Introduction

Goodness is the only investment that never fails.

—Henry David Thoreau

Companies face choices on environmental and social issues. They can worry about pollution or greenhouse gas emissions, or ignore them. Likewise, they can be concerned about employment conditions in third-world subcontractors, or neglect them. This book is about the incentives that they face in making these choices. Are there incentives that lead a corporation to minimize its environmental impact, or to take a stance that is supportive of minorities and of the less privileged members of society? Or are the forces that they face neutral on these issues or even oriented in the opposite directions? These questions matter. Corporations have profound impacts on society in many ways over and above the obvious one of producing goods and services for us. They can generate pollution, drive globalization, employ low-paid labor in poor countries, and contribute to climate change, to name only a few. Their actions in these areas are controversial. So it matters whether they face incentives to direct these impacts in a manner consistent with the social good. I am going to argue that in many cases they do. But an important part of the argument is that this does not happen automatically: it happens as the result of the interaction of a range of non-market forces involving the legal system, the regulatory framework, and, increasingly, civil society. The theme of this book is therefore the interactions between corporate behavior and civil and legal society, and how these interactions structure the company’s incentives on social and environmental issues.
It is not just the actions of corporations that are controversial: there is controversy over a more basic set of issues, namely the responsibilities of corporations on social and environmental matters. There are diverse opinions on this, ranging from a sense that a corporation has open-ended obligations to most of society and is a vehicle for correcting many social ills to the contrary position that its obligations go no further than making profits for its shareholders. Corporations themselves differ on these issues: the Business Roundtable, for example, believes that corporations have wide-ranging responsibilities to a variety of “stakeholders.” The Roundtable identifies stakeholders as customers, employees, suppliers, communities, society at large, stating that “responsibility to all these constituencies constitutes responsibility to society, making the corporation both an economically and socially viable entity.” In practice, many companies define their obligations in a much more limited way. Closely associated with debates about the role of the corporation in society are debates about the roles of organizations that are state-appointed or self-appointed policemen of the corporation, including regulatory bodies such as the U.S. Federal Trade Commission, and nongovernmental organizations (NGOs) that critique and try to influence corporate behavior.

I am not going to take a position on corporate responsibilities, on what corporations should do on social and environmental issues. I am instead going to investigate the forces that drive their behavior in these areas and argue that, perhaps surprisingly to some, there are growing forces that make it in a company’s financial interest to be concerned about its social and environmental footprint. There is evidence that capital markets penalize companies for what is perceived as antisocial behavior, and that consumers are increasingly willing to do the same. To the extent that this is true, companies can gain financially from concern about environmental and social impacts of their activities. In these cases, there need be no conflict between being profitable and doing what is seen as good for society.

One of the factors that matters in this discussion is the practice of socially responsible investment, known as SRI. This is the practice of structuring investment funds to avoid investing in corporations that are seen as transgressing in some manner. One of the earliest such funds was the Pioneer Fund, founded in 1928 by evangelical Protestants who opposed the consumption of alcohol and tobacco. Pioneer Fund avoided investing
in any company involved in the production of alcohol, cigars, or cigarettes. A further movement in this direction occurred in 1971 when a group of churches and religious orders formed the Interfaith Center on Corporate Responsibility (ICCR) with the aim of filing shareholder resolutions and presenting religious challenges to corporate practices with which they disagreed. Today SRI is a significant business: about 10 percent of all institutionally managed funds in the United States are SRI funds, implying that trillions of dollars are invested in this way.

SRI has evolved considerably since the Pioneer Fund. Some is still screened investment, that is, investment in funds that screen out companies with certain characteristics, such as involvement in alcohol, gambling, or weapons production. Others use a more nuanced approach to SRI, rating companies according to their social responsibility and then investing preferentially in companies with higher ratings. The performance of SRI funds relative to non-SRI funds can provide insights into the effect of social and environmental responsibility on financial performance. The relative returns of SRI and non-SRI funds provide evidence on the relationship between social and environmental responsibility and profitability, a central question from a managerial or investor perspective. If being responsible leads to superior financial performance, then investing in companies that have superior social and environmental performance should lead to a superior return.

