CHAMBER OF COMMERCE AND INDUSTRY

WESTERN AUSTRALIA

22 September 2005

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

Dear Sir/Madam

RE: INQUIRY INTO CORPORATE RESPONSIBILITY

Attached is a submission by the Chamber of Commerce and Industry of Western Australia (CCI) to the above inquiry. I thank the joint committee for the opportunity to have input into this process.

Should the committee require further information, please contact me or CCI economist, Noel Richards.

Yours sincerely

J L Langoulant
Chief Executive

The Social Responsibilities of Business

A Submission to the 2005 Senate Inquiry into Corporate Responsibility

September 2005

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Introduction and Overview

About CCI

The Chamber of Commerce and Industry of Western Australia (CCI) is the leading business association in Western Australia. It is the second largest organisation of its kind in Australia, with a membership of almost 5,000 organisations in all sectors including manufacturing, resources, agriculture, transport, communications, retailing, hospitality, building and construction, community services and finance.

Most members are private sector businesses, but CCI also has representation in the not-for-profit sector and the government sector. About 80 per cent of members are small businesses, and members are located in all geographical regions of WA.

Some 100 business associations are affiliated with CCI, expanding the organisation's representative coverage to more than 10,000 enterprises.

Summary and Overview

Recent years have seen renewed focus on the social and environmental dimensions of economic activity, and in particular on the activities of the business sector. This focus has many sources and strands.

It derives in part from the search for new ways of moulding society and the economy in the aftermath of the collapse of communism, and consequent discrediting of state-directed, centralised political and economic models.

It reflects concerns about the processes and effects of globalisation, and the way in which economic decisions and their social and environmental effects increasingly transcend traditional national and regional political jurisdictions.

It is driven in part by the increasing prominence and claims of non-government organisations seeking to fill some of these gaps in authority with the influence of 'civil society'.

This prominence has in turn been both a cause and an effect of a shift in public opinion towards concerns for the social, cultural and environmental consequences of economic activity.

The Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Corporate Responsibility is a response to this shift in public concern. The inquiry attempts to gauge:

- The extent to which Australian corporations currently account for and manage their social and environmental effects;
- To what extent Australian corporations should have to account for and manage their social and environmental effects;
- How the current regulatory framework encourages or discourages the take up of corporate responsibility and;
- How the regulatory framework can be changed to encourage such practices.

CCI finds a weak case for regulatory enforcement of corporate social responsibility (CSR).

This paper highlights that Australian businesses are becoming more aware of and responsible for their social and environmental effects, and more importantly, that this shift in corporate culture is being motivated exclusive of regulatory obligations and mostly by commercial pressures.

That is, operational decision makers tend to have regard for the interests of external stakeholders to the extent that they increase shareholder value.

Regulating to encourage organisational decision makers to have regard for stakeholders beyond this is not in the public interest, and it is not the role of business. Stakeholder views and practices should be accommodated only so far as they improve or safeguard shareholder value.

Although stakeholder views of the firm are usually presented as eminently reasonable and moderate reactions to justifiable community concern about the unwanted side effects of business activity, its more radical interpretations are underpinned by social ideologies about ownership and property rights, accountability and the operation of the economy.

Such policies are flawed and potentially costly for businesses and the economy. Proponents of such policies assume that triple bottom line accounting, ethical investment, stakeholder entitlement and similar theories will yield better outcomes (for some parties, at least) than an economy in which firms are primarily engaged in maximising long-term value for their shareholders within a framework of laws.

The real virtue of the good corporate citizen is that it generates returns for investors by providing customers with the goods and services they want, at prices they are prepared to pay, while proving trustworthy and responsive enough to earn repeat business.

In the process, it creates jobs, bids up wages, pays taxes, and innovates in the perpetual search for an advantage over its competitors. In all of this, government has a proper role in shaping the regulatory environment where good business practice alone might not result in efficient outcomes.

The Role of Corporations

The debate over corporate social responsibility concerns the role of corporations. For as long as businesses with limited liability have existed, there has been debate about how they should be owned, operated, regulated and motivated.

Before addressing the terms of reference of the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Corporate Responsibility, it is important to understand the two differing views of the firm in the context of this issue.

The shareholder-oriented firm

In Australia, the UK and the USA, the commonest understanding of the firm is of a shareholder-oriented institution. This is typically a limited liability joint stock company whose core function is seen as generating profits for its owners.

In this model, corporate governance focuses primarily on ensuring that managers and directors exercise responsible stewardship of shareholders’ funds. There is no expectation that these agents have a responsibility to serve any other interests besides those of the people whose property they manage.

Most exponents of a shareholder-focused model of the firm recognise that it is appropriate to modify the behaviour of business owners, managers and directors in the light of the wider social costs and benefits their businesses' activities engender (although the extent of appropriate intervention is hotly debated).

So, firms' operations are constrained within a framework of laws designed to enforce protections for the interests of customers, employees, other businesses, the environment, the community, the government, and so on.

Under this shareholder-oriented model, these constraints are external. No more is expected of businesses than that they obey the rules as they go about their core function of generating profits.

This limited expectation can be expressed either negatively or positively.

Positive advocates of the shareholder-oriented firm assert that maximising profit within a framework of laws is both the most ethically appropriate behaviour of business managers and the most socially desirable, because it leads to the best economic and social outcomes.

