

## CORPORATE SOCIAL RESPONSIBILITY: THE ROLE OF LAW AND MARKETS AND THE CASE OF DEVELOPING COUNTRIES

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### INTRODUCTION

Is the only goal of the corporation that of maximizing profit? Can the corporation engage in non-profit-maximizing activities? Can corporate responsibility be mandated and controlled by laws and regulations? Will the corporation be responsible if left to its own devices? Is it responsible for the corporation to go beyond the law? What is the effectiveness of the market in fostering responsibility? Are there differences needed in corporate behavior in developing countries? These are some of the questions that this article seeks to address.

This article presents a pragmatic view on the role of law and markets in fostering corporate social responsibility; it recognizes the constraints, demands, and pressures facing corporate managers to put profits at the top of the list of priorities while also recognizing the potential that corporations have to contribute to society's welfare within the rules and freedoms that society imposes and gives to corporations. The position taken in this article is neither the radical view that the corporation is free to pursue profit maximization, regardless of its impact on society, nor is it the equally radical view that the corporation must resolve society's problems and assume responsibility for government failures. The analysis herein is based on the advantages and limitations of the law and the markets in fostering corporate responsibility. The article does not intend to present an apology for corporate responsibility.

The article first discusses what is, and what is not, a responsibility of the corporation, considering its role in today's society and the scope of action afforded by laws and regulations. It then considers the complementary role that markets can play in fostering responsibility, as well as the perverse messages that those same markets send. In this context, the situa-

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tion of law and markets in developing countries is discussed. As the situation in developed countries has a significant impact on the views and corporate behavior in developing countries, we discuss the case of developed countries in order to frame the discussion that follows for developing countries. The final section concludes with a plea for good judgment, avoiding extreme positions.

#### I. WHAT DO WE MEAN BY CORPORATE SOCIAL RESPONSIBILITY?

Management guru Peter Drucker said: “If you find an executive that wants to take on social responsibilities, fire him. Fast.”<sup>1</sup> If he means an executive that wants to take on the role of the government and/or non-governmental organizations, we agree with him. It is very unlikely that managers will have expertise or a comparative advantage in the solution of social problems, and it is not the purpose of the corporation. This quote illustrates the confusion that exists with the term “social responsibility.” Many non-experts take the literal meaning of each word, such that “corporations are responsible for solving society’s problems,” instead of the narrower interpretation that “corporations cannot do whatever they want with society” or “corporations are responsible for the impact of their actions on society.”

There is significant confusion in the private sector, the public sector, and civil society as to the meaning of Corporate Social Responsibility (or CSR, as it is widely known). Perhaps because the concept has evolved from philanthropy, many continue to make it synonymous with philanthropy. The convenience of the acronym has a lot of interested parties discussing CSR as if it were a universal, uniform, well-defined, standard concept. Every party has its own definition, many times unarticulated, which is used to advance or detract from the concept. This failure in communication has led to significant controversy and confusion, even polarizing positions. This is not to say that the discrepancies between many parties are not real, but these discrepancies are exacerbated by the lack of an explicit understanding regarding which of the many ideas embodied in the acronym “CSR” the parties are talking about.

The terms “social” and “responsibility” are also often misinterpreted. For some, “social” refers to social issues such as health, education, security and the like—issues generally under the responsibility of governments. Others more correctly define “social” as a reference to society, including

1. JOEL BAKAN, *THE CORPORATION: THE PATHOLOGICAL PURSUIT OF PROFIT AND POWER* 35 (1st paperback ed. 2005).

the planet and the environment, i.e. the ambit of action of the corporation. For some, “responsibility” stands for accountability for the corporation’s actions; for others, a sense of duty toward society; and for others, good judgment (as represented in the Golden Rule, “Do unto others as you would like done unto you”).

In terms of what actions are included, most people interpret these terms to mean that the corporation has a responsibility toward society, and that the corporation has a responsibility to do something about the problems that affect society; others interpret them to mean that the corporation must take responsibility for its own activities as they affect society. These views have very different implications.

In the first case, the corporation is attributed responsibilities that go beyond the purpose for which it was created, such as becoming involved in the welfare of the population (thereby addressing some of the failures of government). Many of these activities are the responsibility of the citizens themselves and of their local or national governments. Needless to say, most representatives of the private sector do not agree that these are the functions of the corporation and reject the whole concept of CSR. In the second case, the corporation as a legal “person” is responsible for the impact of its activities, and these activities must be carried out with respect toward those affected.

This article is about the latter interpretation of CSR, over which there should be less controversy.<sup>2</sup> Nevertheless, as we will see in the discussion later on, there are some who claim that even this responsibility is limited and that the corporation should only exercise such responsibility if it can be shown that it leads to higher profits. For the purpose of this article, “Corporate Social Responsibility” means the corporation must be responsible toward society and the environment for the impact of its actions. This is not to say that the case is closed. There is significant divergence as to what being responsible for the impact of one’s actions means. The concept of what constitutes responsible behavior changes from context to context, from culture to culture and, within context and culture, changes over time. A few years ago, society did not consider food companies to have any re-

2. Some authors prefer to use the term “sustainability,” which holds a vision that all activities of the corporation must be performed in a manner that ensures that future generations will be able to enjoy a quality of life at least as good as the one we now enjoy. The concept is broader than CSR and its practical implementation is more complicated, as it involves uncertain tradeoffs. Should we leave nature untouched or can we “consume” some of it if in exchange we leave, for example, better infrastructure? It is a concept better suited to guide the actions of society as a whole, including corporations, governments, and civil society. For a discussion, see CHARLES O. HOLLIDAY, JR., STEPHAN SCHMIDHEINY & PHILIP WATTS, *WALKING THE TALK: THE BUSINESS CASE FOR SUSTAINABLE DEVELOPMENT* 13–14 (2002).

sponsibility for the obesity of their customers. It was a matter of genetics or irresponsibility on the part of the consumer. Today, in advanced societies, some responsibility is being attributed to the food producers and some are reacting by producing healthier products and educating the consumer. Nobody would claim today that fast food companies in developed countries think that indifference to these issues will not affect the bottom line. Today, everyone agrees that a pharmaceutical firm should produce drugs that cure the ailment for which they are prescribed, but not everyone would agree that it is the responsibility of pharmaceutical companies to produce cheap drugs for the poor. Highly desirable, yes, but is it their responsibility? Probably not. In some contexts, it might be wise for a firm to do so as consumers may react positively to this, resulting in improved reputation and consumer recognition, which may enhance the competitiveness of the firm.

As the nature and extent of the impact of the corporation's activities are not well defined in all cases, there can still be significant discrepancies among stakeholders as to the corporation's responsibility. Furthermore, many of those stakeholders may demand, or act as if the corporation has, responsibility for some actions (for instance, producing cheap drugs for the poor or enhancing the quality of life in the community), even if the corporation may consider these actions outside of its responsibility or beyond impact of its activities. The corporation may rightly claim that these are not its problems, but ignoring these demands may be costly. These considerations show that even under the narrow definition of CSR, where a corporation has responsibility for the impact of its action (or lack of action), there can still be significant controversy.