This brief discussion has touched on all the main themes of the following chapters. The remainder of this chapter addresses a basic question: what is a corporation’s role in society? I will start from Adam Smith’s vision of the invisible hand, updated to allow for a more refined understanding of economics and for changes in the issues on society’s agenda since the eighteenth century. Chapter 2 develops a theme stated earlier in this chapter, the relationship between social, environmental, and financial performance. How and when does social or environmental performance affect profitability? How does it affect share prices and how does the stock market react to information about these aspects of a firm’s behavior? Chapter 3 develops the socially responsible investment theme, looking at how the SRI industry has evolved, what we know about the returns to SRI funds, and what they tell us about the returns to responsible behavior. Chapters 4–7 present a number of industry studies, showing how these issues play out in a wide range of industries, from financials and pharmaceuticals to Wal-Mart and...
Starbucks and Monsanto. Chapters 8–10 look at what has been the most controversial aspect of social responsibility, the role of corporations in poor countries. Is it responsible to outsource production to low-wage countries? Can big companies make money by selling to the very poor? The remaining chapters pull the earlier ideas together into an analysis of how social and environmental performance fit into accounting and into corporate strategy, and develops an executive perspective on social responsibility. The chapter on accounting (Chapter 11) discusses how we can quantify social and environmental performance and incorporate data on this into financial statements, giving a more complete perspective on a company’s overall performance—a “triple bottom line,” in the words of a phrase that is widely used but rarely defined. In discussing social and environmental issues in the context of corporate strategy, I present a managerial perspective on how and when to develop these aspects of a corporation’s behavior.

Adam Smith and Corporate Responsibility

Adam Smith glimpsed some of the eternal verities of economics, propositions that are central to how economic systems work, and though his successors have refined and modified our understanding, his ideas remain an excellent starting point. Smith, of course, never spoke directly of social or environmental responsibility. In 1776 the underlying concept would not have been understood. Corporations as we know them today barely existed, and their role in economic life was limited. Nevertheless, the Scottish moral philosopher, thinking at a time when North America was a British colony and the industrial revolution mainly a thing of the future, set out a framework that is still productive in the vastly different world of today.

Adam Smith is most widely known for the phrase “the invisible hand.” He argues that in a competitive market economy

every individual . . . neither intends to promote the public interest, nor knows how much he is promoting it. He intends only his own security, his own gain. And he is in this led by an invisible hand to promote an end which was no part of his intention. By pursuing his own interest he frequently promotes that of society more effectively than when he really intends to promote it.
Smith was saying something revolutionary and counterintuitive here. He was arguing against do-gooders and in favor of self-interested behavior, at first sight a strange position for a moral philosopher. What is counterintuitive is the claim that self-interested behavior by each individual in society is good for society as a whole—“By pursuing his own interest he frequently promotes that of society.” In the eighteenth century, this idea was amazing, and even today after many years of familiarity we can still find the concept surprising. Might not self-interested behavior by millions of people lead to chaos and conflict? This scenario certainly seems plausible.

How did Smith reconcile self-interested behavior with an idea of the social good? The answer lies in another much-quoted sentence: “It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest.” In other words, firms and traders do not provide us with what we want and need because they love us. Rather, they do it because they love themselves and their families. They can make money in doing so. If we want or need something, then we are willing to pay for it, and so in principle someone else can make a living by providing it. Our demand gives others an incentive to provide what we need, and incentives are central to the operation of economic systems.

This argument breaks down for the very poor, who may need food or medicines but are unable to pay for them and so unable to stimulate others to meet their needs. The failure of the pharmaceutical industry to produce a malaria vaccine is a perfect illustration: malaria sufferers desperately need treatment, but are too poor to pay a price that would make its development profitable. I will return to this later.