This view has been stated by Milton Friedman, who argued 40 years ago 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."*[1]

The negative view of shareholder orientation presumes that corporate ethics is an oxymoron. In this view nothing better than greed can be expected of business operators and pursuit of owners' interests will be at the expense of the wider community, so a system of laws and regulations is necessary to force corporations to behave according to the community interest.

An oft-quoted observation from 18th century British jurist Edward Thurlow sums up this view summarising the hopelessness of expecting unselfish behaviour from business:

> *"Did you ever expect a corporation to have a conscience, when it has no soul to be damned, and no body to be kicked?"*[2]

The stakeholder-oriented firm

The model of the shareholder-oriented corporation operating within a framework of rules has never been universally welcomed or accepted, nor has it always been applied.

Social democratic and corporatist societies have enlisted business along with labour and government in a concerted effort to achieve some wider social and economic good – broad macro-economic management or more specific objectives such as limiting wage increases in order to control inflation or reduce unemployment, for example.

Recently, there has been a revival in centre-left political circles of interest in broadening the orientation of businesses' objectives as part of a wider approach to economic management.

This has coincided and overlapped with developments in stakeholder theories of management, which argue that the activities of businesses (and government and non-government agencies) should be oriented towards furthering the interests of a range of social and economic groups, or 'stakeholders'.

These theories promote what Elaine Sternberg[3] has described as "entitlement stakeholders".

Some advocates of a stakeholder-oriented approach to the corporation in fact hold very similar opinions to the negative view of the shareholder-oriented firm. They see businesses as inherently anti-social and greedy, and therefore in need of extensive legal and regulatory restraints to make them give due consideration to implications of their operations on employees, customers, competitors, the environment and the community.

But there is a less hostile view which hopes that businesses will voluntarily incorporate broader interests into decision making processes. Perhaps the most well-known political advocate of this form of stakeholder orientation is British Prime Minister Tony Blair, who has argued:

> *"We cannot by legislation guarantee that a company will behave in a way conducive to trust and long-term commitment. But it is surely time to assess how we shift the emphasis in corporate ethos, from the company being a mere vehicle for the capital market, to be traded, bought and sold as a commodity, towards a vision of the company as a community or partnership in which each employee has a stake, and where a company's responsibilities are more clearly delineated."*[4]

The resurgence of interest in stakeholder theory and other views that firms should take a broader focus than the interest of shareholders alone has many sources. In its form most hostile to business, it reflects the views of the more radical elements of the anti-globalisation movement, and their related opposition to corporate activities and rights.

While Marxist solutions to the perceived evils of capitalism may have been largely discredited, an underlying hostility to capitalism persists. Its more mainstream political expression lies in the resurgent 'third way' politics of Britain's 'New Labour' already discussed, whose electoral successes make it an attractive role model to centre-left parties in Europe and elsewhere, including Australia.

At a fairly diffuse social level, it reflects a response to the changing climate of community opinion which has underpinned that political sea-change, including increased environmental awareness and concern, disquiet at globalisation, hostility to corporations and a view that political processes fail to deliver the social and economic outcomes people want.

CSR: How Far Have Corporations Gone?

The International Survey of Corporate Responsibility Reporting, conducted annually by KPMG, found that 14 out of Australia's top 100 companies prepared corporate responsibility reports in addition to their annual reports in 2002. By 2005, this number had risen to 23 out of Australia's top 100 companies[5].

The take-up of responsibility reporting among the Australian corporate community has been slower than in other countries. According to the KPMG report, an average of 33 out of the top 100 companies operating in 16 developed countries had prepared stand alone responsibility reports in 2005.

Nonetheless, other surveys have also demonstrated an awareness of social responsibility among Australian businesses.

A survey of 115 large public and private Australian entities, conducted in 2000 by the Centre for Corporate Public Affairs and the Business Council of Australia[6], found that 85 per cent of participants recognised that their businesses had a social obligation and supported some form of involvement with the community.

In addition, a New South Wales State Chamber of Commerce survey found that 74 per cent of business leaders recognised that their businesses needed to strike a balance between the objectives of building a better society and generating profits. It also found that 78 per cent of Australian companies had a code of ethics or an equivalent statement[7].

This evidence suggests that corporate social responsibility matters to Australian businesses. It matters primarily because the shifts in public opinion towards concerns for the social, cultural and environmental consequences of economic activity have occurred at a time when the public have a greater willingness and capacity to monitor business activities than ever before.

Through this, the public has a greater ability to reward and penalise behaviour of which they approve or disapprove, through co-ordinated or individual actions as consumers, investors, voters and litigants.

This is probably the key reason for the increased incidence of explicitly stakeholder-oriented policies in businesses across Australia - they are to a large degree compatible with, and even conducive to, the promotion of shareholder interests. This is discussed in further detail below.

Good Behaviour is Profitable

From a business perspective, a persuasive case for adopting a stakeholder orientation is that good corporate citizenship is profitable.

At its most fundamental level, the underpinning mechanism of commerce in free markets is ethical - voluntary cooperation to mutual gain.

A strong case can be argued that this is a more ethical foundation than alternative mechanisms for distributing goods and services which, while perhaps driven by more altruistic motives than self-interest, tend to be achievable only through compulsion and confiscation.

At a more practical level, ethical business is generally profitable business.