Under the all-encompassing and abused name of Corporate Social Responsibility, corporations carry out many actions, some legitimate, some purely for public relations. Critics of the idea look at some corporate philanthropy and argue that it is not the responsibility of the corporation as an entity, but rather that it is the responsibility of the individual managers or shareholders to do it with their own money, not with monies that are not theirs and that belong collectively to the shareholders. This philanthropy may be done to enhance the image of a given manager, although it may also enhance the image and reputation of the corporation. Extreme critics would not like it even if the philanthropy enhances the image of the corporation, preferring to do this with activities that are more directly related to the business of the corporation. At best, they tolerate what some call "strategic philanthropy,"<sup>3</sup> philanthropy that contributes to profits. It must be

3. Michael E. Porter & Mark R. Kramer, *Strategy & Society: The Link Between Competitive Advantage and Corporate Social Responsibility*, HARV. BUS. REV., Dec. 2006, at 78, 88–89.

clear to the reader that there is a continuum of actions, some of which can be called misappropriation of common resources for the private good, and some of which benefit both society and the long term value of the corporation. Is the donation of a school building to the community by a pharmaceutical firm responsible or irresponsible? It depends. In a developed country, most likely it is irresponsible. In an underdeveloped area or country, it may be justified if it leads to better educated consumers, although it would be a stretch. Proponents of strategic philanthropy would prefer to see the resources used, for instance, in educating the consumers in better health practices, particularly in the use of their products. The people better placed to make those decisions are the managers, subject to the oversight of the market, including shareholders, as we will discuss below. We need to look at the actions and the circumstances, not just the name of the action. But let us not reject all actions for which someone gives the name of Corporate Social Responsibility, just because some people may understand something different. Do not throw out the baby with the bathwater.

It should be clear by now that the social responsibility concept involves a long-term view of the impacts of all the activities of the corporation, as many of these impacts, both positive and negative, will take time to be felt. It is precisely the short-term horizon, which most managers have, that conspires against corporations acting responsibly. We will discuss this key issue in the next section.

In addition, we are not advocating the idea that the firm is responsible for the public welfare or that it counts among its responsibilities the solving of social problems. Far from it. The firm has responsibilities toward its shareholders, but these responsibilities are fulfilled if the firm is also concerned about the impact of its activities on society and behaves in a responsible manner.

In the preceding discussion, we tried to narrow the concept of CSR, but this concept may have to be expanded for application to developing countries. Some of these countries are characterized by weak regulations and weak governments, particularly at the local level, where government fails to provide basic services. Under these circumstances, the corporation may find that it is in its and its stockholders' best long-term interest to not only be a good citizen, but also to be a contributor to the provision of some basic services. For instance, it may be in its best interest to ensure the quality of water or of primary education, either in order to avoid worker migration or to have a pool of able and healthy workers. Most people in developed countries would not consider these to be the responsibilities of a corporation. Nevertheless, the 1976 Nobel Prize in Economics Laureate

Milton Friedman, an early critic of CSR, acknowledged these benefits even for developed countries, in his famous New York Times article in which he stated:

[I]t may well be in the long-run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government. That may make it easier to attract desirable employees, it may reduce the wage bill or lessen losses from pilferage and sabotage or have other worthwhile effects.<sup>4</sup>

In the case of developing countries, this may be a common occurrence and may even need to be broader in the face of government failure to provide basic services. Friedman does object, though, to calling this “social responsibility.”<sup>5</sup> We do not think that semantics should get in the way. If managers exercising their good judgment believe that this will benefit the corporation, so be it.

Can we then rely on the goodness of the corporation? Can we rely on the efficiency of government to protect the interests of the public? Can we rely on the workings of the market, and if so, how? We will discuss these issues in the remainder of the article.

## II. PURPOSE OF THE CORPORATION

The business of business is business. Milton Friedman’s well-known maxim<sup>6</sup> has been used by those who believe that the only responsibility of the private corporation is to increase profits for its owners or shareholders and to oppose activities that are not directly related to pursuit of profits.<sup>7</sup> Managers tend to see the corporation as having only one “stakeholder,” the shareholder, and believe that this shareholder has a narrow view of profits.<sup>8</sup>

4. Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32, available at <http://www.rohan.sdsu.edu/faculty/dunnweb/rprnts.friedman.html>.

5. *Id.*

6. “In [a free] economy, 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 . . . .” MILTON FRIEDMAN, *CAPITALISM AND FREEDOM* 133 (University of Chicago Press, 1962).

7. A special survey in *The Economist* on CSR added: “The proper business of business is business. No apology required.” *The Ethics of Business, A Survey of Corporate Social Responsibility*, THE ECONOMIST, Jan. 22, 2005, at 20, 22 (after page 54).

8. Here it may be convenient to distinguish between owner-managers, managers on behalf of clearly identified owners (for example, of a family-owned firm) and managers acting on behalf of a multitude of anonymous shareholders. The first two types of managers may not be as detached from the broader responsibilities of the firm as the last one, where the “agency problem” (the potential discrepancy in the decisions taken by managers and those that would be taken by the owners) may be more acute.

This behavior is justified on the basis of business- and economics-school theories of “maximization of shareholder wealth” as the objective of the firm, and is further exacerbated by the attention given to the variation in stock market prices, which tend to overreact to events related to the corporation, in particular to reported earnings. This has been further exacerbated by poorly designed stock options that, with the good intention of aligning the objectives of management with those of the firm, do so based on achieving short-term increases in stock prices. This is not, and should not be, the sole objective of the firm. The “going concern” concept of accounting principles does not match the short-term view of some managers of personal profit maximization and the perverse incentives provided by stock options and bonuses based on short-term performance.

#### A. *Creation and Destruction of Market Value*

In the case of stock market prices reacting to reported earnings, and even in the case of a firm whose shares are not traded, current generally-accepted accounting principles conspire against a broad and long-term view of the firm’s activities. These accounting principles are based on recognition of expenses actually incurred and income actually received over the reporting period, usually a short-term horizon. They do not and cannot recognize values that cannot be measured in an objective way. In many cases, the accounting principles have a conservative bias, recognizing as an expense some outlays that could be capitalized, i.e. deferred for future expensing, as they will yield future benefits. Current accounting principles do not recognize, for instance, investments in human capital, in intellectual property, and in creating brand value and reputation (unless acquired in a merger or acquisition), which may be some of the most valuable assets.<sup>9</sup> These principles do not recognize the consumption of natural capital (the negative or positive impact on the environment), which may not have a tangible financial cost for the firm in the short run, but may have a cost in the long run and certainly have, sooner or later, a cost for society.<sup>10</sup> Supposedly, stock market valuation does include these items, but we argue that if it does, it does so in a fickle way with a short-term orientation, and does

9. The market value of firms like Coca-Cola and IBM is overwhelmingly related to intangibles like brand value and reputation.

10. The most common example these days is the case of greenhouse gas emissions. In most cases, corporations do not face the costs to society of those emissions because the cost, for example, of oil or coal does not include the future damage to the environment in their prices. Cost of labor, technology, raw materials and the like are included, but the costs of increased concentrations of carbon dioxide in the atmosphere are not included. An accountant would say that these costs are not quantifiable and are better ignored. This creates perverse incentives to use more of the mispriced resources.

not provide the right incentives for management to act in the most convenient, long-term interest of the firm. There is no need to elaborate or repeat the recent examples of firms in which short-term maximization of market value by managers, for their benefit, led to irresponsible and illegal behavior, with the consequent *destruction* of market value for shareholders.

We are not saying here that stock price and reported earnings are not good guides for management behavior. But we will argue that they are not enough and in many cases may lead to irresponsible behavior and a destruction of value. Neither are we advocating a different accounting or pricing system, but we will argue for a broader conception of the corporation based on the concepts of Corporate Social Responsibility. As we will see below, these concepts require us to take a broader view of the firm's activities and include other stakeholders in the decision process like employees, customers, suppliers, communities, governments, civil society and the environment from which the firm gets its resources and disposes of its unwanted items.<sup>11</sup> These stakeholders must be part and parcel of the concerns of the firm in addition to the providers of capital (who, although critical, are not the only ones who make the firm a long term viable entity). This is not to say that stakeholders have rights in the same way that shareholders have rights to the residual value of the firm, but it means that they cannot be ignored.<sup>12</sup>

What type of firm would exist with plenty of capital (provided by shareholders) but no employees to produce the products, no customers to buy them, or no proper environment in which to get input and operate? Recall that not all markets are as perfect as those of capital in the most developed countries. The firm does not pay for the value of clean air; the negative consequences of climate change due to carbon emissions; the full-cost price for the water it uses; and in some cases, for the value of labor it uses (in a very imperfect market for labor) or the negative impact that it has on the surrounding community. There are many instances of mispricing

11. For instance, the German Constitution states: "Property imposes duties. Its use should also serve the public weal." GRUNDGESETZ [GG] art. 14, § 2 (F.R.G.) available at [http://www.bundestag.de/htdocs\\_e/parliament/function/legal/germanbasiclaw.pdf](http://www.bundestag.de/htdocs_e/parliament/function/legal/germanbasiclaw.pdf) (in English) and <http://www.gesetze-im-internet.de/bundesrecht/gg/gesamt.pdf> (in German).

