15 September 2005

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
Department of the Senate
Parliament House
Canberra ACT 2600
Australia

Re: Inquiry into Corporate Responsibility

Dear Committee Secretary,

I am in the final year of a PhD in Corporate Social Responsibility (CSR) and stakeholder theory at the University of Melbourne. This submission draws upon the theory and empirical findings of international research in these areas, emanating from the academic field of Business and Society (aka Social Issues in Management). This field has been addressing the questions posed by this Inquiry over many decades. Indeed, it is from this field that the concepts of stakeholder management, CSR and corporate citizenship have emerged and flourished. Thus, it seems imperative that this inquiry has available to it the wealth of thought and findings so far generated.

Please feel free to contact me if I can be of further assistance in your deliberations.

Sincerely,

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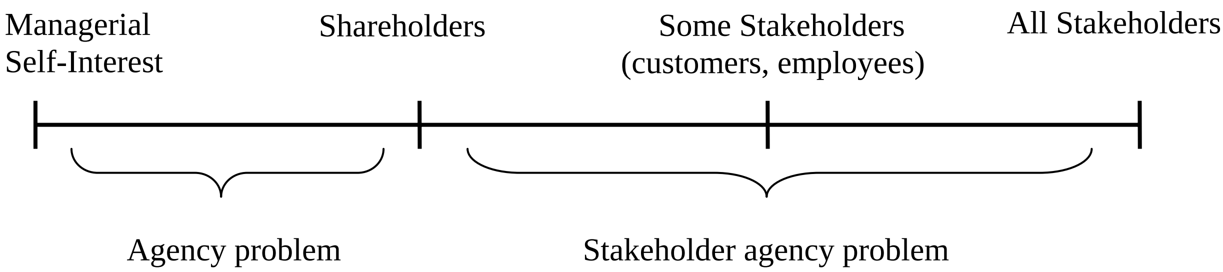
Inquiry into Corporate Responsibility: Academic Theory and Findings

a. The extent to which organisational decision-makers have an existing regard for the interests of stakeholders other than shareholders, and the broader community.

While no study has sought to test this question across the breadth of Australian organisations, suffice it to say that Australian organisations will represent the breadth of possibilities of responses, from managerial self-interest through to consideration of all of the organisation's stakeholders (see continuum figure 1). Typically, Australian organisations have adopted the shareholder value maximisation strategy that was argued most convincingly by US neo-classical economist, Milton Friedman (1962, 1970). However, many Australian organisations, such as Westpac[1] and BHP Billiton, have recently incorporated a stakeholder approach within their corporate strategies. A study by Berman, Wicks, Kotha and Jones (1999) found that the quality of relationships with customers and employees can have a significant impact upon financial performance[2]. It may therefore be expected that the managers of successful organisations also consider these two groups (as well as shareholders) within their strategic decision making.

Figure 1. Managers have an existing regard for…



The continuum above highlights how, just as agency theory (Jensen and Meckling, 1976) articulates the agency problem of a misalignment between the principal and agent's objectives, stakeholder theorists have articulated a stakeholder-agency problem (Hill and Jones, 1992). That is, recognising that the organisation is a nexus of implicit and explicit contractual relationships between all stakeholders (not only shareholders), the stakeholder-agency problem represents the issue of managers' decision making prioritising one contractual partner to the detriment of its other contractual partners. The current inquiry represents the juxtaposing of the agency problem with that of the stakeholder-agency problem.

[1] Indeed, Westpac is an internationally recognised leader, ranked number one amongst all of the world's banks on the Dow Jones Sustainability Index (DJSI) for the last four years, including 2005-06.

[2] The Berman et al. (1999) study tested the impact of the five broad variables measured in the KLD index, an ethical investment index that has become the most popularly utilised by stakeholder researchers. These variables, which are roughly commensurate with stakeholder groupings, include employee relationships, diversity, local communities, the natural environment, and product safety/quality.

b. The extent to which organisational decision-makers should have regard for the interests of stakeholders other than shareholders, and the broader community.

