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Corporate Responsibility

When Will Voluntary Reputation Building Improve Standards?

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Activists are often unhappy with the laws governing business behavior and with their enforcement. One strategy they use to alter the behavior of corporations is to target not the laws but the corporations, hoping that they will change without being legally obliged to. Sometimes firms do, because they would rather incur the costs of behaving "better" today than the costs of being "shamed" later. But how does this reputational mechanism work? Will it achieve the right standards? Which companies will it affect? And are there good reasons to prefer it to alternative ways of setting standards?

Many people feel that stronger rules or better enforcement is needed on a range of social, economic, political, and environmental issues. As the economy becomes increasingly international, more attention is directed to international rules or rules in other countries. But since institutions for setting and enforcing rules remain much stronger at the national level, changing rules elsewhere is not easy. History suggests that change is often achieved by war or, occasionally, economic sanctions. A less troubling way is by treaty, creating cross-border judicial systems. This process can be painfully slow.

As the international economy has apparently outgrown national political institutions, "corporate social responsibility" has once again become a hot topic. Large companies have always faced demands to exceed their legal obligations, especially when those obligations are thought to be weak. Now that many activists argue that the most important weakness is international rather than domestic, these demands increasingly target multinational companies, their suppliers, and other international businesses.

Corporate social responsibility means different things to different people. But for the purposes here, it is defined as socially minded behavior such as respecting human rights, refusing to pay bribes, caring for local communities, and adhering to environmental standards. A natural question arises: When is this corporate social responsibility a good substitute for other, more formal institutions, and when is it likely to disappoint? In other words, what is corporate social responsibility good for?

A reputational issue

Firms have several reasons to behave in socially responsible ways. One is simply that a corporate culture may value more than mere profit. A second is that social or environmental action can directly increase profit. Improving energy efficiency, for example, can reduce costs.

A third reason is that much corporate social responsibility is essentially a reputational game in which companies behave better in return for a better deal from customers, suppliers, employees, investors, or other stakeholders (Oxford Analytica 2000). For example, "socially responsible investing" is now big business, driven largely by screening strategies in which it is permissible to hold shares only in companies that satisfy such criteria as decent treatment of staff or protection of shareholder rights. Though held up as ethical, such behavior is often just sound business practice. Mainstream investors increasingly view socially responsible investment as good strategy. The idea, yet to be thoroughly tested, is that firms that behave well will find it easier to raise funds.

The most direct and well-known reputational effects result from campaigns against corporations accused of causing environmental damage or violating the rights of workers or indigenous people, such as the high-profile campaigns against BP, Nike, and Shell. These campaigns aim to achieve change by punishing the company. They may persuade stakeholders to boycott the company, leading to higher costs or lower revenue. And they may make it more difficult for the company to obtain licenses and approvals later on.

This is essentially a classic reputational mechanism. Stakeholders in a company expect it to adhere to certain rules. When it does not, the stakeholders "punish" the company by making its business less profitable or even putting the company out of business. That gives the company an incentive to conform to the stakeholders' expectations. Companies are also commonly rewarded for good behavior (such as "fair trade") through analytically equivalent mechanisms.

It would be wrong to presume that because corporate responsibility campaigns appear to be well intentioned they will have good effects. What is important is to understand the power of the reputational mechanism to achieve change and the social usefulness of the change achieved. Its power to achieve change is determined by the ease with which stakeholders can monitor compliance and punish cheating. Its social usefulness depends on the quality of the standards enforced.

When can reputational campaigns achieve change?

The reputational mechanism works when firms would rather incur the costs of behaving well today than pay the costs of being punished for misbehavior later. Game theory, more usually applied to understanding how cartels stick together, sheds light on when this will happen:

- Firms must be long-lasting and patient; otherwise the temptation to make a quick buck through dubious practices may prove overwhelming.
- Boycotts must be easy to inflict. Consumer boycotts in commodity markets such as gasoline require little effort by individuals. By contrast, employee resignations are costly to inflict and tend to have a significant effect only in the long term or when the stakes are very high.
- Offenders must be easily identified and monitored, so that firms know that if they step out of line, they are likely to be caught. Modern communications ease detection and monitoring (but also support false allegations).
- The costs of obeying the rules must be moderate compared with the costs of the reputational damage that can be inflicted.

The pattern of corporate responsibility campaigns is understandable in the light of this analysis. Campaigns have focused on large multinationals not because their ethical records are necessarily worse but because they are easily identified and in for the long haul. Campaigns have been most successful when targeting companies that sell into competitive consumer markets: consumer products are visible and easy to target, and competition makes it inexpensive for consumers to inflict boycotts. Producers of intermediate goods and services find it easier to evade boycotts.

Campaigns commonly target the market leader rather than the most irresponsible company, in the hope of achieving widespread change. This approach makes little connection between behavior and punishment and fails to create the right incentives for change. Sympathetic commentators have noted that corporate responsibility campaigns would have more effect if they gave companies more credit for doing things right (Freeman and Elliott 2003). Moreover, campaigns allow less prominent firms to escape censure, and these firms have refused to change their behavior.[1]

Where campaigns demand improved behavior in general, rather than adherence to a particular (rigid) standard, companies can respond with relatively low-cost approaches. For example, Shell responded to pressure from environmentalists by beginning to publish detailed environmental and social accounts, supporting the Kyoto Protocol, and making a commitment to phase out gas flaring. Each of these actions has a relatively modest cost, measured in millions against annual profits of billions. Eliminating gas flaring can even create a profit stream.