12. Some argue that a major flaw in the stakeholder approach is that it lacks a method of balancing these competing accountabilities:

The ultimate responsibility always points to the rights of the owners; the managers are proxies for those owners and have an obligation to meet the business needs of the corporation. Managerially, stakeholder theory is primarily a tool for managers to accurately and thoroughly consider threats and opportunities to the business.

Craig M. Sasse & Ryan T. Trahan, *Rethinking the New Corporate Philanthropy*, 50 BUS. HORIZONS 29, 34 (2007).



input, including input that the firm uses but does not even account for. Some compensation to the earth and to society may be due.

*B. Legal Theories of the Firm and Profit Maximization*

This discussion goes to the heart of the different conceptions of the purpose of the corporation. There are at least two legal theories of the firm. On one side is the contracts theory, which views the corporation primarily as a set of property or contractual relations; on the other side, the entity theory recognizes the corporation as a concession from society with its attendant rights but also obligations. Under the contracts theory, the corporation is a collection of private contracts between shareholders, managers, and others. In this view, the primacy is the contract with shareholders, which allows and conditions all other contracts. From this, it follows under the theory that the corporation should only be governed by the interests of the property owners or the contracting parties.<sup>13</sup> It is up to the bargaining power of each of the parties to the contract to defend their interests; therefore, the corporation should defend the interests of the shareholders. And under the assumption that shareholders, being rational human beings, want more wealth and will never be satiated, the conclusion is reached that the objective of the firm is to maximize shareholder wealth.

Under the entity theory, there is a recognition that the corporation operates within society, that it needs the resources that the planet and society can provide in order to carry out its activities, and that it needs society to buy its products and services. The corporation does not operate in isolation. As such, it has responsibilities toward society. This theory recognizes the complexity of the corporation's relationships with others and assumes that many of the "contracts" of the contracts theory may not be explicit—for instance, those formed with the surrounding community, with the people that breathe the air released from the factories, and so on. It also recognizes that there could be an extreme asymmetry of power between the corporation and the explicit and implicit contracting parties, particularly as the corporation becomes larger and more global. It recognizes that the state has a role to play in the regulation of these relationships, as it has granted the corporation the right to operate with limited liability and/or as a separate legal personality.

The former theory is based on the assumption that the firm is omnipotent and provides goods and services needed by society; therefore, we

13. CHRISTINE PARKER, *THE OPEN CORPORATION: EFFECTIVE SELF-REGULATION AND DEMOCRACY* 3–7 (2002).

should all be thankful and not ask for anything more. The latter assumes that the corporation's activities are based on a "license to operate" from society. All contracting parties (whether explicit or implicit) who have a stake in the activities of the corporation are stakeholders, including those with primacy of rights—the shareholders.<sup>14</sup>

While the firm may be private in the sense that it is owned by private individuals, directly or indirectly, it does not necessarily operate exclusively within the realm of those individuals. As it operates in the public space, it does have public responsibilities. Contrary to what some authors state, stakeholders do not pretend to have "a pseudo-ownership interest in the corporation,"<sup>15</sup> but they do have a stake in the activities of the firm and can exercise their rights within a competitive, democratic, and free system if provided with all the necessary information to make informed decisions. In particular, they can refuse to buy products and services. It is not that the corporation has to work for the public good, but if it wants to work for its own good, it had better consider the impact of its activities on the public good.

Many critics of CSR assert that the business enterprise is an important social good for four reasons: job creation, production of goods and services, creation of wealth, and moral and material support of other activities of civil society.<sup>16</sup> These critics argue that these are the social responsibilities of the corporation, and it does not have any other responsibilities to society.

The economic theory of the firm, mostly based on the legal theory of contracts, has influenced many business and economics students. In order to be presented in an understandable way, this theory develops a simple model that for its simplicity requires heroic assumptions: information flows freely and is fully reflected in the prices of goods and services, there is perfect competition in markets, labor markets function with no friction, wages reflect the marginal contribution of labor, and so on.<sup>17</sup> There is no need to dwell on the gap between these assumptions and the real world; even in the most advanced societies, they do not hold true. The conclusion of the model is that profit must be maximized to enhance the welfare of

14. For a comprehensive critique of the theory of shareholder value, see MICHEL AGLIETTA & ANTOINE REBÉRIOUX, *CORPORATE GOVERNANCE ADRIFT: A CRITIQUE OF SHAREHOLDER VALUE*, 22–47 (2005).

15. Henry G. Manne, Op-Ed, *Milton Friedman Was Right*, WALL ST. J., Nov. 24, 2006, at A12.

16. MICHAEL NOVAK, *THE FUTURE OF THE CORPORATION* 14–15 (1996).

17. Most textbooks of microeconomics and of corporate finance describe the perfect competition assumptions. See, e.g., WILLIAM J. BAUMOL & ALAN S. BLINDER, *ECONOMICS: PRINCIPLES AND POLICY* 195–97 (Thomson/South-Western 10th ed. 2006) (1979).

society. In a purely competitive environment with no externalities,<sup>18</sup> with perfect markets, and where the individual always prefers more money to less, the pursuit of profit will make everyone work harder, resources will be better used, only the most efficient firms will survive, and everyone will be better off. Take care of profit and the rest will take care of itself. Profit is literally the last line, the bottom line of the income statement; it is the net of all revenues and expenses, summarizing everything that occurred in the business. This profit belongs to the owners (or shareholders in the case of a corporation), and it is all that matters. The shareholders put the capital at risk, which secures other financial, labor and material resources. Profits are “the bottom line” of business.

These newly minted economists and MBAs go into the world with this model of the world. Even knowing the assumptions are not valid, they are told that the results of the model are valid. Alford and Naughton take a broader view of the role of business in society: “A purely financial description of the firm is appealing in that it is quantifiable and allows for the creation of both simple decision making rules and complex mathematical analysis of the financial structure of business, but this description is inevitably abstract and disconnected from the real world of business.”<sup>19</sup>

Based on the preceding discussion, we can assert that profits are one of the major responsibilities of the corporation. If a legitimate corporation is not profitable it will eventually cease to exist and will not be able to perform any role in society, including the important one of providing employment. But this is not to say that the sole purpose of the corporation is that of maximizing profits for shareholders. In fact, “no corporate statute has ever stated that the sole purpose of corporations is maximizing profits for shareholders.”<sup>20</sup> Corporations must also consider the impact of their activities on the other stakeholders, minimizing and compensating the negative effects and enhancing the positive ones. These considerations may garner the favor of customers and society in general and help minimize and control risks, which may lead to better profits.

18. Externalities are said to exist when the price of the product does not reflect all costs that society incurs to make it available to consumers, or when at least some of the benefits associated with the consumption of the good or service can be captured by others that pay nothing for it. Pollution is a negative externality.

19. Helen Alford & Michael J. Naughton, *Beyond the Shareholder Model of the Firm*, in 2 RETHINKING THE PURPOSE OF BUSINESS 28 (S.A. Cortright & Michael J. Naughton eds., 2002).