So from Smith’s perspective the market economy is good for society because business can make a living by meeting other people’s unmet needs. Smith goes on to argue that in the absence of markets and trade, every household would have to meet all of its own needs; in a market system, in contrast, all can benefit from the division of labor. Some specialize in baking, others in brewing, and so on. As a result, each trade is conducted by specialists with a gain in efficiency relative to a world where everyone is a jack-of-all-trades.

What can Smith’s world view tell us about a corporation’s responsibilities? In a nutshell, this is a redundant question. After all, if self-interested behavior by corporations leads to the social good, what more can we ask of
the corporate sector? Why would we worry about this whole set of issues? There is no need to press for responsible behavior by corporations: in such a Smithian world, the conflicts that give rise to an apparent need for corporate responsibility as something over and above profit orientation would be absent, and all that society would ask of its corporations is that they seek to profit by meeting citizens’ needs.

This is precisely the line taken by a prominent contemporary conservative economist, Milton Friedman, who saw himself as a direct intellectual descendent of Adam Smith. In a widely cited article in the Sunday *New York Times* in 1970, Friedman remarked that

> there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.

His argument is Smithian: to make profits, corporations have to meet people’s needs, and in a competitive world they have to do so at reasonable prices. In the process, they provide income and employment, and pay taxes. So corporations meet our needs, provide income and employment, and produce tax revenues, making it churlish to expect more of them.

In addition, Friedman adds an argument that was not relevant in Smith’s time, an argument that derives from the separation of ownership and control typical of modern corporations that are owned by shareholders, usually institutional investors such as pension and mutual funds, but managed by professional managers. Managers owe responsibility to their employers, the shareholders, and not to society as a whole, Friedman argues. In fact, he claims that the only responsibility managers have to society as a whole is to follow the law and act within the generally accepted ethical conventions. Friedman has scathing comments on business people who talk of the need to preserve the environment, maintain diversity, or meet other social goals, remarking that “businessmen who talk this way are unwitting puppets of the intellectual forces that have been undermining the basis of a free society these past decades.” Friedman then articulates clearly what is implicit in Smith on the issue of corporate obligations to society: that a discussion of
this is redundant because a well-functioning market will ensure that corporations operate fully in the public interest.

If corporations do well financially by doing good for society, then the panoply of regulatory institutions that characterize a modern economy is largely redundant. In Adam Smith’s world we would need a competitive authority to ensure that firms compete rather than collude, but most of the rest of our contemporary regulatory framework would be redundant, including the nongovernmental groups that concern themselves about firms’ actions with respect to the environment and with respect to the less fortunate members of society.

External Costs

Is this an accurate picture, or is something missing here? Much of what Smith said is correct, and for someone writing in 1776 his insights were extraordinary. What’s more, he expressed himself clearly and memorably, which has helped keep his words in front of us. There is a lesson there for some of today’s economics writers! But there are two crucial points missing from the Smith and Friedman arguments. Smith was unaware of them, but Friedman was not: indeed he mentions one of them only to sweep it under the carpet when he refers to “governments having the responsibility to impose taxes and determine expenditures for such ‘social’ purposes as controlling pollution or training the hard-core unemployed.” Governments do indeed have such a responsibility, which arises naturally from issues that Adam Smith missed. They were not as relevant back in the colonial era as they are today. Central to understanding governmental roles is the recognition of when corporate interests are fully aligned with those of society and when they are not. In 1952 in an immortal and overly assertive phrase, Charles E. Wilson (“Engine Charley”), president of General Motors, asserted that “what’s good for General Motors is good for America.” Mr. Wilson was claiming, more prosaically, that corporate and social interests are fully aligned. To understand what this claim involves, let us start with some interesting examples.

Consider Apple, Intel, and Microsoft: in twenty years they created the personal computer industry, an industry affecting everyone in the developed
world and many in developing countries, changing lives and businesses, and creating billions of dollars in value for shareholders and tens of thousands of jobs for new employees. They contributed massively to society and did so for the cause of making money for their shareholders. They made money for their shareholders by developing goods that consumers wanted, paid taxes to the government, and illustrate well Adam Smith’s view of capitalism as a system in which self-interest leads to the common good.

