’ and with human capital as the most crucial asset (Zingales, 2000: 1624). Zingales (2000) argues that, in contrast to the traditional firm, the boundaries of the contemporary firm are in constant flux, and that these can easily be changed by financing and governance choices. Hence, he argues that there is a need for a new theory of the firm.

However significant these changes in the business environment appear to be, the notion that managers are agents who must first and foremost uphold their obligations to shareholders appears to prevail. It may be, therefore, that it is not necessary to create a new theory of the purpose of the firm, and that what is needed is a new theory of how firms may meet these traditional objectives in this new setting of an extremely complex operating environment. This is in effect what Jensen (2002) argues.

Zingales’ (2000) description of the emergence of the contemporary firm provides a justification for why, in the mid-1980s, the development of a stakeholder theory was indicated and hence provided. The main contribution of stakeholder theory is perhaps that this theory was built on real observations of how contemporary firms operate, rather than on more restrictive assumptions on how the traditional firm is expected to operate. What stands out in Zingales’ (2000) argument to highlight the significance of stakeholder theory is his description of a change from ‘direct control’ to a ‘looser form of collaboration’ and the shift from an asset-intensive to a human capital-intensive corporate structure. Stakeholder theory provides the model for how a ‘looser form of collaboration’ between constituents works and how these relationships, or what Zingales (2000) later refers to as implicit contracts, may be managed.

3.4 The Importance of Implicit Contracts

Zingales (2000) argues that the boundaries of the firm, in terms of control and valuation, have become blurred. The control of the firm has been gradually shifted from management and shareholders to employees, something that was unthinkable for the traditional firm. This has rendered explicit contracts between firms and employees very incomplete and increased the importance and value of unique implicit contracts. It seems probable that it was exactly this trend that prompted the development of stakeholder theory. Indeed, stakeholder theory
may be viewed as a theory of how and why to manage the contractual relationships that the firm holds with its stakeholders, especially implicit contracts that may exist (Ruf et al., 2001).

CSR, stakeholder management and valuable implicit contracts appear to form a triangle of contemporary value creation. What makes Zingales’ (2000) contribution important is his careful examination of how implicit contracts now hold a more significant position in business life than they have previously, and how this affects the underlying theory of the firm and thus every other discipline which rests on the assumptions of this theory.

The notion of the firm as a nexus of contracts has long been an accepted alternative view of the firm, which has implications for how firms are valued (Jensen, 2002; Zingales, 2000). This view posits that the value of the firm is the sum of the values of all existing claims on the firm. Whether or not implicit claims or contracts are included in this definition has significant consequences for how firms are valued, and, obviously, the greater the importance of implicit contracts the greater will be the difference between the firm’s value when calculated as the sum of the value of explicit claims only versus the value of both explicit and implicit claims. Because implicit claims have become so important in later years this has made the difference more apparent and provided a great challenge for valuation. This is because implicit claims are inherently difficult to value, as they are not tradeable.

Since implicit contracts are not legally binding there is no explicit cost involved in not honouring an implicit contract. However, breaches of implicit contracts sometimes carry significant implicit costs. The value of an implicit contract is directly dependent on the likelihood of the contract being honoured, in the eyes of the holder of the contract, which depends on the credibility of whoever offers the contract. Organisational reputation is therefore often the most precious asset the organisation has. Reputation can rarely be purchased, and may take years of persistent good performance to gain yet it can be lost very quickly at considerable cost to the firm. Such cost may be both explicit, as in the case of legal costs, as well as implicit, as in the case of lost revenue. Zingales (2000) links such reputational capital with the cost of financial distress and bankruptcy costs when he uses the term ‘organisational capital’. Zingales thereby describes organisational capital as a function of how trustworthy the firm is in terms of honouring implicit claims, in the eyes of stakeholders.
The growing importance of implicit contracts links both the transaction cost economics and the resource-based views of the firm, implying that a reputation for honouring implicit contracts may reduce costs and add wealth through development of unique resources. Such reputation and unique resources appear to be clearly linked to CSR, and this again explains the importance that has been attributed to CSR in recent years.