20. See Einer R. Elhauge, *Corporate Managers' Operational Discretion to Sacrifice Corporate Profits in the Public Interest*, in ENVIRONMENTAL PROTECTION AND THE SOCIAL RESPONSIBILITY OF FIRMS: PERSPECTIVES FROM LAW, ECONOMICS, AND BUSINESS 23 (Bruce L. Hay, Robert N. Stavins & Richard H.K. Vietor, eds., 2005).

Could and should the firm behave responsibly only if there is a link with profits? In the next section we discuss this question in the context of the role of law in the regulation of socially responsible activities.

### III. RESPONSIBILITY, LAW, AND ETHICS

Corporations are artificial creations, *persona ficta*.<sup>21</sup> In Spanish-speaking countries, the most common form of corporation is called a *sociedad anónima*, an anonymous society, implying in its name that it does not have responsibility as a person. We do not know who it is in the same way we do not know the author when we attribute a work to Anonymous. Can these artificial creations have responsibilities, or is it only real persons that can have them? Being anonymous, how can their behavior be controlled?

#### A. Corporate Regulation

In an ideal world, managers would have strong ethical principles and laws and regulations would not be needed, leaving corporations free to adapt their activities and make the necessary trade-offs to achieve maximum gains for all. In this ideal world, the market would act as the regulator, guiding the firms to the actions that society considers most desirable. As is, markets are far from perfect and not all managers have strong ethical principles. In most cases, the public does not have the capacity and knowledge to exercise its preferences so as to reward responsible corporations and punish irresponsible ones. Worst of all, as we mentioned above, the market may send the wrong signals. Earl Warren, former Chief Justice of the U.S. Supreme Court, remarked: "Not only does law in civilized society presuppose ethical commitment, it presupposes the existence of a broad area of human conduct controlled only by ethical norms and not subject to law at all." Discussing this quotation, David Hess commented: "Many areas of corporate behaviour are simply beyond the ability of the law to control, and we must rely on managers' ethical decision-making to achieve societal objectives."<sup>22</sup>

According to this view, ethics covers a broader range of behavior than the law, and ethical considerations are indispensable as they complement

21. CHRISTOPHER D. STONE, *WHERE THE LAW ENDS: THE SOCIAL CONTROL OF CORPORATE BEHAVIOR* 3 (Waveland Press, Inc. 1991) (1975).

22. David Hess, *Corporate Social Responsibility and the Law*, in 1 *CORPORATE SOCIAL RESPONSIBILITY* 154, 154 (José Allouche ed., 2006).

the inability of the law to assure responsible behavior.<sup>23</sup> “Although the law is a necessary condition for creating socially responsible corporations, it is not a sufficient condition.”<sup>24</sup> Can and should we design laws that control all possible misbehavior? Most likely the answer to both questions is no, unless we want to cripple the capacity of the corporation to go about its business. Laws simply cannot address every aspect and possible scenario necessary for individual or company behavior, as there is always an underlying assumption regarding a certain level of ethical and moral behavior. Moreover, creating overly complex and difficult regulatory structures actually inhibits companies from operating at optimal levels and impedes their ability to identify the most effective measures and methods for compliance. Such an approach is even less realistic in the case of developing countries, which tend to have limitations in terms of enforcement. Nevertheless, there are some aspects of responsible behavior that can and must be regulated.

The traditional approach to regulation is that of command and control, whereby an undesirable behavior is detected and laws and regulations are passed that seek to prohibit or control the behavior.<sup>25</sup> While in some cases this approach is effective, in many cases it is inefficient and may lead to undesirable behavior. In cases where the costs of the misbehavior are perceived by society to be large and where there is a clear relationship between the behavior and the consequence, command and control regulation may be effective and sometimes may be the best approach. For instance, cases of market failure like pollution, toxic ingredients, and slave and child labor can and must be regulated.

In other cases, regulations may be harder to design and/or enforce. Take, for instance, the case of working conditions for labor. Some minimal behavior may be mandated, but there are many aspects that cannot be mandated. For instance, maximum working hours, minimum age, rest periods, lighting, quality of air and the like may be regulated, but the richness of the work performed and the capacity for advancement, for example, may not be regulated. Even if regulated, the corporation may find other ways to undermine the regulations if the cost-benefit is favorable, as we will discuss below.

Command and control regulations do achieve some of the presumed objectives, but their implementation presents many difficulties. For in-

23. Even the bitterly critical survey of CSR by *The Economist* admitted: “Sometimes the aims of the business and rational self-interest will clash with ethics, and when they do, those aims and interests must give way.” *The Ethics of Business*, *supra* note 7, at 20.

24. Hess, *supra* note 22, at 155.

25. *Id.* at 154.

stance, as they have to apply to all cases, which may be very different, and cannot be tailor-made for every case, regulations will tend to be inefficient and will cover the common elements found in all cases, which may be few. To counter this, the regulator will have the tendency to overregulate, including by attempting to implement unnecessarily complex rules that are too difficult or costly to implement.<sup>26</sup>

These regulations will need strong enforcement procedures and institutions and may be suited for countries or areas with high institutional development, including the ethical manpower to enforce them. They also run the risk that the creativity of the corporation is directed to avoiding the negative effects of regulation instead of looking for better solutions to the problems at hand. Under the regulatory scheme, there is also the tendency to try to solve every problem by regulating it, thereby increasing the costs of compliance, and probably eliciting selective compliance.<sup>27</sup>

Also, these regulations will tend to elicit reactive behaviors on the part of the corporation, some of which are counterproductive. The most common one is strict compliance with the letter of law, forgetting the spirit of the law, such that the corporation may not take reasonable or ethical actions if not mandated by the law. Not only will the regulation tend to be a race to the bottom, but so will compliance. Then there is the problem of capture of the regulator, depending on the relative power of both parties. In the case of large corporations grouped in industry associations, this power can be significant. Depending on the balance of power, and sometimes on the political inclination of the regulator, he or she may be co-opted to design favorable regulations or enforce them lightly.

The corporation, used to minimizing costs and maximizing revenues, will comply with regulations according to its cost-benefit analysis. It will first evaluate the probability of being caught, the amount of the fine if it is caught, and in less institutionally-developed countries, the ways out of the fine. All of this is balanced against the “benefits” of non-compliance. Some corporations will continue selling products that may be fatal because the cost of settling lawsuits may be cheaper than undertaking a recall or taking the product off the market (needless to say, this is cynical irresponsibility, but played within the rules of the game). Regulation may not be enough. It will be the market for responsibility that will tip the balance of this cost-benefit equation, when customers penalize the corporation with their wallets. We will discuss the potential role of the market later.

26. PARKER, *supra* note 13, at 8–12.

27. Hess, *supra* note 22, at 159–61.

This is not to say that there should no be regulation, but that regulation should be limited to those cases where regulations are effective and efficient and where they can be suitably enforced. If society were to rely on the law to control all possible corporate behaviors, the laws and regulations would end up severely limiting the activities of the corporation, and society would lose a significant part of the benefits of business. Private initiative is a very powerful incentive that, as much as possible, should not be curtailed. A balance must be struck between crippling the initiative, allowing freedom of the corporation, and protecting the welfare of society.

To achieve this balance, command and control regulation is supplemented by self-regulation, international hard and soft regulation, and the workings of the markets.

The most common response of industry to command and control regulation is that of self-regulation, which involves the issuance of codes of conduct, both at the individual level and the aggregate industry level, and the institution of compliance programs within the firm.<sup>28</sup> These self-regulations can be the result of legitimate attempts by corporations and industries to self-police their behavior and put peer pressure on each other. Many times these are attempts to preempt more costly regulation by governments or to mitigate negative reactions from society. The following quotation from a lawyer advising corporations on the discussion of pending legislation in the U.S. Congress in early 2007 is illustrative of the reaction: "Corporations should consider the extent to which they wish to become part of the legislative process. Otherwise, they may find themselves subject to compulsory CSR guidelines and left with no say or meaningful input into their own CSR programs."<sup>29</sup>

The key to the value of self-regulation is the credibility of the enforcement and the willingness to be exposed to the scrutiny of stakeholders, in particular the media and civil society, through independent monitoring, certification, auditing and public reporting. There are myriads of instances of self-regulation that we do not have the space to cover. The interested reader is referred to a compendium of these codes.<sup>30</sup>

28. For a comprehensive discussion of the implementation of practical strategies for self-regulation, see PARKER, *supra* note 13, at 8–12. For a summary of the issues, see Hess, *supra* note 22, at 154–55.