Businesses in competitive markets which repeatedly sell over-priced or shoddy goods, which fail to pay suppliers, which exploit or under-pay workers or which harm the communities they operate in are usually not profitable for any length of time (although exceptions do exist, at least temporarily).

So good managements and responsible boards have always stressed ethical behaviour on the part of employees and agents, and more general business virtues such as courtesy, honesty, value for money and reliability, knowing these to be a considerable source of long-term competitive advantage.

The report by the NSW State Chamber of Commerce summed up the advantages of corporate social responsibility for the business community generally and for individual enterprises:

> *"The business community benefits when companies act responsibly. It gains a voice in the political arena, legitimacy, trust, power and freedom from regulations. These gains ensure that Australian companies will be competitive in domestic and global markets. Enterprise level benefits can be grouped into four areas; operating performance, market goals, human resources and external relations."*[8]

The findings of the survey of 115 large public and private Australian entities, conducted by the Centre for Corporate Public Affairs and the Business Council of Australia, confirm this view:

> *"For three-quarters of the companies in this study the goal of long-term business sustainability is at the heart of the 'business case' for community involvement. They see involvement not as a means of improving short-term business competitiveness but as a way to maintain trust, support and legitimacy with the community, governments and employees. They see community involvement as a social responsibility of business but one that is clearly aligned with the long-term commercial interest of companies."*

Many businesses have embarked tentatively or reluctantly on stakeholder-oriented programs only to embrace them with increasing enthusiasm as they are seen to yield dividends. Companies have implemented triple bottom line accounting and in the process achieved improvements in operating efficiency or savings in input or waste management costs that have greatly exceeded both the cost of the program, and expectations.

But the gains from ethical trading practices and environmental responsibility are not new, so they are not in themselves enough to account for the increase in the number of businesses which publicly and explicitly commit to one or more forms of stakeholder orientation.

The increase in business activity in this area may in part reflect opportunity.

In recent years there has been rapid growth in the range and depth of courses and consultancies, advisory bodies, literature and academics available to assist businesses who wish to adopt a systematic approach to business ethics, corporate social responsibility or triple bottom line accounting, for example.

Yet this increase in the opportunities for devising and implementing stakeholder-oriented policies may itself be an effect of increased demand for these services, rather than the cause for their adoption.

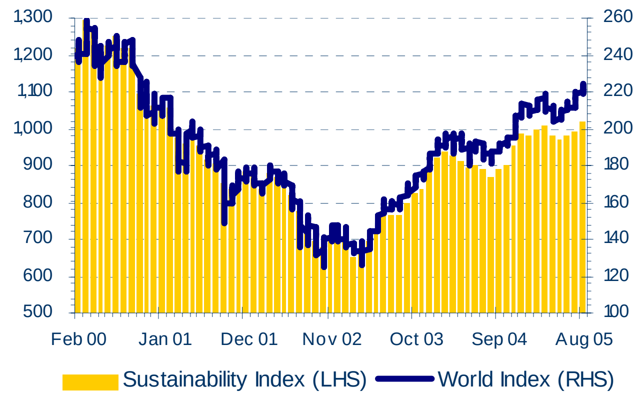
Bad Behaviour is Costly

Rather than corporate virtue being rewarded more richly than in the past, a more plausible explanation for corporations' increased stakeholder orientation may be that its absence is being more heavily penalised. The community is becoming more concerned about the behaviour and ethics of the firms they do business with (and those they don't).

They have more opportunities to monitor, publicise and respond to business behaviour – through the media, the internet, and via pressure groups such as Corpwatch[9] established specifically in order to monitor and criticise corporate behaviour.

Not only are people more informed about corporate behaviour, they are more willing and able to

Chart 1 - Dow Jones Share Prices Indexes
Sustainability Index vs World Index



Source: Yahoo Finance

influence and penalise that behaviour, as consumers, investors, voters and litigants. Public activism has been targeted at corporations in Australia including James Hardy, Alcoa and McDonalds[10].

The reputations of corporations and their brands have been shown to be vulnerable to concerted publicity campaigns, and businesses have been forced to respond to activists' allegations, even when they were ill-founded[11].

Ethical investment funds screen out businesses whose products and/or practices they believe immoral, and it has been claimed that investors can make as good or even better returns from investing in these firms than in the general run of corporations[12], although more recent evidence suggests that the apparently superior performance of sustainable or ethical funds is not necessarily permanent, but depends on market conditions.

Chart 1 illustrates this point. The Dow Jones Sustainability Index[13] matched or outperformed the Dow Jones World Index to early 2000. In recent times however, global markets have strengthened due to the resources boom while the sustainability index, which contains few mining related companies, has flattened.

More hard-nosed corporate investment analysts have also turned their attention to the social, ethical and environmental practices of the businesses they invest in, driven not so much by desire to penalise behaviour deemed immoral, as by concern for the financial risks associated with it. In part this may reflect under-estimation of risk in the past. But it seems to be driven more by the fact that the financial penalties associated with being held guilty of improper behaviour are much greater than ever before, whether guilt is in the eyes of the public, NGOs, or the courts. Boards and directors, as well as shareholders and investment analysts, are reacting to this changed risk environment.

The USA has led the way in the rising tide of litigiousness which has seen huge damages claims awarded against tobacco and gun manufacturers, those who produce faulty goods, polluters and so on. This phenomenon is not limited to the USA but is affecting business behaviour (and also not-for-profit and government agencies) throughout the world.