This question has arguably motivated a whole field of academic study. It has been considered within the stakeholder literature from two different perspectives: firstly, the 'normative' perspective, or what is morally the right thing to do; and secondly, the the 'instrumental' perspective, or whether managerial regard for the interests of all stakeholders may be used as a strategic instrument towards maximising organisational performance and, thus, shareholder wealth. The instrumental perspective is otherwise known as 'enlightened organisational self-interest', and represents the win:win scenario where the organisation and its stakeholders all benefit. In answering this question, I will discuss the normative and instrumental stakeholder perspectives and present the conclusions from these literatures. I will then discuss the political-ideological biases underpinning viewpoints on this issue, which explain why the debate is expected to continue despite the firm conclusions emanating from the stakeholder literature. The members of the Committee should take note of this area of study to understand their own biases in answering the questions of this Inquiry.

Normative stakeholder theory

Although technically incorrect, stakeholder theory is considered by many to have emerged as a rebuttal to the ethical arguments of Milton Friedman (1962, 1970) in support for managers maximising shareholder wealth. Friedman's argument focused upon prioritising the property rights of shareholders, underpinned by the utilitarian belief that unencumbered market forces provide the most socially optimal outcome.

Two rebuttals that are representative of the normative stakeholder literature are by Donaldson and Preston (1995) and Phillips (2003). Donaldson and Preston (1995) argued that Friedman's utilisation of property rights to justify the dominance of shareholder value maximisation "runs strongly counter to the conception that private property exclusively enshrines the interests of owners" (p83). Drawing upon the arguments of property theorists, Donaldson and Preston argued that contemporary thought has explored and articulated the limits to the rights of property owners, where these rights clash with the rights of the community and others. Property rights allow the owner to carry out certain actions, but these are not unlimited. In this case, shareholders do not own the company, as such, but only own the right to the residual cash flows, a limited right that supports the responsibility avoidance of 'limited liability'. These limited rights discredit the charge that managers must act solely on behalf of shareholders.

Phillips (2003) drew upon John Rawls' principle of fairness to argue that when the organisation accepts benefits from other stakeholders it becomes morally obliged to those stakeholders. This principal focuses upon the immorality of free-riding. In general, as the organisation accepts benefits from other stakeholders apart from shareholders, it is also morally obliged to these stakeholders. For example, when it utilises public roads and emergency services it becomes obliged to the local community. From this perspective, organisations not respecting these obligations may be viewed as 'free-riding'.

Analysing "the *extent* to which organisational decision-makers should have regard for the interests of stakeholders other than shareholders", however, is more problematic and has not been adequately dealt with by the normative stakeholder literature. For example, Donaldson and Preston (1995) recognised that limited property rights discredits exclusive shareholder value maximisation and "brings the interests of others into the picture" (p83), but it does not prescribe which others should be considered and which actions of the owners should be restricted. Similarly, Phillips (2003) prescription of obligations being ascribed relative to contributions is problematic in practice. How should managers "compare the new assistant brand manager's contribution to the firm with the contribution made by the janitor who has cleaned the office of these new managers for fifteen years", etc. (Walsh, 2005, p435)? Phillips counters by suggesting that the balancing of stakeholder obligations is more art than science. But this seems a trifle evasive.

The conclusion of normative stakeholder theory, therefore, is that, based upon ethical theory, managers most certainly should have regard for the interests of stakeholders other than shareholders. However, the exact extent to which they should have this regard is a question still to be addressed.

Instrumental stakeholder theory

Instrumental stakeholder theory refers to the instrumental benefits to the organisation (and thus shareholder wealth) of strategically considering other stakeholders apart from shareholders. That is, regard for other stakeholders is a 'means' to the 'end' of maximizing shareholder wealth. Where this is the case, organisational decision-makers should have regard for the interests of stakeholders other than shareholders because it is the best interests of shareholders. As such, this argument represents 'enlightened self-interest'[3]. I will, firstly, present a brief overview of the underpinning theory of the instrumental stakeholder perspective, followed by a discussion of the empirical evidence testing this perspective.