29. Michael A. Levine, *Strategic Thinking: Legislating Corporate Social Responsibility*, GREEN-BIZ, Apr. 2007, [http://www.greenbiz.com/news/columns\\_third.cfm?NewsID=34959](http://www.greenbiz.com/news/columns_third.cfm?NewsID=34959).

30. DÉsirÉE ABRAHAMS, *REGULATING CORPORATIONS: A RESOURCE GUIDE*, (prov. ed. Dec. 2004), <http://www.unrisd.org/> (select the "Publications" hyperlink; then search for "Regulating Corporations A Resource Guide").

With the weakness of the command and control regulation discussed above and the acceleration of multi-country operations by many corporations, there has been a need for more global regulations, both for multinational companies on cross-country operations and for purely national companies on a host of issues of common interest in most countries. With multi-country operations, the corporation can engage in regulatory arbitrage, i.e. by placing operations where regulation is weakest or where it can be overridden by regulatory capture, particularly in developing countries. This cross-border activity can escape the reach of national regulations. “The global reach of [transnational corporations] is not matched by a coherent global system of accountability.”<sup>31</sup> This growing power of the multinational corporation is exercised both in seeking favorable treatment in international trade treaties and in resisting attempts at international regulation.<sup>32</sup>

### B. *Multilateral and Civil Regulation*

As a result, there are a large number of soft regulations, some more binding than others. Roughly speaking, we can categorize these global regulations into multilateral regulations and civil regulations. The first ones are normally the result of international treaties or conventions developed by multilateral bodies like United Nations agencies that, when ratified by member countries, become international law applicable in those countries.<sup>33</sup> Many of these regulations cover the activities of corporations, either implicitly or explicitly, when the language refers to the application to “non-state actors.” Examples of these regulations are the International Labor Organization (ILO) Declaration on Fundamental Principles and Rights at Work and the many anti-corruption conventions.<sup>34</sup> There are other multilateral regulations that are not ratified by countries and hence are of voluntary application. Examples are the Guidelines for Multinational Enterprises and the Principles of Corporate Governance, both developed by the Organi-

31. The Secretary-General, *Report of the Secretary General on the Realization of Economic, Social and Cultural Rights*, ¶ 72, U.N. Doc. E/CN.4/Sub.2/1996/12 (July 2, 1996).

32. Significant efforts were expended in the successful blocking of the approval of the U.N. Sub-Commission on the Promotion and Protection of Human Rights resolution 2003/16 on Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights.

33. See Karim Medjad, *In Search of the ‘Hard Law’: Judicial Activism and International Corporate Social Responsibility*, in 1 CORPORATE SOCIAL RESPONSIBILITY, *supra* note 22, at 181, 181–85.

34. See, e.g., Int’l Labour Org., ILO Declaration on Fundamental Principles and Rights at Work, <http://www.ilo.org/dyn/declaris/DeclarationWeb.IndexPage> (last visited Sept. 27, 2007); U4 Anti-Corruption Resource Centre, Themes, <http://www.u4.no/themes> (last visited Sept 13, 2007).



sation for Economic Co-operation and Development (OECD);<sup>35</sup> and the ten principles of the Global Compact, developed by the United Nations.<sup>36</sup> The fact that these regulations are non-binding does not mean that they can be ignored, as stakeholders can demand compliance and future binding regulations may build upon them.

Another category of regulations is that of civil regulations, which are codes of behavior developed by non-governmental entities and as such are non-binding and of voluntary compliance. "Civil regulation represents an effort to fill the governance gap between the law and the market."<sup>37</sup> These include, among others, codes of conduct, reporting guidelines, factory monitoring guidelines, and certification criteria. Examples are the Clean Clothes Campaign Code of Labor Practices,<sup>38</sup> applying to labor issues in the garment industry; the Collevocchio Declaration on Financial Institutions and Sustainability,<sup>39</sup> developed by over one hundred advocacy groups; and the Equator Principles on sustainable practices in project finance,<sup>40</sup> developed by the International Finance Corporation with major international banks. These non-binding regulations are used by civil society organizations to pressure corporations into compliance with social responsibility principles.<sup>41</sup>

Resort to the guidance offered by international standards is accordingly the most defensible position. International norms enjoy the authority of universal consensus by the international community including persuasive moral weight free from parochial national law. Reputable companies cannot fail to observe the origins of international agreements even where voluntary. . . . It could be suggested that several instruments, even if applicable to corporations, do not constitute law *per se*. However, it is characteristic of the incremental lawmaking process that formally non-

35. ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, THE OECD GUIDELINES FOR MULTINATIONAL ENTERPRISES (rev. ed. 2000), available at <http://www.oecd.org/dataoecd/56/36/1922428.pdf>; ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, OECD PRINCIPLES OF CORPORATE GOVERNANCE (rev. ed. 2004), available at <http://www.oecd.org/dataoecd/32/18/31557724.pdf>.

36. United Nations, The Ten Principles of the Global Compact, <http://www.unglobalcompact.org/AboutTheGC/TheTenPrinciples/index.html> (last visited Aug. 28, 2007).

37. DAVID VOGEL, THE MARKET FOR VIRTUE: THE POTENTIAL AND LIMITS OF CORPORATE SOCIAL RESPONSIBILITY 9 (2005).

38. Clean Clothes Campaign, Feb. 1998 Code of Labour Practices for the Apparel Industry Including Sportswear, <http://www.cleanclothes.org/codes/cccode.htm> (last visited Aug. 28, 2007).

39. Friends of the Earth, Collevocchio Declaration, <http://www.foe.org/camps/intl/declaration.html> (last visited Aug. 28, 2007).

40. The International Finance Corporation, IFC Equator Principles, [http://www.equator-principles.com/documents/Equator\\_Principles.pdf](http://www.equator-principles.com/documents/Equator_Principles.pdf) (last visited Aug. 28, 2007).

41. For a very comprehensive, yet not exhaustive, compendium of international instruments and treaties affecting corporate responsibility, see INTERNATIONAL DOCUMENTS ON CORPORATE RESPONSIBILITY (Stephen Tully ed., 2005), and ABRAHAMS, *supra* note 30.

legally binding materials (so-called 'soft law') subsequently undergoes a process of 'hardening.'<sup>42</sup>

One of the latest attempts at soft-regulating CSR practices is the European Parliament Resolution urging the European Commission to extend legal obligations in relation to corporate accountability, such as directors' duties, foreign direct liability, and environmental and social reporting.<sup>43</sup>

A good illustration of the complications of command and control regulation and of soft regulation is the attempt by the International Organization for Standardization (ISO), which develops hard standards for materials, engineering processes, and the like, to develop a standard for Corporate Social Responsibility. In the process of development, it was decided that a certifiable standard was not feasible given the myriad of possible interpretations and the difficulty of regulating behavior; in the end, the ISO decided to develop non-compulsory guidelines. In its own words, "[t]here is a range of many different opinions as to the right approach ranging from strict legislation at one end to complete freedom at the other. We are looking for a golden middle way that promotes respect and responsibility based on known reference documents without stifling creativity and development."<sup>44</sup>

### C. Regulation, Responsibility, and Business Value

Given the limitations and inefficiencies of devising laws and regulations of business behavior, it does not seem necessary to ask the question: *should* corporations go beyond the law? If the law ends up being at a rather minimum level because of the need to preserve business flexibility, the significant lobbying by corporations and their industry associations, and the costs of overregulation, it should not be necessary to ask them to go beyond the law—they should offer to do so voluntarily. This is the essence of Corporate Social Responsibility: a win-win situation whereby the corporation does not have to bear the costs of overregulation and in return performs its activities in a responsible manner. Both sides of this equation—less regulation, more responsibility—can enhance society's welfare. Granted, not all managers play by these rules, and it is here that the market must step in, as we discuss later on.