But sadly not all firms are like them: a dramatic contrast is provided by the tobacco companies, who sell a poison that is slow-acting and addictive, so that they can actually make money while killing their customers. It is true that they pay taxes and provide employment, but even so many people will have difficulty in seeing them as a positive force in society. What about the auto and oil companies, which help us experience freedom by means of personal mobility, while polluting the environment and changing the climate? They seem to be intermediate between the two cases. What differentiates high-tech firms like Microsoft, Apple, and Intel from the tobacco, oil, and auto companies?

To understand this we have to go beyond Adam Smith, to the concepts of private and social costs, a distinction attributable to Cambridge economist Arthur Pigou, who wrote in the first half of the twentieth century. When a firm’s private and social costs are the same, which is more or less the case with the tech sector, markets work well for society, aligning corporate and social interests. But when corporate and social interests are not aligned, markets don’t do such a good job, as is the case with tobacco and, to a lesser degree, oil and autos. This explains the conflict between corporations and society in these sectors, and the differences between these sectors and the others.

The private costs of an action are those paid by the person carrying it out. A car user pays fuel bills, maintenance bills, and insurance bills, among others. These then are some of the private costs. There are other costs of auto use that do not fall on the user, examples being the costs of pollution, of contributions to climate change, and of adding to congestion. Driving an auto imposes costs in each of these categories on everyone in the community; indeed, in the case of climate change the costs are imposed on everyone in the world. These are the external costs of using a car, and the total cost of auto use is the sum of the private costs and the external costs: this
sum is called the social cost. External costs are the costs of an activity that are paid by other people, people who are not responsible for the activity and possibly gain no benefit from it. When there are no external costs, the invisible hand does a great job of running the economy and ensures that the outcome is efficient, that the economy’s resources are well used, and that none of the resources are wasted. Economists make this precise in a proposition called “The First Theorem of Welfare Economics,” which asserts that under certain conditions, among them no external costs, competitive markets lead to economic efficiency. External costs are an important characteristic of some of the industries where there are conflicts between corporations and society: the tobacco industry imposes external costs on its consumers, their families, and on the health-care system, and the oil industry, like the auto industry, is a driving force behind pollution and greenhouse gas emissions. So when these industries grow, some of the costs of their growth are paid by citizens who have no connection with them, because of the externalization of costs. These citizens naturally ask why they should shoulder these extra costs, which are neither of their choosing nor associated with any benefit to them. Not surprisingly, there can be opposition to the growth of firms with external costs. High-tech firms, in contrast, externalize few of their costs, which is why the growth of Apple, Intel, and Microsoft was unambiguously positive for the economy and for society as a whole, and was well received.

This discussion of external costs gives us some intuition into when, to quote “Engine Charley” once again, “what’s good for General Motors is good for America.” A precondition for the alignment of corporate and social interests is that no costs are externalized. This is a requirement if what is good for General Motors, or any other corporation, is to be good for America too. Adam Smith did not think of this point—pollution was probably not a serious problem in his day, and climate change certainly was not—and Milton Friedman implicitly and perhaps disingenuously assumed in his New York Times article that the government was taking care of the problem. The most straightforward way for a government to address this issue is to tax the activity that externalizes costs by an amount equal to the externalized costs. So if the external costs of using a gallon of gasoline are $1.50, this means a $1.50 tax on gasoline. Then the cost to the user of using gasoline reflects all the costs of its use, private as well as external. In the
absence of a corrective policy of this type, external-cost-generating activities tend to be carried out on too great a scale for the good of society, implying that their operation generates conflicts between those carrying out the activities and those bearing the external costs.