By contrast, Shell refused to close its businesses in Nigeria despite a storm of protest after the execution of the activist Ken Saro-Wiwa and others by the dictatorship of General Sani Abacha. Leaving Nigeria would have cost the company billions of dollars, a cost far greater than any boycott could inflict.

Boycotts can rarely discourage every company. Large companies based in rich countries have more valuable reputations to protect than smaller companies and those based in developing countries. When Talisman Energy, a medium-size Canadian oil and gas company, quit its operations in Sudan, it did so not just because of activism but because of the risk that the United States would impose sanctions preventing it from raising capital on U.S. markets. Talisman sold its stake to India's national oil company, the Oil and Natural Gas Corporation, which clearly felt that neither activists nor sanctions could cause it enough damage to make the deal unattractive.

What are the right standards?

Economic interests and ethical values vary greatly, so it is hardly surprising that global standards for corporate responsibility are controversial. Any system of rules, whether voluntarily adopted by companies or negotiated in a treaty, would struggle to resolve such differences. Still, most parties in the corporate social responsibility debate could probably agree that standards should both pass a cost-benefit test (with costs and benefits broadly defined to include social and environmental issues) and favor the poor, not the rich. How might voluntary standards stack up against compulsory standards on these criteria?

On costs, voluntary standards might be expected to do well, since firms have a strong incentive to work out ways to satisfy their critics that are not prohibitively expensive. By contrast, compulsory standards, lacking the same flexibility, can impose high costs. One caveat: the cost of monitoring or reporting may be higher in an ad hoc voluntary system.

On the benefits side, there is less reason to be confident. The corporate social responsibility agenda naturally responds to high-profile, emotive issues, which do not overlap perfectly with areas where the most good can be done (Freeman and Elliott 2003). All parties in the debate have a responsibility to look for issues that offer the biggest benefits rather than those that are the most sensational. Multilateral agencies could provide valuable leadership by highlighting important but underexposed problems.

On the distribution of benefits between rich and poor, there is no doubt that the globalization of media reporting has made the corporate social responsibility agenda more global and more responsive to the world's poorest. Even so, a risk remains that companies will comply with standards by shifting costs to others—for example, by avoiding low-wage economies because of pressure about labor standards. That response may impose a small cost on the company but a big cost on the poor.

The risk of such unintended consequences is higher if campaigns for better standards depend on a superficial understanding by consumers—and if those affected by the new rules are excluded from the debate. On such issues as fair trade, climate change, and labor rights the global corporate social responsibility agenda may not always match local interests (Ward 2004).

The messy process of reputation-based corporate social responsibility campaigns may have an unexpected benefit: the process seems difficult for industry cartels to subvert. Regulatory capture has long been a risk for any system of compulsory rules. Social and environmental rules are no exception. One observer alleges that private firms that audit corporate social and environmental performance "have occasionally acted like vested interests" in private forums for setting international standards—and argues that voluntary regulations are less vulnerable to capture (Gordon 2000, p. 9). That makes sense, because "capturing" voluntary regulations would require capturing public opinion, arguably more difficult than subverting a bureaucrat.

Voluntary standards are no substitute for a benevolent, well-informed regulator. But since no such regulator will appear on the global scene in the near future, the reputational process of developing voluntary standards for corporate responsibility will continue to play an important role.

Policy implications

Viewing corporate social responsibility as a reputational game suggests the following lessons:

- *Reputation building is a minor issue for some firms.* Firms that are small and short-lived, make intermediate products, or have little presence in industrial countries are likely to be immune to corporate responsibility campaigns. Improving their standards may therefore require different approaches.
- *Reputation-based standards risk excluding less visible groups.* Those affected by proposed standards must have a voice; otherwise the standards supported by the reputational mechanism will not be the standards demanded locally.
- *Voluntary action will minimize costs but is less likely to maximize benefits.* Multilateral agencies therefore have an important role in ensuring that the corporate social responsibility agenda focuses on maximizing benefits rather than newspaper column inches.
- *Reputation-based standards are probably less vulnerable to regulatory capture.* Agencies should avoid supporting or endorsing standards that represent a cartel between companies and established narrow pressure groups.
- *Voluntary standards will be experimental and flexible.* Formal regulation can struggle to cope with a wide variety of sectors and geographic locations (Ayres and Braithwaite 1992). So flexibility that allows standards to evolve and firms to try something new should be seen as useful, not threatening.
- *Voluntary standards can lead to better things.* Voluntary standards can help build the consensus, expertise, and goodwill that can lead to binding standards (Gordon 2000). So despite the flaws of reputation-based standards, there is reason to give them time to develop.

As the corporate social responsibility debate develops, multilateral agencies such as the Organisation for Economic Co-operation and Development, United Nations, and World Bank Group have a significant part to play. In most circumstances they have little or no ability to set and enforce global rules. Yet within the reputational arena they have much influence as conveners or in supporting (or refusing to support) corporate codes of conduct.

Note

1. For example, Nike has put resources into setting up collaborative bodies for responsible behavior (Global Alliance, Fair Labor Association), but only a few competitors have joined.

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