42. Stephen Tully, *Preface to INTERNATIONAL DOCUMENTS ON CORPORATE RESPONSIBILITY*, *supra* note 41, at xx–xi.

43. Resolution of 13 March 2007 on Corporate Social Responsibility: A New Partnership, EUR. PARL. DOC. PE 387.010, ¶¶ 27, 29, 37 (2007).

44. Work is expected to be completed by 2008 as ISO 26000, and the latest developments can be seen in the working group website. The International Organization for Standardization, ISO Social Responsibility, <http://www.iso.org/sr> (last visited Aug. 28, 2007).

Yes, corporations should go beyond the law. The question now is: *Can* corporations, legally, go beyond what is required by law or would they be damaging the interests of shareholders if they did? Or is “a manager who spends money on environmental protection beyond what the law requires . . . wrongly spending shareholders’ money”?<sup>45</sup> It is not that we are picking on Mr. Friedman, it is that his views are shared by many, many managers. These managers would be wrongly spending shareholders’ money if, and only if, the corporation controlled both the market and the government, i.e. maintained a monopoly in an institutionally underdeveloped country. Why bother with the environment under these conditions?

There should be little discussion that managers can and should go beyond the law if such activities can be proven to lead to profits or, as we prefer to state it, when they increase the value of the corporation.<sup>46</sup> The apparently subtle difference between profits and business value is the source of significant misunderstanding as to what constitutes legitimate activities for the corporation. By firm value we do not mean current reported profits or the price of shares, but rather the long-term value of the corporation. There are two very important differences in the characteristics of what are considered responsible activities. One is the timeline over which benefits from these activities is considered, and the other is the valuation of these benefits. Some will take a very stringent position, influenced by accounting or by stock market valuations, and will only consider as legitimate those activities that can be quantified and shown to affect reported earnings or the stock price over short periods of time (recall the impact on stock options and the short timelines of most managers). For us, the definition of the impact on the value of the firm must include a considerably longer period and include even those activities with impacts that cannot be quantified, like the impact on reputation. In economic terms, we refer to this as the present value of all future earnings (including the impact of intangible assets), discounted at a rate that takes into account the lower level of risk that some of these activities will bring, such as investments in reduction of potential environmental liabilities.<sup>47</sup>

45. Hess, *supra* note 22, at 155 (attributing this argument to Milton Friedman).

46. Elhauge correctly points out that only those activities that voluntarily go beyond the law “in some socially desirable way” can be called corporate social responsibility. Elhauge, *supra* note 20, at 16 n.2.

47. See Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, J. APPLIED CORP. FIN., Fall 2001, at 8, 12–13.

#### D. *Going Beyond the Law and Business Value*

While there should be no question that managers can go beyond the law if the responsible activities lead to profits, there is more controversy as to what activities do lead to profits. For example, the firm may invest in environmental protection. Under the traditional approach this will be seen merely as an expense (recall the previous Friedman quotation on environmental “expenses”) that will reduce the value of the corporation, unless there is an increase in revenues or a reduction of risk. This increase in value may come from avoided future expenses, be it in the form of avoided actual costs or reduced litigation, or in a higher preference in the market for the corporation’s products, or even in the unquantifiable increase in reputation and goodwill. In this case, we prefer to use the word “investment” instead of “expense.” As the market may not recognize those activities that do not have an impact on reported earnings or the stock price, it is incumbent upon the firm to ethically inform the market of those activities. Managers must inform the market of these activities and the expected benefits, quantifiable or not. The information is not for the purpose of influencing stock prices—it is truly to ethically inform the market.

This approach to responsible activities also has the virtue of applying to corporations whose shares are not traded in the markets, either because they are privately held or because the stock market is not well developed. For instance, in Latin America stock market valuations may not be reliable as there are less than 1,500 corporations with listed stocks, and of these, less than 100 trade frequently and in all the major stock markets; the bulk of trading volume is in less than ten stocks in each of the major markets.<sup>48</sup> The other millions of mostly small and medium businesses do not trade in any exchange. As very few firms are subject to the discipline of stock pricing, we cannot rely on stock market valuations to guide responsible behavior. For those companies whose stocks that do trade, there have been some attempts at promoting responsible behavior in developing countries, mostly concentrated on issues of corporate governance. An example is the Brazilian stock exchange’s Novo Mercado, which is a segment for shares issued by companies that voluntarily abide by corporate governance practices and transparency requirements.<sup>49</sup>

48. See, e.g., THE WORLD BANK, FINANCING GROWTH, <http://www.financial-indicators.org/resources/financing-growth.pdf>.

49. See, e.g., Bovespa, Get to Know the Novo Mercado, <http://www.bovespa.com.br/Companies/NovoMercadoSpecial/NovoMercadoi.htm>.

But one question remains: can the corporation go beyond the law, even if it *does not* lead to an increase in value?<sup>50</sup> “Despite contrary assertions by advocates of a profit-maximization duty, the law has never barred corporations from sacrificing corporate profits to further public interest goals that are not required by law.”<sup>51</sup>

To support the ideas that the law does not cover all ethical activities, and that the activities of the corporation may not all be profit-maximizing, it may be illustrative to consider the American Law Institute’s Principles of Corporate Governance:

Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business: . . . (2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and (3) May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.<sup>52</sup>

While admitting that this is merely an opinion and is not legally binding, a majority of U.S. states’ corporate constituency statutes explicitly allow managers to consider non-shareholders’ interests, including those of stakeholders like employees, customers, suppliers, creditors and society at large.<sup>53</sup> It must also be said that this discretion is not unlimited and the interest of the corporation must be the overriding consideration, but without the need of having to prove that the activities lead to increased profits. Needless to say, none of this means that managers have the duty or obligation to engage in these activities—they have the option. Fortunately there are control mechanisms in the corporation and in the market that would prevent managers from abusing this discretion. Either the board of directors, the shareholders or the market for corporate control (to be discussed later) would exercise some restraint.

Federal law also seems to recognize a discretion to sacrifice corporate profits to further public interest objectives because Rule 14a-8 [of the Securities and Exchange Commission] allows shareholder proposals on social responsibility issues significantly related to the corporation’s busi-

50. The remainder of this section draws on Elhauge, *supra* note 20, and comments on that paper by John J. Donohue, *Does Greater Managerial Freedom to Sacrifice Profits Lead to Higher Social Welfare?* and Mark J. Roe, *On Sacrificing Profits in the Public Interest*, in ENVIRONMENTAL PROTECTION AND THE SOCIAL RESPONSIBILITY OF FIRMS, *supra* note 20, at 77 & 88.

51. Elhauge, *supra* note 20, at 23.

52. *Id.* at 24 (citing 1 AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01 (1994)).

53. Even the state of Delaware, where a large number of firms are incorporated, still holds in its Code that the corporation can have the power to “[m]ake donations for the public welfare or for charitable, scientific or educational purposes, and in time of war or other national emergency in aid thereof . . .” DEL. CODE ANN. tit. 8, § 122(9) (2006). Only in the case of sale of corporate control are managers to seek the maximization of the price of the firm. See Elhauge, *supra* note 20, at 24–25.

nesses even when not motivated by profit-maximizing concerns . . . this includes proposals whose significance in relation to corporate business is ethical rather than financial.<sup>54</sup>

Because these activities that may be profit-sacrificing must be significantly related to the corporation's business, they cannot also be done for the purpose of personal gain for the managers or related parties. Yet, this is the case of many philanthropic activities done mostly for enhancing the reputation of some managers. Although the corporation may benefit from the exposure, many times the motivating factor is alien to the business. This reinforces the concept expressed before that even philanthropy should be done in areas related to the corporation's business.