Conflicts between corporations and society over environmental issues almost always derive from external costs associated with pollution, pollution being the classic example of an external cost. Some of the costs of an activity are externalized to the population as a whole through the spread of pollutants. Deforestation is another source of environmental conflict, again driven by differences between costs and benefits. To a landowner, forests typically have economic value only as lumber and farmland, whereas to society at large they have recreational value, existence value, value in biodiversity support, and value in carbon sequestration. Deforestation imposes external costs on the community by withdrawing many benefits that it has been receiving from the forest and is another source of environmental conflict, again driven by externalization of costs. The significant external costs associated with the environmental impacts of corporations are the main reason we have agencies such as the U.S. Environmental Protection Agency, and a range of legislation designed for environmental protection. They also explain the growth of the environmental NGO sector, with groups such as Environmental Defense, Natural Resources Defense Council, Greenpeace, Friends of the Earth, The Nature Conservancy, the Union of Concerned Scientists, and many others, several of whom will feature in later chapters. Without external costs, there would be no rationale for any of this.

A review of firms and industries where social and environmental issues have arisen provides many more examples of externalization of costs—in fact, it will be a common theme of many examples in the chapters that follow. BP provides an illustration: in 1997 it took a stand on climate change, accepting very early on the scientific evidence behind Intergovernmental Panel on Climate Change (IPCC) forecasts and acknowledging the appropriateness of reducing greenhouse gas emissions. BP imposed a firm-wide cap on greenhouse gas emissions and began a corporate emissions trading system. Emissions have been reduced significantly, ahead of schedule, and BP claims that this has not only cost nothing, but has also in fact increased net income by about $600 million. Viewed from an economic perspective, what BP has done is to acknowledge that its operating costs—private
costs—are less than the social costs of its activities and take measures to bring the two into line. In economic jargon, it has internalized some external costs. It has moved to reduce greenhouse gas emissions, something indicated to be appropriate by social costs but not by private. Dow Chemical presents a similar case: it responded to pressures to reduce pollution by systematically cutting back on all sources by which it could lose chemicals to the environment, and in the process claims to have saved tens of millions of dollars of valuable solvents. Dow, like BP, has acted as if a social cost were a private cost. These companies have moved to avoid conflicts with society over environmental issues, conflicts that could have cost them greatly in terms of goodwill and brand equity, and in the process have also saved themselves significant amounts of money. Their investments paid them what in other contexts has been termed a “double dividend.”

So BP and Dow were able to make money by reducing pollution, which suggests that in fact they had miscalculated their private costs initially, and that pollution was surprisingly not the least expensive way of disposing of their wastes. How could this be? One contributing factor is that in some cases the costs of polluting, costs that were saved by ending pollution, were opportunity costs. BP was flaring natural gas from some of its oil wells. There was no cash cost for this and so no line item in the accounts showing it as a cost, but there were revenues forgone as this gas could be collected and sold. Likewise with Dow, the loss of expensive reagents and products into the environment reduced the yield of its production processes in a way that was hard to see, and this was not visible in its accounting data. So in these examples social costs did to some degree have private counterparts, but these were noncash costs that were not visible from standard accounting perspectives. Many corporations may be missing noncash private costs like these, and in the process overstating the differences between private and social costs and between the corporate and public interests, an accounting shortcoming that good social and environmental policies can remedy.

Heinz provides another example of a company that profited from careful response to an environmental conflict, in this case over the killing of dolphins while fishing for tuna, a side effect causing the social costs of tuna fishing to exceed the private costs. The problem was that catching tuna often involved killing dolphins, and Heinz, a major seller of canned tuna, was held responsible for this. Environmental NGOs organized a boycott
of Heinz, and in response Heinz chose to change their tuna sources from
the eastern to the western Pacific, where the dolphin bycatch is much less,
thereby becoming the dolphin-friendly tuna source. They incurred extra
costs in doing this, but enhanced their brand and earned the congratulations
of prominent politicians and environmentalists, avoiding what would
almost surely have been a costly and bruising confrontation with environ-
mental groups. In terms of our economic model, they did what BP and
Dow did: they brought their private costs into line with the greater social
costs and internalized external costs.