These phenomena in turn are part of an ongoing process in which the limitations on the liability of businesses and their agents have been steadily unwound, through increases in the penalties applied to corporations and their employees for behaviour perceived to harm individuals or other businesses, and in the range of behaviours which are penalised.

The cost of such penalties affects businesses' bottom lines.

Increasing the range of activities subject to penalty, or the magnitude of penalties imposed, means that a profit-maximising corporation will make increased efforts to ensure that the penalty is avoided – after all, that is the point of raising penalties in the first place.

In summary, a business whose sole purpose is to generate returns for its shareholders has good reason to avoid the costs of acting unethically - whether it is to protect a corporate or brand image, to avoid the damaging effects of consumer boycotts, to attract and retain the investment dollars of shareholders concerned to invest ethically or investment managers concerned at the risks of unethical investment, or to escape the widening net of corporate crimes and liabilities and the increasing penalties they attract.

The financial rewards of virtue and costs of transgression represent a strong business case for behaving ethically.

CSR: How Far Should Corporations Go?

The discussion above highlights the rising awareness of corporate social responsibility among corporations, and explores the incentives that exist for shareholder-oriented businesses to adopt stakeholder-friendly policies.

It also partly answers the question of how far corporations should go in accepting responsibility for social and environmental concerns. The notion that good behaviour is intrinsically profitable and bad behaviour costly suggests that corporations will have regard for social and other effects of their business activities as they seek to maximise shareholder value.

CCI believes that this is as far as businesses should go in having regard for the interests of stakeholders. The extension of stakeholder rights beyond what is in the interests of the business's shareholders – or what Sternberg calls "entitlement stakeholders" – risks inferior outcomes for the wider community as well as business owners.

There are two key flaws of stakeholder entitlement – conflicting priorities, and the undermining of accountability.

Conflicting Priorities and Values

Stakeholder entitlement requires operational decision-makers to resolve conflicts between values, objectives and stakeholders' interests. This is difficult because the interests of stakeholders conflict and views on ethical behaviour and social responsibilities differ.

Among a firm's stakeholders, the interests of customers and employees, employees and owners, owners and the community in which the business is operated, the local community and more distant suppliers, are obviously going to conflict on occasion.

More basic questions arise. Who is a stakeholder (virtually anyone, according to Freeman's[14] definition)? Are all stakeholders given equal weight, or do some get more consideration than others (e.g. full-time compared to part-time employees)? How are managers to know what all stakeholders' interests are? What if an activity harms some stakeholders and benefits others? What happens when the members of a class of stakeholders have preferences which are not identical (e.g. some employees want weekend work, others don't)?

Most importantly, given the difficulty of knowing what stakeholders' interests are and of eliminating conflicts between them, how is a balance to be achieved?

Commenting on a similar list of conflicts and questions, Elaine Sternberg[15] argues that:

> *"It may now be objected that such problems are, nonetheless, routinely resolved in practice. And indeed they are. But the way that they are managed, is by using the substantive goal of the organisation as a decisive criterion. If the purpose of the corporation is to maximise long-term owner value, or to produce the environmentally-friendliest widgets, or to provide employment for the blind, that purpose enables managers to identify which groups need to be considered, and which of their perceived benefits are relevant and legitimate; it indicates how benefits are to be ranked, and how conflicts are to be resolved. To be workable, stakeholder theory must employ the very substantive objectives that it explicitly rejects."*

Not only that, but Sternberg points out that the theory of stakeholder entitlement is not compatible with any organisation (not just a business) having any substantive objective.

Under stakeholder theory, environmental protection, educational excellence, community health, employment of the disabled, care for the aged, equal opportunity or sporting success are no more legitimate as primary aims of an organisation than maximising shareholder value. Each assumes that some stakeholder interests are so important they override others, and in stakeholder theory that assumption is not accepted.

Accountability and Governance

Even if these questions of entitlement can be resolved, harder problems of accountability remain.

Under the shareholder model, the ethical values that underpin the concept of shareholder value maximisation are based on three related principles:

- Respect for individuals' dignity and autonomy, which implies a preference for voluntarism and co-operation over coercion.
- Respect for property rights, which demands that no person should have the right to direct someone else's property to a particular use without their consent (or, fair compensation); and
- Respect for contracts, which should be honoured for ethical as well as legal and practical reasons.

The case for stakeholder orientation beyond that consistent with maximising shareholder value is based on a different set of principles. As described by Elaine Sternberg[16], the stakeholder entitlement view has as its central tenet:

> *"…that organisations, and particularly businesses, must do more than just take their shareholders into account. It maintains that organisations must instead be accountable to all their stakeholders, and that the proper objective of management is to balance their competing interests."*

Both the shareholder and stakeholder oriented view of the role of business raise fundamental questions about accountability. However, the latter proves much more difficult for firms to address.

Accountability requires that individuals must account to others for the decisions they make and the way they behave. It also requires defined authority, so that those to whom agents are accountable are entitled to exact penalties on agents who fail to perform.

In a typical shareholder model corporation, directors are accountable to shareholders while employees and other agents are accountable, through managers, to directors.

However, under stakeholder theory Sternberg[17] points out that both of these types of accountability are repudiated. In their place, it proposes a structure of accountability which is so diffuse as to be unenforceable.

For example, any bad management decision or employee action can be justified on the grounds that it is in the interest of some stakeholder group.