3.5 Jensen’s Critique of the Use of Stakeholder Theory

To this point it has been suggested that although the business environment has changed dramatically in recent years, thereby changing the ways in which firms operate and create value, the predominant perception of the main purpose of the firm being maximisation of shareholder wealth still appears to prevail. Jensen (2002) argues that while wealth maximisation should be the only objective of the firm, observation of actual firm behaviour suggests the fundamental purpose of the corporation has become ambiguous as a result of the adoption of stakeholder theory. Consequently, he argues, there is confusion as to what role business has in society and what functions it is expected to serve.

Jensen (2002) suggests the contemporary firm unreservedly embraced stakeholder theory and interpreted its concepts as an alternative to the traditional objective of wealth maximisation. He suggests that, “fuelling the controversy are political, social, evolutionary, and emotional forces that we don’t usually think of as operating in the domain of business and economics. These forces serve to reinforce a model of corporate behaviour that draws on concepts of ‘family’ and ‘tribe’” (Jensen, 2002: 8). This is similar to Levitt’s (1958) argument, however Jensen’s (2002) argument differs in that he more clearly separates objective from process when arguing that the quality of stakeholder relations should not be an objective to replace wealth maximisation, but that the quality of stakeholder relations may be an important part in the process of wealth maximisation.

The validity of Jensen’s (2002) argument that firms’ corporate objectives have changed is arguable. The symptoms Jensen (2002) describe may be a consequence of managers realising exactly what he himself argues, that wealth maximisation is a complex process in today’s operating environment, and that wealth maximisation may well depend on the quality of stakeholder relations. Managers may therefore find it useful to signal to shareholders and other stakeholders that they appreciate this and are acting accordingly. The misinterpretation
of stakeholder theory may lie with the management literature or with managers themselves. It may be that the management literature has interpreted and promoted stakeholder theory as a contender to the traditional wealth maximisation objective. However, it is also possible that managers who have misinterpreted stakeholder theory as an alternative corporate objective that leaves them freer to pursue the interests of other stakeholders, themselves included, and that they have interpreted stakeholder theory as a justification for pursuing the interests of these stakeholders at a cost to shareholders. Nonetheless, there is no strong evidence to suggest that this is an accurate description of how contemporary firms are managed.

Jensen (2002) argues that stakeholder management fails as a managerial objective because it fails to provide a complete specification of the corporate purpose or objective function. Although it is suggested here that stakeholder theory was not intended to be a contender to value maximisation, it appears that some may have interpreted stakeholder theory as at least complementing value maximisation and that a problem of multiple and ambiguous corporate objectives may have resulted from this. In that case, Jensen (2002) does contribute by providing a reminder of why a single objective is better than multiple objectives.

As Jensen (2002) argues, the performance of a manager pursuing a single objective can easily be measured. This is, of course, true as long as the objective pursued is objectively quantifiable, measurable and assessable, which wealth creation is. In contrast, the pursuit of multiple objectives opens up the possibility of ambiguity, hence presenting a measurement problem. Without a primary objective, whatever this may be, managers are left without a single reference point to provide a guide for what is to be accomplished, how to keep score, and how to measure better versus worse. A managerial objective must involve an overriding objective (regardless of how many restrictions are placed on this function) that is measurable and one-dimensional, that is, there is no ambiguity in which of two outcomes are preferred. This ambiguity problem only exists where the trade-off between the different objectives is unknown. It is impossible to make unambiguous judgements on performance or efficiency without having identified the trade-off between the factors involved.

Jensen’s (2002) argument is therefore not really that single objectives are always preferable to multiple objectives, but rather that multiple objectives do not work unless the trade-offs between objectives are known. Jensen (2002: 8) argues stakeholder theory poses an
alternative objective to the wealth maximisation objective, stating that “stakeholder theory says that managers should make decisions that take account of the interest of all the stakeholders in a firm”. When arguing this he refers to Freeman (1984), although there appears to be no assertion by Freeman (1984) to imply that stakeholder theory provides an alternative corporate objective to the traditional objective of wealth maximisation. The underlying assumption appears rather to be that wealth maximisation may depend on the quality of stakeholder management. It would therefore be unreasonable to argue that stakeholder theory is faulty when it is rather managers’ interpretation of stakeholder theory that is to blame.