The underpinning theory of the instrumental stakeholder perspective is based upon the descriptive correctness of stakeholders mediating the relationship between all of the organisation's activities, labelled corporate social performance (CSP)[4], and its financial performance (FP) (figure 2.). The stakeholder mediating role was summarised by Clarkson (1995, p112), "[i]f any primary group perceives, over time, that it is not being treated fairly or adequately…it will seek alternatives and may ultimately withdraw from that firm's stakeholder system". Wood and Jones (1995) provided a more detailed explanation, that the role of stakeholders in relation to the organisation is to (a) set expectations, (b) experience effects, (c) evaluate outcomes, and (d) act upon these evaluations. These actions will take the form of rewards or

[3] Ethically, instrumental stakeholder theory has been criticized as being based upon organizational self-interest, or egoism, and is thus unethical. However, ethical support for considering one's own interests at the same time as others' interests (i.e. not to the detriment of others; a win:win outcome) is explained within feminist ethics (e.g., Gilligan, 1982).

[4] The most cited definition of CSP is by Wood (1991), who recognised that organisations are assessed not only upon the outcomes of their activities, but also on their motivations and the means by which they achieve their outcomes: CSP is "a business organisation's configuration of principles of social responsibility, processes of social responsiveness, and policies, programs and observable outcomes as they relate to the firm's societal relationships" (Wood, 1991, p693).

punishment, with the motivation of reinforcing or changing the organisation's activities (Rowley and Berman, 2000). Importantly, the relationship will be positive where stakeholders' actions are predicated by ethical concerns as well as their own instrumental concerns. For example, where consumers' actions are based upon environmental or labour rights concerns as well as the value or utility they derive from the organisation's products and/or services.

Figure 2. Stakeholders' mediating role in
the CSP-FP relationship

How stakeholder actions influence the organisation has recently been explained using resource dependence theory (Pfeffer and Salancik, 1978) (e.g., Frooman, 1999; Jawahar and McLaughlin, 2001). From this perspective, an organisation is viewed as being dependent upon various stakeholders for the critical resources that enable it to operate. For example, consumers provide the organisation with revenue, employees provide labour, while governments provide infrastructure and other services. Stakeholder rewards or punishment will impact the organisation through providing or withholding these resources, or through placing conditions upon their usage (Frooman, 1999).

Organisations practising stakeholder management, such as Westpac and BHP Billiton, have explicitly argued that it is in the best interests of shareholders. However, if the instrumental stakeholder, or enlightened self-interest, argument has been accepted in theory, what is the evidence that it holds true in practice? Indeed, a CSR strategy contradicts the traditional beliefs of neoclassical economists. For example, Milton Friedman (1962, 1970) argued that being socially responsible will cause the firm to be uncompetitive and decrease shareholder wealth.

Academics have sought to empirically test the instrumental stakeholder argument through measuring the relationship between corporate social performance (CSP) and financial performance (FP) (i.e. between 'doing good' and 'doing well'). Initial results, however, were ambiguous and far from compelling. Margolis and Walsh (2003) reviewed 95 academic articles testing the relationship and found that only 53% of these supported the instrumental stakeholder argument, while 42% of the studies either found a mixed relationship or no relationship at all. Meanwhile, the remaining 5% of studies that found a negative relationship is hardly evidence that unethical behaviour pays off. Nevertheless, Margolis and Walsh concluded that the assumptions behind the enlightened self-interest argument must be treated with caution.

Much of the focus on these ambiguous results within the literature has questioned whether the relationship has been properly measured. While FP can be measured in different ways, the subjectivity and abstraction of measuring CSP causes it to be even more contentious. In response to this measurement issue, Orlitzky, Schmidt and Rynes (2003), conducted a meta-analysis that collated all the findings from 52 previous CSP-FP studies. This technique controls for the different measures used for CSP and FP. They found that, although variable, CSP was positively related to FP. On average, the instrumental stakeholder perspective is correct - firms that do good *will* do well. Therefore, in order to maximise shareholder wealth, organisational decision-makers should have regard for the interests of stakeholders other than shareholders.