Growing coffee on plantations destroys tropical forests and biodiversity,
again externalizing some of the costs of coffee production. Starbucks, work-
ing in conjunction with the NGO Conservation International, has invested
in environmentally friendly sourcing of coffee, to some degree offsetting
these external costs. Similarly with bananas, plantation production can
have profoundly negative environmental and social impacts, and recently
in conjunction with the NGO Rainforest Alliance, Chiquita has reorgan-
ized its plantations to minimize these negative impacts and cut back on the
externalization of costs. McDonald’s packaging produces waste, externaliz-
ing collection and disposal costs, hence McDonald’s moves, in conjunction
with the NGO Environmental Defense, to produce less bulky packaging.
Shell’s proposal to dispose of the Brent Spar oil buoy in the North Sea was
seen, incorrectly in retrospect, as externalizing substantial disposal costs
and was opposed by Greenpeace and others on these grounds.

Monsanto provides a complex example of a company damaged by its
failure to anticipate conflicts over possible external costs associated with
its products. Monsanto invested billions of dollars genetically modifying
crops to make them more productive and to require less use of insecticides,
rendering the growing process less environmentally harmful. Their aim
was to make agriculture sustainable while improving crop yields in poor
countries. With this aim and with proprietary technologies to implement
it, Monsanto should have been a poster child for corporate environmental
responsibility; they were instead destroyed by opposition from environmen-
tal groups. Consumer opposition to genetically modified crops led to their
being abandoned by farmers, financially weakening Monsanto, which was
then taken over. Monsanto’s problem was that it focused on one private—
social cost gap—that associated with the use of insecticides on growing
crops—but in the process missed another more serious one—that associated with people’s fears of genetically modified foods. From the consumer perspective, Monsanto was seeking to raise farm productivity and lower farm pollution by passing to consumers new and unknown risks, the risks of foodstuffs that had never been extensively tested. Monsanto’s failure was not a failure to take its environmental responsibilities seriously, but a failure to implement this thoroughly and follow through on all of its implications.

Many of the cases and examples that are central to a discussion and evaluation of corporate social and environmental responsibilities hinge on the externalization of some aspect of a product’s costs. One interpretation of several nonmarket systems that impinge on corporate behavior is that their role is to force corporations to internalize the external costs associated with their activities. Legal systems, regulators, and NGOs can all be seen in this light as systems that raise the firms’ awareness of the full social costs of their activities and pressure them to treat external costs as private costs. They can also pressure society to sanction firms that do not respond. To the extent that they do this well, these institutions correct a shortcoming in the market mechanism and serve a real economic purpose.

Fairness

There is another important limitation of the invisible hand. Market economies are efficient provided costs are not externalized, but they need not be fair. Markets are important in determining the distribution of income and wealth, but nothing in the way they operate implies that the ways in which income and wealth are distributed within the population will seem fair or reasonable. People who have scarce and highly valued skills, such as opera singers or rock stars or football players, will be rich, while those with more abundant but socially valuable skills, such as teachers or social workers or police officers, may be poor. Inheritances may transmit fortunes from a productive and successful generation to its less valued successors.

Contemporary debates about outsourcing are in part about fairness and illustrate this class of conflict. What is the fair wage for unskilled labor in the garment industry in poor countries? Competitive markets will set this low, because they reflect the balance of supply and demand, with an
When Principles Pay

abundance of labor driving the price down to little more than a dollar a day. Is this socially acceptable? Is it consistent with generally accepted ideas of justice and fairness? The question seems especially sharp when people earning a dollar a day for a long and arduous day’s work are making goods that are sold for a hundred dollars or more to consumers earning tens of thousands annually. For some, this seems clearly unjust; for others, it is just a reflection of how the world operates. The underlying point here is that the efficiency of markets does not imply that their distributional outcomes are socially acceptable: this is a matter on which opinions can legitimately differ widely, and do so. It is a classic source of social conflict. Many of the debates concerning social responsibilities arise from this.