With employees and managers acting as both agents and stakeholders, the chain of accountability turns into a self-referential loop in which the exercise of authority to the advantage of some stakeholders against others can be legitimised.

To the extent that all stakeholders' interests must be taken into account when significant decisions are made, management is likely to be cumbersome and unresponsive.

For such a model to be effective would demand profound changes in law and corporate governance.

At present, shareholders unhappy with the way a board manages their assets are free to invest elsewhere, or, if a majority of shareholders agree, to dismiss the board. Managements which do not maximise shareholder value are at risk of hostile takeover. Employees who do not carry out the instructions of management can be sacked.

These structures of incentive and accountability are explicitly designed to ensure that management has a strong incentive to put shareholder interests first, within the constraints of the law.

They are based on and reinforced by a structure of corporate governance rules which recognise that managements might not of their own volition always pursue shareholder value as their central priority, and which try to ensure that as near as possible they are made to do so.

This is an environment in which both custom and law aim to ensure a management team which consistently made decisions which are not in the interests of its shareholders does not last.

For as long as shareholders retain the freedom to buy and sell shares and the right to sack directors, those directors are likely to continue to accord special priority to shareholders' wishes.

Whether a legal structure based on accountability to other stakeholders as well as shareholders could be made workable is debatable. What is certain is that such a model would bear little relationship to the system of economic freedom and property rights which underpins our current system.

This does not mean that such stakeholders have no sanctions against the firm; but it means that those sanctions are exercised by means other that its ownership and governance structures. Employees unhappy with a business's employment practices can negotiate changes, resign or take up their grievances through a trades union. Suppliers and customers can stipulate contract conditions, or failing this take their business elsewhere or pursue legal redress when appropriate. Local communities use planning, pollution, trading and other laws and regulations to set limits and conditions on the way businesses operate. Governments apply a plethora of laws to ensure that environmental conditions and social and other protections are enforced by business.

Where the wider aims of corporate social responsibility are pursued by management authority, at the very least the effect is to politicise business. Milton Friedman argues[18]:that it is actually more akin to theft than social responsibility:

> *'"What does it mean to say that the corporate executive has a 'social responsibility' in his capacity as businessman? If this statement is not pure rhetoric, it must mean that he is to act in some way that is not in the interest of his employers.*
>
> *[in pursuing such interests] "…the corporate executive would be spending someone else's money for a general social interest. Insofar as his actions in accord with his 'social responsibility' reduce returns to stockholders, he is spending their money. Insofar as his actions raise the price to customers, he is spending the customers' money. Insofar as his actions lower the wages of some employees, he is spending their money."*

Even if such pursuit of social and environmental objectives with other people's resources was legitimate, the manner of that pursuit is unaccountable and undemocratic.

In democracies like Australia, most people are familiar with, and unperturbed by, the processes by which property rights are routinely constrained or removed in the service of the common good, whether through the payment of taxes to support government services and transfers, through laws limiting pollution and noise, zoning restrictions on the use of buildings, and so on.

We might disagree fiercely about how much tax should be raised, from whom, and how the money should be spent. Opinions differ no less on appropriate legislation and regulation, whether the issues are the location of heavy industry, the suburban speed limit or the fencing of swimming pools.

In a democracy, these controversies about how to tax and how much to tax, what to spend and what laws to pass, are subject to public and media scrutiny and community consultation, institutional restraints and the final test of the ballot box.

As Friedman describes it, the use by business leaders of other people's money in pursuit of a broader social objective is analogous to the government's role as taxer, re-distributor and regulator, but without the accountability:

> *"We have a system of checks and balances to separate the legislative function of imposing taxes and enacting expenditures from the executive function of collecting taxes and administering expenditure programs and from the judicial function of mediating disputes and interpreting the law."*
>
> *"Here, the businessman self-selected or appointed directly or indirectly by stockholders - is to be simultaneously legislator, executive and jurist. He is to decide whom to tax by how much and for what purpose, and he is to spend the proceeds - all this guided only by general exhortations from on high to restrain inflation, improve the environment, fight poverty and so on and on."*

In effect, the business person becomes a public ("civil") servant, and must be made accountable in a similar manner:

"On grounds of political principle, it is intolerable that such civil servants - insofar as their actions in the name of social responsibility are real and not just window dressing - should be selected as they are now. If they are to be civil servants, then they must be selected through a political process. If they are to impose taxes and make expenditures to foster 'social' objectives, then political machinery must be set up to guide the assessment of taxes and to determine through a political process the objectives to be served."

Stakeholder orientation beyond that which is consistent with maximising shareholder value opens a whole range of issues of principle concerning property rights and freedom of choice, corporate governance, transparency and political, social and commercial accountability.

The Wider Case Against Regulation

The terms of reference of this inquiry asks about the extent to which the current legal framework governing directors' duties encourages or discourages them from having regard for the interests of stakeholders, and if revisions to the legal framework are needed to encourage corporate decision makers to have regard for stakeholders.

The discussions above present a case against imposing government regulations to compel businesses to consider the interests of stakeholders other than shareholders.

Public and Private Regulation

This does not mean that businesses should be free of environmental, social, safety or other regulation – such rules remain a necessary and important role of government.

Nor does it mean that businesses should or will disregard their impact on the environment and the community. As discussed above, doing business ethically and with regard for the interests of stakeholders is increasingly important to long-term profitability.