The continuing debate

Despite the firm conclusions emanating from the stakeholder literature and the adoption of these views by many leading organisations, such as Westpac and BHP Billiton, the stakeholder audience does not represent the breadth of business and society views. Recently, a debate between the shareholder value maximisation view and the stakeholder view was presented in the academic journal Organization Science (Vol. 15, No. 3, 2004). The issues considered in this debate are likely to be repeated in the current inquiry.

Sunderam and Inkpen (2004), representing the shareholder view, recognised the instrumental benefits to the organisation of a stakeholder strategy (which Friedman, earlier, had not). However, they argued that the shareholder view maximises the value of the whole firm, allowing the firm to maximise returns to all its stakeholders. The argument was that the shareholder approach is therefore ‘pro-stakeholder’. The underpinning argument to this view was reducible to the perspective that balancing many stakeholder interests is simply too complex for managers and thus will result in inferior performance. They argued that more than one objective function is a recipe for confusion. Shareholder value, on the other hand, is a single-valued metric that is easily observed and measurable.

Freeman, Wicks and Parmar (2004), representing the stakeholder view, countered that the shareholder view entails adoption of the ‘separation thesis’ – the assumption that economics and ethics may separated. They argued, as Ghoshal (2005) also very effectively argued, that maximising shareholder value is not the value-neutral, ideology-free theory it is presented as. They argued that, “At its worst, it involves using the prima facie rights claims of one group - shareholders – to excuse violating the rights of others” (p365). This was most clearly exemplified in Australia in the case of James Hardie.

Countering the argument that the shareholder approach is ‘pro-stakeholder’, these authors presented the instrumental stakeholder argument that having regard for other stakeholders enhances shareholder returns. Surprisingly, at this point, they did not explicitly counter that Sunderam and Inkpen’s argument allows the possibility of some stakeholders’ rights being violated in order to achieve net utilitarian benefits. Next, countering the argument that stakeholder management is too complex, Freeman et al. argued that, in contrast, it is the most effective tool for a complex world. They argued that in our daily lives we constantly make compromise solutions weighing the interests of many groups. Indeed, managers who maximise shareholder value often have to compromise between maximising short and long-term profit. On the other hand, a single objective function distorts moral reality, encouraging unethical practice and increasing the possibility of scandal and, with it, financial and reputational damage.

The Committee may note that the arguments are somewhat reducible to opinions regarding the effectiveness of single versus multiple objective functions. This was commented on by Ghoshal (2005). In countering the property rights argument of Friedman by referring to the contributions of other stakeholders in creating value, Ghoshal asked, "Why must the mainstream of our theory be premised on maximising the returns to just one of these contributors? The answer – the only answer that is really valid – is that this assumption helps in structuring and solving nice mathematical models" (p80).

The ideological bias behind these views was explored in research by Tetlock (2000). Tetlock argued and found evidence that our competing views on human nature, specifically regarding the opportunistic tendencies of others (i.e. psychological egoism), and our cognitive preferences for simplicity[5] or abstraction/complexity predict our predication toward the shareholder and stakeholder models. Those who support the shareholder view, such as Sunderam and Inkpen, demonstrate a predication toward cognitive simplicity, while those who support the stakeholder view, such as Freeman et al., demonstrate a predication toward abstraction/ complexity. Tetlock argued that our cognitive preferences drive our understanding and interpretation of advice, events and empirical results. He concluded that support for the stakeholder view is contingent, then, upon our values and not on empirical evidence of superiority.

This study provides important guidance for understanding the lack of agreement between supporters of the shareholder and stakeholder views. Importantly, the Committee members should recognise that the subject matter of this inquiry is politically contentious. I implore the Committee members to understand individual contributors' personal biases, as well as consider and seek to set aside their own personal biases when interpreting the submissions and other information at its disposal when answering the questions of this Inquiry[6].

c. The extent to which the current legal framework governing directors' duties encourages or discourages them from having regard for the interests of stakeholders other than shareholders, and the broader community.