In light of the difficulties of interpretation and the variety of opinions, it is not surprising that courts would prefer to leave decisions to the good judgment of managers. Roe, in his comment on Elhauge, summarizes the argument thus:

Gaps in rules exist and will persist because regulators are not omniscient. If corporate players could fill in these gaps voluntarily, even while sacrificing profits, the public interest could be furthered. Corporate law allows managers to do so (1) indirectly, through the business judgment rule, and (2) directly and explicitly, once we wind through the doctrinal maze.<sup>55</sup>

One author, to avoid having to have this discussion, suggests changing the Business Corporation Act, or the commercial codes in civil law countries, and adds that the interests of the corporation and of the shareholders should be pursued, "but not at the expense of the environment, human rights, the public safety, the communities in which the corporation operates or the dignity of its employees."<sup>56</sup> If this were politically feasible, it would solve a lot of problems, but most likely the discussion would shift to what actions are done at the expense of those affected parties and to what extent have they been affected. We would still have to rely on good judgment.

In summary, the case for the corporation engaging in socially responsibility activities, if they enhance the value of the firm, is beyond doubt. What has been the source of discussion is the meaning of "enhancing the value of the firm." For some purists, it would mean only activities that increase reported profits in the financial statements or the price of the shares in a quantifiable and direct way. Our position is that this is too stringent an interpretation, and the goal should be activities that enhance the

54. Elhauge, *supra* note 20, at 27.

55. Roe, *supra* note 50, at 88.

56. Robert Hinkley, *How Corporate Law Inhibits Social Responsibility*, BUS. ETHICS (CORP. SOC. RESP. REP.) Jan.–Feb. 2002, at 5, available at <http://www.commondreams.org/views02/0119-04.htm>.

long-term value of the firm, whether quantifiable with current accounting practices of economic measurement tools or not, according to the best judgment of the manager. The discussion has pointed out that, with discretion, managers can also engage in socially responsible behavior that does not contribute to the value of the firm, and might even be profit-sacrificing, provided that it is for societal, and not personal, benefit and is significantly related to the corporation's business.

From the preceding discussion, we conclude that profits are not a necessary condition for engaging in responsible behavior. Nevertheless, as business managers may not agree with the preceding arguments and do have a bias toward profit maximization, responsibility may be better accepted if it is couched in terms of enhancing current and/or future profits, value, or competitive position, i.e., if the business case for corporate responsibility can be made it will be easier for managers to engage in responsible behavior.

#### IV. LAW AND REGULATION IN DEVELOPING COUNTRIES

Because every developing country has a different legal structure, even a different legal system, it is impossible to generalize. As an example, we can use the countries of Latin America that at least share the same legal system, civil law. In general, corporate law is composed of the civil code, the commercial code, and some special laws on business societies and on capital markets for those corporations issuing securities. None of these instruments contain regulations as to the purpose of the societies or the firm, leaving any details to the bylaws establishing the firm. While there are some references to the responsibilities of management, they tend to be vague and limited to the prescription of managing the affairs of the firm with honesty and within the law. There does not seem to be any obligation to maximize profits. Nevertheless, the influence of U.S. legislation, of U.S. business and economics schools, and of U.S. multinational corporations may bias the behavior of local managers. So long as they operate within the bylaws of the firm and the constraints included in their performance contracts, managers are legally free to pursue the management of the firm as they see fit. Shareholders are the ones that either developed the bylaws of the firm upon incorporation or bought into the corporation with knowledge of the existing bylaws. There do not seem to be legal constraints to engaging in activities that pursue the social welfare, obviously exercising good business judgment.

Unlike regulation in developed countries, which is tempered by the need to allow for corporate flexibility, in developing countries regulation is

hampered by deficiencies in setting and enforcing it. In general, the capacity to produce regulations tends to be weaker and even more reactive—trying to correct a problem rather than anticipate it—than in developed countries. This has the consequence that some areas that do require regulation may not be properly covered. For instance, environmental and labor regulations tend to be weak.

In developing countries there is a controversy regarding the extent of regulation needed. For some, regulations should be as stringent as those in developed countries. Some go even as far as requiring those standards in free trade agreements.<sup>57</sup> For others, regulations must be adapted to the conditions prevailing in the country, not only in terms of capacity for enforcement, but also in terms of the impact on overall welfare. Some damage to the environment may have to be tolerated if it leads to overall increases in the quality of life. The rules for child labor may have to be tempered in areas where doing otherwise may lead children to worse activities or where families cannot survive without the extra income. Lower wages may have to be tolerated in exchange for compulsory participation in schooling and health services.

[I]t is inappropriate to expect those in the developing world, where incomes are anywhere from one-tenth to one one-hundredth of those in the United States or western Europe, to demand the same standards that we in the developed world enjoy today. Incorrectly assuming that they do would lead firms to spend too much on environmental and other protections (strange as that may seem to some) and too little on wages and new job creation.<sup>58</sup>

This is a very complicated issue, as some countries may be tempted to lower standards—a race to the bottom—in order to attract foreign investment, for instance. Hopefully, the markets for responsibility, to be discussed below, can exercise some control over this.

Furthermore, the capacity to enforce regulations seems to be the weakest point in developing countries, both in terms of technical expertise and in consistency and continuity of effort. In some countries the problem of regulator capture is acute, as the difference in income, access to resources, and access to information is rather large between the regulator and the regulated. Also, as there is a scarcity of qualified personnel, regulators either come from or expect to later work for the regulated industry, thereby

57. Sometimes more as protectionist measures than for moralistic purposes.

58. Paul R. Portney, *Corporate Social Responsibility: An Economic and Public Policy Perspective*, in ENVIRONMENTAL PROTECTION AND THE SOCIAL RESPONSIBILITY OF FIRMS, *supra* note 20, at 107, 124.



losing independence. This may also happen in developed countries, although to a much lesser extent.

Under these conditions, there is an even greater need to supplement deficiencies with a more proactive role for stakeholders, as will be discussed below. This is so in the case of developed countries because of regulatory restraint, and in the case of developing countries because of regulatory failure.

These issues are even more important for developing countries given the broader need for the corporation in society, not only in the production of goods, services, employment, taxes, etc., but also in covering government failures like the provision of the public services of basic health and education.

## V. MARKETS FOR RESPONSIBILITY

Can markets stimulate responsible behavior? In general the answer is obviously yes, but the effectiveness of the market will depend on the existence of many conditions. The model of competitive markets assumes that individuals and firms pursue their self-interest—in the first case, maximizing their utility, and in the second case maximizing profits, but in both cases without regard for others. All actors are assumed to have perfect information regarding demand, supply, and prices; there are a myriad of buyers and suppliers, none of which are significant enough to influence quantities or prices; and the benefits and costs are borne exclusively by the buyers and sellers. The existence of these markets has significant benefits in providing efficient allocation of scarce resources, incentives for productivity and freedom of choice.

Yet even if these conditions were met and markets were perfect, would they guarantee responsible behavior? Only if buyers and sellers were also concerned for the welfare of others and acted accordingly. If they were only concerned about themselves individually, they would like, for instance, cheap prices even if it meant exploiting labor or destroying the environment, provided it did not affect them in a tangible way. Can the markets be moral and promote responsible behavior?<sup>59</sup> They can, and the key question is how markets can be used to enhance responsible behavior.