Rather, it points out that regulation to achieve ill-specified, ambiguous or conflicting objectives on business is likely to be ineffective or counter-productive.

US Federal Reserve Chairman Alan Greenspan[19] has summed up this policy imperative. Although specifically directed to the regulation of financial instruments, the principles he outlined broadly apply to any form of regulation:

"In making such evaluations, it is critically important to recognize that no market is ever truly unregulated. The self-interest of market participants generates private market regulation. Thus, the real question is not whether a market should be regulated. Rather, the real question is whether government intervention strengthens or weakens private regulation. If incentives for private market regulation are weak or if market participants lack the capabilities to pursue their interests effectively, then the introduction of government regulation may improve regulation. But if private market regulation is effective, then government regulation is at best unnecessary."

It is naïve and inappropriate to expect businesses to assume social and environmental responsibilities beyond those which comply with the negative imperatives of conventional regulation (don't pollute, pay no less than minimum wages, etc) and maximise shareholder value.

Profiting from Corporate Social Responsibility

Elaine Sternberg and others point out that having regard for the interests and preferences of stakeholders is good business practice and benefits shareholders, stakeholders and the wider community.

There is another sense, however, in which adopting the rhetoric of corporate social responsibility, triple bottom line etc. can be profitable for the wrong reasons – by artificially inflating demand for a business's products under the guise of promoting community wellbeing through mechanisms, which in reality, deliver little or no real community benefit.

For example, Gary Johns, a senior fellow with the Institute of Public Affairs[20], gave a fairly cynical interpretation of the recent involvement of Insurance Australia Group (IAG) in the debate over climate change and the claim that it will increase the risk of damaging climate-related events:

> *"…an insurance company cannot change the climate,… but it can change the climate for customers. IAG is using the data to scare people to take out insurance. In other words, it is doing what it normally does, drum up business – but in this instance it is using the cover of the greenhouse issue. IAG is indulging in public policy debate in order to win customers. The Kyoto Protocol is being used as a 'dog whistle' on climate change to have people take-out insurance on weather damage to their properties. Good for business, bad for public policy."*

This example highlights a more fundamental argument against corporate social responsibility as a claim to public virtue. Although it can be profitable to be seen as socially and environmentally responsible and costly to be seen as irresponsible, there are dangers in pandering to public opinion when that opinion is not based on facts and good policy. A paper by David Henderson[21], a former chief economist at the OECD, highlights this clearly:

> *"It may indeed be true, or eventually become true, that a general adoption of CSR [corporate social responsibility] would promote the objective of making MNEs [multi-national enterprises] better liked and appreciated, and thus help to keep them alive and profitable in an unfriendly world. But this would come at the cost of accepting false beliefs, yielding to unjustified attacks, and impairing the functioning of the market economy."*

This raises a fundamental problem with the concept of corporate social responsibility: it assumes that triple bottom line accounting, ethical investment, stakeholder entitlement and similar theories will yield better outcomes (for some parties, at least) than an economy in which firms are primarily engaged in maximising long-term value for their shareholders within a framework of laws.

This reflects the widely-held view that good outcomes can only arise from good intentions and that the profit motive is intrinsically distasteful.

Above all, it is indicative of a lack of faith in the capacity of the 'invisible hand' of the free market to deliver a better economic, environmental and social outcome than the good intentions of business leaders, suitably stiffened by laws, incentives and stakeholder responsibilities.

Proponents of this view point to the failure of free markets to deliver social, economic and environmental outcomes as good as we might wish, and conclude that the economic system is a failure. But those who doubt the efficacy of markets have never yet been able to point to an economy or society where a 'visible hand' has done better, whether that hand is guided by the state, a plurality of stakeholders, or well-intentioned business leaders.

The real virtue of the good corporate citizen is that it generates returns for investors by providing customers with the goods and services they want, at prices they are prepared to pay, while proving trustworthy and responsive enough to earn repeat business.

In the process, it creates jobs, bids up wages, pays taxes, and innovates in the perpetual search for an advantage over its competitors. All of this contributes far more to society than pious good intentions.

In all of this, government has a proper role in shaping the regulatory environment where good business practice alone might not result in efficient outcomes. This is achieved in Australia through provisions in corporations and trade practices law, health and safety standards, environmental protection regulations, anti-discrimination and labour protection laws, and competition and consumer protection initiatives.

But by increasing business costs, blurring accountability and impeding the efficient operation of capital markets, the advocates of mandated corporate social responsibility and stakeholder entitlements would impede the business sector's capacity to make this valuable contribution to the economy and society.