The current legal framework prescribes that managers should act in the interests of the corporation, which has been interpreted as maximising returns to shareholders. As such, it encourages managers to have regard for the interests of other stakeholders *only* when this is in accordance with the interests of shareholders. This situation is represented in the stakeholder literature by instrumental stakeholder theory. As referred to above, empirical findings support the instrumental stakeholder perspective – on average, firms that do good *will* do well (see Orlitzky et al., 2003).

[5] Simplicity should not be interpreted as simple-mindedness, but a preference for cognitive closure. Simplicity is then evidence of insight, whereas complexity is seen as evidence of confusion. In contrast, those who are comfortable with abstraction see complexity as evidence of thoughtfulness.
[6] I will readily own up to my own personal biases in this regard. While sitting on the fence in terms of cognitive bias, I have strong anti-psychological egoism values that predicate me towards the stakeholder view.

However, what is of concern here is the notion ‘on average’. Generally, we may feel comfortable that the current legal framework encourages managerial regard for other stakeholders. However, under some conditions this will not be the case. Certainly, stakeholders are harmed in the pursuit of profit, as is the justification of this inquiry. As such, the current legal framework *dis*courages managerial regard for other stakeholders under these conditions.

What might some of these conditions be? It was explained above that the instrumental relationship (i.e. CSP-FP) is based upon stakeholders rewarding and punishing organisations based upon their ethical concerns as well as the utility they derive from the organisation. This mediating role, however, will sometimes fail. Some of the conditions that lead to, in this case, market failure are imperfect information, lack of competitive intensity, and ethical free-riding.

Firstly, for stakeholders to act upon an organisation’s activities they must be made aware of these activities. Those who are unaware of, for example, labour rights abuses in developing countries, will not be able to punish those organisations conducting the abuses. This also works in reverse. Those who are unaware of an organisation’s good deeds are unable to reward them. Both Westpac and Nike are currently experiencing this phenomenon, having turned around previously heavily criticised practices to now being leaders in their respective fields. Yet, the wider community is generally unaware of the very sincere changes they have both made.

Secondly, stakeholders will be unable to act on their evaluations of an organisation’s actions if there is insufficient competitive intensity (i.e. choice) within a market. For example, a car driver who wishes to boycott a particular petrol supplier will be forced to buy petrol from that supplier when it is the only supplier within geographic range of the capacity left in the driver’s tank.

Lastly, many stakeholders will act in accordance with their own self-interest, and not reward or punish organisations based upon the ethical treatment of other stakeholders, effectively playing the role of ethical free-riders (Doane, 2005). This is important to ensuring a positive relationship between regard for other stakeholders and financial performance when the particular stakeholders disregarded, or treated unethically, are relatively powerless to impact the organisation. For example, sweatshop workers with no alternative employment opportunities, and consumers with few disposable funds, are not able to impact organisations sufficiently to enact a change in the organisation’s behaviour. In these instances, these relatively powerless stakeholders are reliant upon forming an alliance with other more powerful stakeholders in order to attain sufficient power to enact organisational change. However, the absence of ‘care’ for powerless stakeholders amongst other stakeholders weakens the CSP-FP relationship.

Indeed, the evidence that stakeholders utilise ethical concerns when dealing with organisations is not compelling. Doane (2005) presented evidence from a UK ethical consumerism study that found that despite 83% of consumers ‘intending’ to act on their ethical concerns on a regular basis, only 18% acted on these concerns occasionally, and only 5% acted on them regularly. Similar results have been viewed in terms of green consumerism, where Makower concludes that, “The truth is the gap between green consciousness and green consumerism is huge" (cited in Doane, 2005, p26).

What these contingency factors demonstrate is that managerial regard for other stakeholders is not always correlated with improving shareholder wealth. While on average, the current legal framework encourages managerial regard for other stakeholders, under these conditions it, in fact, discourages such a regard.

d. Whether revisions to the legal framework, particularly to the Corporations Act, are required to enable or encourage incorporated entities or directors to have regard for the interests of stakeholders other than shareholders, and the broader community.

The implications of the contingency factors presented in the preceding question – imperfect information, lack of competitive intensity and ethical free-riding – is that public policy should be used to counter market failure. As with general market failure, this may be achieved through a combination of the encouragement of market forces and intelligent regulation.