Nevertheless, if it is true as Jensen (2002) argues, that managers seek to benefit multiple stakeholders of the firm without any more specific objective function, this clearly will lead to ambiguity in measuring their performance as managers. Jensen (2002) proposes a solution to the alleged conflict between stakeholder theory and the value maximisation theorem. He proposes what he calls an “enlightened value maximisation” objective, which he equates to “enlightened stakeholder theory”. The essence of these two terms is that the corporate objective is still wealth maximisation, but with an added emphasis on the possible dependency of long-term wealth maximisation on good quality stakeholder management.

While Jensen’s (2002) introduction of “enlightened value maximisation” is useful the idea this conveys is not new. It simply provides the objective function that would be implied if it was already established that, firstly, value maximisation is the ultimate objective of the firm; secondly, shareholders extract all their value or utility from financial wealth; thirdly, the value of the firm is a complex function of variables including the quality of the firm’s stakeholder relations; and fourthly, that there exist positive synergies between the quality of the relations that the firm holds with at least some stakeholders and the value of the firm. Jensen’s (2002) contribution is therefore the allowance of the third and fourth positions, which are hypotheses that were not new in 2002 given the evidence provided here.

Although this idea is not new the terminology is, and these new terms do contribute by translating the ideas provided in the CSR literature into more explicit terms. In this case, they provide a merger between stakeholder theory and the fundamental financial value maximisation position. The question is whether Jensen’s (2002) introduction of enlightened
value maximisation actually provides a practical solution to ambiguities in performance measurement. It appears that this is not the case.

4. Conclusion

The role of business within society, and therefore the interpretation attributed to CSR at any given place and point in time, appears to have evolved and changed significantly since the beginning of the 20th century. In spite of this, the arguments for and against CSR have remained virtually unchanged over this time. While the question of how firms may approach CSR has enjoyed considerable attention in the literature the question of when and why firms should assume CSR, and what consequences this may have for the firm and for society, remains unanswered. The fact that the interpretation of CSR is subjective is not an adequate reason to keep avoiding this debate. The indiscriminate acceptance of CSR is likely the reason why CSR is so vulnerable to criticism from advocates of the traditional firm model.

Several aspects of the criticism directed towards the widespread acceptance of CSR are well founded. Philosophically, the case for keeping the responsibilities of the private and public sectors separate is a strong one. Practically, the case for managers needing to operate towards single, rather than multiple, objectives is also compelling. An attitude to CSR that does not violate these requirements appears to be achievable, via for instance Jensen’s (2002) idea of “enlightened value maximisation”. At any rate, if CSR advocates wish to appeal to the wider public, including adherents to the traditional view of the firm, it is important to be clear about the assumptions underlying the CSR concept whenever it is discussed.

Despite continued warnings that CSR is a contender to the traditional firm model, there is little evidence to suggest firms actually have adopted CSR as an alternative to the wealth-maximising objective. Rather, CSR appears to have been accepted as being an integral part of meeting the profit-maximising objective as Jensen (2002) suggests, although firms should arguably become much clearer about this in their communications to stakeholders. It is not enough to allocate space in promotional and informational material stating that management is committed to CSR. Nor is it adequate to provide minute descriptions of activities policies that are put in place to promote CSR, including triple bottom line accounting. Management need to be clear about how CSR fits into the corporate objective function, and must clearly
communicate to stakeholders, especially owners, whether CSR is pursued as a part of the wealth-maximising objective or whether CSR is pursued with cost to owners.
Notes

1. Theory X holds that humans are simple beings who are basically lazy, will shun responsibility whenever and wherever possible, and are motivated only by economic incentives (Luthans et al., 1990).

2. Beauchamp (1989) provides in-depth analyses of many cases on stakeholder activism concerning issues including gender discrimination, product safety standard, unfair dismissal for whistle blowing, advertising to children, false or misleading advertising, chemical waste, animal testing, and advertising health threatening substances.

3. The notion of the firm as a nexus of contracts is, according to Zingales (2000), attributed to Alchian and Demsetz (1972) and Jensen and Meckling (1976).

4. Note that this term has been attributed other meanings in the literature. Cornell and Shapiro (1987) define organisational capital as “the current market value of all future implicit claims the firm expects to sell”, whilst also acknowledging that other slightly different definitions of this term are used in the literature. This is slightly different from the meaning Zingales (2000) attributes to this term, although they certainly seem to be related.
References