David Henderson's paper concludes with a warning of the potential damage which corporate social responsibility and related movements could inflict. Though lengthy, it is worth quoting in full:

> *"CSR is often presented, by moderates and enthusiasts alike, as a sober and judicious response to challenges that have to be met and new developments on the world scene. Such a description does not fit the facts. Many of the alleged new developments have not in fact taken place: they are part of the mythology of global Salvationism. Because the myths are largely believed, because the rationale and functioning of a market economy are not well understood, and because of widespread acceptance of the need for deliverance from above, the assessment of issues and events by many international businesses, and by others in the business milieu, appears as neither judicious nor informed. Appeasement, and the wish to disarm opposition, go together with a large measure of sympathy with, and acceptance of, a collectivist perspective. The views and demands of NGOs and other hostile critics are treated as more soundly based and more representative than they really are. A misleading view of the world is uncritically accepted.*
>
> *"CSR is flawed in its prescription as well as its diagnosis. What it proposes for individual businesses, through 'stakeholder engagement' and giving effect to the 'triple bottom line', would bring far-reaching changes in corporate philosophy and practice, for purposes that are open to question and with worrying implications for the efficient conduct of enterprises. Across economic systems and political boundaries, it would strengthen existing tendencies to regulate transactions, and to limit competition, in ways that would further restrict the opportunities and freedom of choice of people and enterprises. These various effects, both within firms and beyond them, would undermine the market economy and reduce welfare. Despite the attractions of the phrase and the hopes that it appears to*

> *offer, the adoption of CSR marks an aberration on the part of the many businesses concerned, and its growing hold on opinion generally is a matter for concern."*

Alternative Measures to Regulation

This inquiry also seeks feedback on alternative, voluntary mechanisms that can encourage operational decision makers to have regard for stakeholder interests aside from regulation. But as Greenspan's comments on page 14 highlight; commercial self-interest is a powerful motivation for firms to behave ethically.

Voluntary measures that go beyond shareholder maximisation are likely to be limited in their application. The NSW State Chamber of Commerce paper on corporate social responsibility encapsulates the difficulty that operational decision makers' face in embracing stakeholder interests outside of those that increase shareholder value:

> *"Most Australian business leaders would like their company to have a positive impact on society and the environment. Yet in the day-to-day commercial pressures to maximise shareholder value and profitability, managers are wondering if they can afford to have 'fuzzy feelings' about their business operations."*

Irrespective of voluntary measures and/or regulation, reporting is often seen as a means by which stakeholders can keep corporations accountable for their social and environmental performance (the triple bottom line) in the same vein that financial reporting keeps boards of directors and chief executives accountable to owners.

However, it is not logical that a company's social and environmental practices be separately disclosed to maintain accountability in the same way that financial information is disclosed.

It is considerably easier to compare financial performance across firms than it is to compare social and environmental performance. Are users, whether stakeholders or ethical investment funds, expected to judge whether one entity's involvement with indigenous communities is better than donations made by another entity to a children's charity? Information about a corporation's social and environmental activities is not material like financial information. Shareholders and stakeholders do not derive benefit from knowing what practices are employed but from the effects of such practices.

Conclusion

The appeal of corporate social responsibility, triple bottom line accounting and stakeholder entitlements among businesses is strong. Some corporations have displayed willingness, and even eagerness, to abandon a shareholder orientation in favour of a wider focus.

Under headings such as triple bottom line accounting, corporate social responsibility, stakeholder capitalism and ethical investment, many businesses are incorporating environmental, social, stakeholder and ethical dimensions of their activities into core objectives along with shareholder returns.

To a large extent, this represents a commercial necessity for businesses to recognise and respond to developments in their operating environment as opposed to a need to respond to regulatory requirements.

For example, the rise in stakeholder orientation among firms is likely to represent the fact that its absence is being more heavily penalised by a community becoming more concerned about the behaviour and ethics of businesses.

The commercial incentive is not purely to avoid negative outcomes. Many businesses have implemented triple bottom line accounting and achieved improvements in operating efficiency or savings in input or waste management costs.

These measures are adopted by firms because they make good business sense and are in the interest of shareholders. It is not appropriate to encouraging decision makers to accommodate stakeholder interests beyond this via the regulatory framework.

This is because stakeholder policies beyond those which maximise shareholder returns have the potential to create costly and inefficient outcomes. For example, if business is obliged to further the interests of the community, society, government and environment as well as owners, a range of conflicting questions arise such as which groups and interests are entitled to consideration in how the business is run? And by what means is that consideration to be put into practice?

Even if these questions of entitlement can be resolved, harder problems of accountability remain. Giving other stakeholders real influence over how a corporation operates would require an entirely new framework of corporate accountability and sanctions.

It would rewrite property rights and constrain freedom of choice, redefine corporate governance and transparency, and require new institutions of political, social and commercial accountability.

An overarching concern for CCI is that stakeholder entitlement and related ideas appear to be based on a profound misunderstanding of how modern businesses and economies operate.

It assumes that good results can only come from good intentions – that business activity will only benefit society, the community, the economy and the environment if that is what business leaders (or regulators or stakeholders) set out to achieve. But this is not the case.

A market economy - in which the production, distribution, pricing and use of goods and services are primarily determined by people's purchasing decisions - leads to a better social and economic outcome than one in which well-intentioned business leaders or regulators try to second-guess people's wants and needs.

Government already has a role in shaping the regulatory environment where good business practice alone might not result in efficient social and environmental outcomes. Extending social policy objectives to corporations is not in the public interest. It moves corporations into the sphere of public policy and service provision, which is not the role of business.

Appendix: Terms of Reference

Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Corporate Responsibility Terms of Reference.

The Committee will inquire into Corporate Responsibility and Triple-Bottom-Line reporting, for incorporated entities in Australia, with particular reference to:

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

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

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

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

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

f) The appropriateness of reporting requirements associated with these issues.

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

In inquiring into these matters, the Committee will consider both for profit and not-for-profit incorporated entities under the Corporations Act.