Firstly, lack of competitive intensity may be partially rectified by increasing competition, and thus choice, within a market. More practically, perhaps, imperfect information may be rectified (at least partially) by increasing the reporting requirements of organisations in terms of their treatment of other stakeholders (e.g., Triple Bottom Line reporting). This would also require auditing of such reporting, as with financial reporting. Indeed, auditing is a requirement of the UK Government's recent legislation of Triple Bottom Line reporting. Also, in a perfect market, stakeholders would be able to access this information at the point of transaction with the organisation. For example, supermarket products would contain ethical information along with the ingredients and other information. There are practical issues involved with this, of course, however technology may be utilised to encourage the move toward perfect markets.

However, the notion of encouraging stakeholders to 'care' for other more powerless stakeholders is not enhanced by increasing the prevalence of market forces. Similarly, regulating 'caring' is preposterous. However, regulating against harm is not, and is indeed in keeping with the liberal philosophy underpinning Western democracy.

At this point, it is relevant to discern between regulating 'for' CSR and regulating 'against' irresponsibility. This pertains to whether any regulatory changes might prescribe managers to act in accordance with the interests of shareholders *and* other stakeholders, or for managers to act in accordance with the interests of shareholders *but not at the expense of* other stakeholders. The aforementioned position seeks to legislate 'goodwill', an impossible and fruitless task. Indeed, complying with goodwill regulations is as much of an oxymoron as 'business ethics' is now currently viewed.

However, regulating *against* doing harm is a social expectation of government and the judiciary. Prescribing managers to act only in the interests of shareholders allows the possibility of harm being done to other stakeholders under conditions where instrumental stakeholder theory does not apply. This should be viewed by the

Committee as governmental negligence, as recognised by Commissioner Jackson in the recent James Hardie inquiry. Previous thinking, that there are net utilitarian benefits to society by prescribing managers to act only in the interests of shareholders (e.g., Friedman, 1962, 1970), is dated and has been countered by normative stakeholder theorists. As previously quoted, “At its worst, it involves using the prima facie rights claims of one group - shareholders – to excuse violating the rights of others” (Freeman et al., 2004, p365). This must be not be allowed.

e. In considering this matter, the Committee will also have regard to obligations that exist in laws other than the Corporations Act.

No specific comment.

f. Any alternative mechanisms, including voluntary measures that may enhance consideration of stakeholder interests by incorporated entities and/or their directors.

While legislating against harm, governments should also seek to encourage organisational behaviour that is consistent with the public good. Apart form reporting requirements, governmental funding of CSR indices (e.g., Corporate Responsibility Index, RepuTex) and other research into the contingencies of instrumental stakeholder theory are encouraged. Additionally, governments should focus upon their own mediating role. Apart from legal issues, where this is likely to be insufficient is in terms of procurement. Government bodies should incorporate CSR factors within their procurement policies. For example, positions upon CSR indices could be included.

g. The appropriateness of reporting requirements associated with these issues.

Reporting requirements are vital to ensure the proper workings of the stakeholder mediating role and thus organisational compliance to instrumental stakeholder theory (as explained in question 4). The Committee may look to the experiences of the UK government, who have recently instituted these reporting requirements.

h. Whether regulatory, legislative or other policy approaches in other countries could be adopted or adapted for Australia.

I point the Committee towards the experiences of Europe and particularly of the UK, which has been a leader in this area (e.g., the UK Operating and Financial Reporting Review).

However, recent work by Matten and Moon (2004) should contribute to the understanding of the applicability of other countries’ experiences to the Australian context. These authors explained how the prevalence of proactive CSR initiatives is dependent upon the institutional environment of the organisation, which will differ in different countries. For example, European organisations are less likely to demonstrate proactive CSR initiatives than US companies due to the more socially pervasive European institutional environment. For example, universal healthcare in European countries makes redundant the US CSR initiative of offering health plans to employees. In this regard, the Australian institutional environment is more akin to the European model than the US. As such, the Committee should look to European experiences as having more relevance for the Australian situation than US experiences.

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