Some of these debates have implicitly been mentioned already: the sweatshop issue is a source of much debate about social responsibilities. This is a debate about the acceptability of market outcomes in terms of fairness and equity. Is it reasonable that the people who make our shoes or clothes should work ten hours or more daily for one or two dollars? Is it reasonable that children should work in these conditions? If not, whom should we charge with responsibility for remedying this situation and how should they go about it? What are the responsibilities of Western companies outsourcing some of their production processes to low-wage areas—should they pay the local wages, U.S. wages, or somewhere in between? These are core issues in discussions of social responsibilities, and they reflect the fact that the invisible hand is dexterous at using resources efficiently, but not at ensuring outcomes that most people think fair.

Such debates inevitably arise in a market economy. They arise not only in an international context, though they are perhaps at their sharpest there, but also in domestic issues. Current debates about Wal-Mart’s wage and benefit levels are a reflection of this same syndrome within the U.S. economy. In a very different disguise, this issue also arises in the financial sector: debates about insider trading, favoritism in the allocation of initial public offerings, or hidden commissions in insurance policies are all debates about what is a fair and proper distribution of the gains from market participation. In the United States, the recent failures of several large corporate pension funds, even as senior corporate executives earn millions of dollars a year with huge guaranteed pensions, raise similar questions. As in the environmental case, conflicts and debates about fairness involve government
agencies and citizen groups, with participants including regulators such as the state attorneys general and the Food and Drug Administration in the United States, consumer protection agencies in other countries, and NGOs concerned about poverty in developing countries.

Shareholders

Many twentieth-century economists have stressed the fact that shareholders are the owners of a company and those to whom executives have a duty. Furthermore, that duty, as was clear in the discussions of Friedman’s views, is to maximize profits. Profits go to shareholders and are the returns to the capital that they invest in the company. So, maximizing profits is maximizing the return to shareholders. The legal system in the United States (but not in all other advanced industrial countries) has determined that profits are one of the primary goals of the corporation, though not the exclusive goal, and have explicitly permitted the use of some of a corporation’s resources in the promotion of the interests of nonshareholders. The famous case of Dodge v. Ford affords some insight into this. It arose from Henry Ford’s decision to stop paying extra dividends to shareholders in order to raise wages and investment. Ford declared that his aim was to “Do as much good as we can, everywhere, for everybody concerned…” He went on to say:

My ambition is to employ still more men, to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes. To do this we are putting the greatest share of our profits back in the business.

The Dodge brothers, shareholders, sued him on the grounds that his primary obligation was to their welfare and that he was failing in his duty to shareholders. They won, with the court in Michigan ruling that

The difference between an incidental humanitarian expenditure of corporate funds for the benefit of the employees, like the building of a hospital for their use and the employment of agencies for the betterment of their condition, and a general purpose and plan to benefit mankind at the expense of others, is obvious.
There should be no confusion (of which there is evidence) of the duties which Mr. Ford conceives that he and the stockholders owe to the general public and the duties which in law he and his co-directors owe to protesting, minority stockholders. A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among shareholders in order to devote them to other purposes.\footnote{13}

The Court’s statement that “a business corporation is organized and carried on primarily for the profit of the shareholders. The powers of the directors are to be employed for that end” is a very stark summary of the shareholder-centered perspective on corporate responsibility, though this was softened by the statement elsewhere that

\begin{quote}
We do not draw in question, nor do counsel for the plaintiffs do so, the validity of the general proposition stated by counsel that . . . although a manufacturing corporation cannot engage in humanitarian works as its principal business, the fact that it is organized for profits does not prevent the existence of implied powers to carry on with humanitarian motives such charitable works as are incidental to the main business of the corporation.\footnote{14}
\end{quote}