23 June 2005

Notes and References

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Sternberg, Elaine '*The Stakeholder Concept: A Mistaken Doctrine*', Foundation for Business Responsibilities, Issue Paper No. 4, November 1999. Sternberg differentiates between two essentially

Comments and Notes

[1] Friedman, Milton (1962), "Capitalism and Freedom", University of Chicago Press.

[2] Lord Chancellor of England Edward First Baron Thurlow, cited in Business & Society Review, No. 72, Winter 1990, p. 51

[3] Sternberg, Elaine 'The Stakeholder Concept: A Mistaken Doctrine', Foundation for Business Responsibilities, Issue Paper No. 4, November 1999.

[4] Quotation taken from Peters, P. "Tony Blair's "Stakeholder Economy": A Midterm Assessment", October 1999, on the Lexington Institute's web site. Original source.

[5] KPMG Sustainability Services, *International Survey of Corporate Responsibility Reporting 2005*. Page 10.

[6] Centre for Corporate Public Affairs in conjunction with Business Council of Australia, *Corporate Community Involvement: Establishing a Business Case*. Page 11.

[7] "Taking The First Steps: An Overview Of Corporate Social Responsibility In Australia" NSW State Chamber of Commerce, February 2001, page 11. First paper in a series entitled "the common good".

[8] "Taking The First Steps: An Overview Of Corporate Social Responsibility In Australia" NSW State Chamber of Commerce, February 2001, page 6. First paper in a series entitled "the common good".

[9] See http://www.corpwatch.org.

[10] In 2004, industrial firm James Hardy was the subject of boycotts and public scrutiny after it stalled on payouts to cancer victims whose illnesses were brought on through the use of James Hardy products containing asbestos.

In 2002, Alcoa came under intense public scrutiny in WA after it was forced to shut down a piece of refinery equipment blamed for causing serious health effects. Alcoa resolved several multi-million dollar compensation claims from its workforce and it bought up several houses from nearby residents.

In 2005, Tasmanian potato farmers launched a nationwide campaign demanding that McDonald's demonstrate more social responsibility. Tasmanian food processor Simplot lost half its McDonald's french fries contract to New Zealand, creating a loss of about $50 million to the Tasmanian economy.

[11] For example, the cases of Brent Spa and McDonalds. In the Brent Spa case, Greenpeace ran a campaign which included a range of assertions subsequently shown to be false, but which nonetheless led Shell Expro to abandon plans to sink its Brent Spar installation in the North Sea.

In the case of McDonalds, the 2004 documentary ‘Super Size Me’ by Morgan Spurlock led to the fast food outlet phasing out its trademark ‘super size’ fries and drinks in its U.S. restaurants even though, as McDonalds pointed out, Spurlock’s decision to eat nothing but McDonalds food for a month was irresponsible.

[12] In an article on the financial and market information website TheMotleyFool, Chris Rugaber concludes that socially responsible investment funds do not necessarily yield lower rates of return, but that differences in performance may be short-term effects of differences in portfolio composition. Fees and expenses tend to be higher than for other comparable investment funds. See Rugaber, “socially responsible investing” 28 March 2001, on http://www.fool.com/Specials/2001/sp010329.htm.

[13] The Dow Jones Sustainability Indexes were launched in 1999 and are the first global indexes to track the financial performance of the leading sustainability-driven companies worldwide. Selection in based on an independent benchmark based on economic, environmental and social criteria. See http://www.sustainability-index.com.

[14] Evan, W and Freeman, R (1993) ‘A Stakeholder Theory of the Modem Corporation: Kantian Capitalism,’ in Beauchamp and Bowie, Ethical Theory and Business, p. 82.

[15] Sternberg, Elaine ‘The Stakeholder Concept: A Mistaken Doctrine’, Foundation for Business Responsibilities, Issue Paper No. 4, November 1999.

[16] Sternberg, Elaine ‘The Stakeholder Concept: A Mistaken Doctrine’, Foundation for Business Responsibilities, Issue Paper No. 4, November 1999. Sternberg differentiates between two essentially benign ideas about stakeholders and a third strand she calls stakeholder entitlement theory: “Two of usages of 'stakeholding' are commonplace and unobjectionable. The first is a conventional observation about motivation: people are more likely to take an interest in a process when they consider that they have a stake in its outcome; the stake need not be financial. The second innocuous usage is simply a reminder that the world is complex: many factors must ordinarily be considered when pursuing even ostensibly simple outcomes. This is a basic truth that successful businesses have long understood and respected”

[17] ‘Creating and Maintaining an Ethical Corporate Climate’, Woodstock Theological Center Seminar in Business Ethics, Georgetown University Press, 1990.

[18] Friedman, Milton. ‘The Social Responsibility Of Business Is To Increase Its Profits’, article in originally printed in the New York Times (1970), accessed from http://homepages.bw.edu/~dkrueger/BUS329/readings/friedman.html

[19] Remarks by Federal Reserve Chairman, Alan Greenspan. *“Government Regulation and Derivative Contracts”*, at the Financial Markets Conference of the Federal Reserve Bank of Atlanta, Coral Gables, Florida. February 21, 1997.

[20] *“Insurance Company Whips Up a Storm”*, by Gary Johns. The Australian Financial Review – Opinion. 16 August, 2005.

[21] Henderson, David. ‘Misguided Virtue: False Notions Of Corporate Social Responsibility’, New Zealand Business Roundtable, June 2001. p.86