U.S. law does not recognize a legally enforceable duty to maximize profits: in fact, as the Dodge case suggests, it specifically permits firms to sacrifice profits to public interest goals whose attainment is not required by law.\footnote{15} Over thirty states have “corporate constituency” statutes that allow companies to consider the interests not only of shareholders but also of customers, suppliers, employees and the community at large. The American Law Institute’s Principles of Corporate Governance state that

\begin{quote}
Even if corporate profits and shareholder 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 to the responsible conduct of business; and (3) May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.\footnote{16}
\end{quote}
Another important legal issue here is the “business judgment rule,” which states that if the executives of a corporation believe that a policy is in the best interests of shareholders, then shareholders who disagree with the policy have no grounds for legal redress. The essence of this rule is that courts will not argue with the business judgment of a corporation’s executives: they judge legal issues and not business ones. This gives considerable discretion to executives to promote social and philanthropic ends on the grounds that they will contribute to the company’s long-term profitability.

In contrast to the shareholder-centered perspective, the late Sumantra Ghoshal, a management guru from the London Business School, developed an apparently persuasive argument that employees rather than shareholders deserve to be treated as the primary concern of managers. He argued that employees carry more risk than shareholders. If a company fails, the employees lose their jobs and the investments they have made in knowing the company’s business. Finding another job is difficult and usually involves a pay cut. Often employees lose their pensions too. Shareholders, he argued, are less exposed: they have diversified portfolios and can readily find other investments, standing to loose less from failure. Indeed, if the company appears to be doing badly, they can sell their shares and move on much more easily than employees. So employees are more at risk in a company’s failure than the shareholders and perhaps, Ghoshal argued, deserve more consideration than they receive in the shareholder-centric model that dominates economists’ thinking.

There are two fallacies here. First, it is not accidental that economists see profit maximization as the proper objective of the corporation. The invisible hand works well only if corporations do maximize profits. The first theorem of welfare economics, to which I alluded before, states that efficiency in the use of society’s resources emerges from competitive profit-maximizing behavior on the part of firms, provided that there are no external costs and certain other conditions are met. So from an economic perspective it is not shareholders who have primacy, it is profits. Profits represent value added by a company, the difference between the cost of its inputs and the value of its outputs, and for a well-run economy we generally want this value added by the corporate sector to be as large as possible. But profits normally go to shareholders, so shareholders seem to have primacy. But, a propos of Ghoshal’s observations, employees can be shareholders too. Indeed, in many of the most successful new corporations in the United States, employees are significant shareholders.
Second, it is also a fallacy that shareholders are less committed to the company than employees. While some shareholders such as hedge funds undoubtedly are, and move into and out of a company’s shares at short notice, there are many large pension funds that take long-term positions in corporations and expect to hold them through all the vicissitudes of corporate life. Large pension funds are so big that they have to focus their investments mainly on large-cap companies, and the sizes of their stakes in these are such that they cannot quickly sell and move to another firm: doing so would move prices too sharply against them.

Conclusions

In the ideal world of Adam Smith, companies do well by society just by making profits—they do well and do good at the same time. This is the point of Milton Friedman’s 1970 piece in *The New York Times*. But the eighteenth century and the Enlightenment are behind us, and the world in which we live is a world of external costs and of disputes about what is a fair distribution of the benefits from economic activity. In this world, the invisible hand needs some help to reach an efficient outcome. Here, corporate interests are not automatically aligned with the social interest. Society gains from realigning corporate interests with social interests, and corporations also gain from this realignment as it reduces conflicts between them and society. Conflicts between social and corporate interests in general hurt both parties: they hurt society because the outcome of economic activity is not what we collectively want, and they hurt corporations because the corporation is generally the loser in the long run. So if corporations behave as if they have obligations on the social and environmental fronts as well as in the area of profits, then both sides can gain. Society can gain from a fairer or more efficient allocation of resources and the corporation from a less conflictual relationship with the environment in which it operates. In the next chapter we shall see some of the reasons why a corporation might voluntarily choose to assume social and environmental obligations that are not legally mandated. Ultimately, I will argue, this is a matter of self-interest. Primarily, this self-interest arises from considerations of liability and of brand enhancement, though there are other dimensions in which this can prove rewarding.