One approach to the issue of corporate responsibility is to assume that markets are perfect and as such, they should be left alone—only if market

59. For a very entertaining and lucid debate between a liberal economist and a conservative journalist, see REBECCA M. BLANK & WILLIAM MCGURN, *IS THE MARKET MORAL? A DIALOGUE ON RELIGION, ECONOMICS AND JUSTICE* (2004).

failures are found should specific regulations be enacted to correct them. For some, departures from the perfectly competitive model are the rule and for others, they are the exception.<sup>60</sup> Another approach is to start with the assumption that markets are not perfect, and to design regulations in order to ensure a level of responsible behavior that is non-negotiable, basic, and to which all firms must comply, but at a level that preserves the freedom of the firm to contribute to the efficient production of goods and services that society demands. We would then rely on the markets to fill the gaps left by regulation. We favor this second approach, not only because observation of everyday life shows extensive market imperfections, but because we are also interested in responsibility in developing countries where there is no doubt that markets are mostly imperfect. In all cases, especially in developing countries, care must be taken not to substitute market failure<sup>61</sup> with government failure.

One of the grossest violations of perfect economic markets is that of prices failing to reflect all costs. Markets need prices to be clear, and all actors must act on those prices. A very important question remains as to whether markets price social and environmental costs properly.<sup>62</sup> The answer in most cases is that they do not. Based on the accounting and economic principles mentioned above, prices in market transactions tend to include only incurred costs in the accounting sense and opportunity costs in the economic sense, but they do not include social and environmental costs. For instance, prices may not reflect the fact that wages are below what they would be in a competitive market for labor, or the fact that production costs do not include the costs to society of pollution or the emission of greenhouse gases. How can we make corporations internalize these costs? One way is to make all markets perfect: the market for labor, the market for air, and so on. As this is utopian, what can we do in the meantime? We can

60. Two Nobel Prize laureates in economics are on opposite sides of the argument: Milton Friedman and Joseph Stiglitz.

61. Economists normally identify four types of market failure: externalities, public goods, natural monopolies, and imperfect information. For a definition of externalities, see *supra* note 18. Public goods are goods for which prices cannot properly be charged, for instance, national defense. Natural monopolies are goods or services for which no competition is feasible or economically efficient (technology is contributing to the elimination of what were once considered natural monopolies, like electricity distribution). Imperfect information refers to the fact that market participants rarely have all the information needed for making decisions. In the discussion that follows, we cover all these issues explicitly or implicitly, as they have the potential to stimulate irresponsible behavior.

62. Even the defender of competitive markets, The Economist, admits that "prices do not reflect true social costs and benefits" but goes on to say that "[t]he question is whether false prices are causing big economic mistakes." Notice that the only mistakes that seem to matter are "economic" mistakes. *The Ethics of Business*, *supra* note 7, at 16.

beef up government regulation to counteract these market failures, or as discussed before, we can develop the market for responsibility.

To avoid stifling business with overregulation and to supplement fair government regulation, we propose the actions of ten drivers in the *market for responsibility*<sup>63</sup> (which goes beyond the more limited term of civil regulation) to counteract economic market failures. Some call this social regulation or regulation by society. We prefer the term “market,” which creates a positive rather than negative connotation of “regulation.”

*Enforcement of laws and regulations:* As pointed out before, laws and regulations may be necessary conditions but they are not sufficient. Institutions that enforce the regulations in ways that deter and correct irresponsible behavior are key.

*Active civil society:* To supplement the oversight of regulators and to induce responsible behavior that may not have been regulated, strong civil society institutions may be needed. These include institutions that develop standards of reporting and, in general, the activities of civil regulation mentioned before.

*Developed financial markets:* Financial markets can be drivers of responsible behavior but can also be deterrents. On the positive side, for example, if banks, insurance companies, and shareholders would be willing to lend at lower rates, charge lower premiums, or pay higher prices for shares of responsible firms, they would be sending the right signals. And this need not be for altruistic reasons—responsible firms may be less risky, less subject to potential liabilities, or more able to capture new markets that are being opened for responsible products and services, which would make banks and firms more valuable. On the negative side is greed. Firms that devote resources to invest (not spend) in responsibility with the hope of long-term gains may have short-term costs that make them vulnerable in the takeover market. With the insatiable appetite of today’s private equity firms, any responsible firm that does not maximize the value of its shares is at risk of being taken over, going private, changing management, and being taken public again for huge gains by the raiders.<sup>64</sup> To some, this introduces discipline in the markets. Unfortunately, it may have the effect of stimulating irresponsible behavior.<sup>65</sup>

63. We include a broader conception for this “market for virtue” than others do. See VOGEL, *supra* note 37.

64. See Roe, *supra* note 50, at 91.

65. This comment is not intended to be an indictment on private equity, as there have been some takeovers that intended to capitalize on the potential gains for corporate responsibility.

*Educated consumers and buyers:* Consumers and buyers are the key actors in the markets for responsibility, as all firms must sell goods and services and are therefore subject to the desires of this group. Nevertheless, even if consumers and buyers wanted to reward responsible behavior, they may not have access to information on the quality of the practices of firms. Most consumers say that they would buy and even pay a premium for responsible firms' products, but when asked whether they do buy those products most will tell you they do not know if the products they buy were produced by responsible firms.<sup>66</sup> Only in very special cases is that information available. This is the case of large firms selling massively into the market; these firms are under the scrutiny of civil society organizations and their cases are well publicized. Corporations like Nike, McDonald's and Wal-Mart are fully aware of the potential of consumer pressure, but a firm that manufactures brakes for railroads may escape scrutiny. Large buyers, which in turn are subject to consumer pressure, may exert pressure on their suppliers, even if these suppliers are unknown to civil society or consumers. This has been the case in the improvement of working conditions in sporting goods manufacturing in developing countries due to the pressures of consumers and civil society on firms like Nike.

*Activist media:* Internet and the traditional media can be forces for responsibility by educating and informing consumers and society at large of the practices of corporations. With the spread of the Internet, the speed and scope of reporting has increased dramatically, and the Internet is becoming a force in reporting and eliciting responsible behavior. Needless to say, it can be misused and the media must also be subject to monitoring and enforcement to prevent irresponsible practices.

*Monitoring and reporting institutions:* As in the media, specialized institutions that monitor and report on issues such as working conditions are important to detecting, highlighting and, most importantly, deterring irresponsible behavior. There are now a growing number of institutions that certify the responsible practices of producers, whose certification is needed to access many developed markets.<sup>67</sup> Again, these institutions must also behave responsibly as they are not exempt.

66. This is what retailers call the "30:3 phenomenon," where thirty percent of buyers say they have responsible production in mind when buying but only three percent actually make purchasing decisions based on responsible production values. Michael Skapinker, *There is Good Trade in Ethical Retailing*, FIN. TIMES (London), Sept. 11, 2007, at 11.

67. Examples are the Forest Stewardship Council (FSC) in the wood industry, Worldwide Responsible Apparel Production (WRAP) in the garment industry, and Fair Trade in a variety of industries including, for instance, the coffee industry.

*Activist employees:* From the inside, without having to wait for the outside market to exert pressure, activist employees and middle management can induce and implement responsible practices where they are most effective—from within.

*Committed top management:* As with employees, but in a separate category, top management can and must exercise a leadership position. It is extremely unlikely that a responsibility program will work without the support and commitment of top management. Needless to say, managers require not only the moral fiber but also the right incentives to behave responsibly. As discussed above, there are significant market pressures that conspire against responsible behavior.

*Exposure to globalization and competition:* Firms that are exposed to globalization may experience the pressures of international markets and of international civil society. In order to sell in some markets, particularly in Europe, it is becoming increasingly important to be and appear to be responsible, sometimes requiring certification from an independent monitoring institution. Global markets can act as driving forces for responsibility by rewarding firms with better prices and access to other markets (for instance, Fair Trade coffee in European markets). Exposure to competition can also be a driving force for responsibility. The extreme opposite case is that of a monopoly that, even if regulated on responsibility issues, would have very little incentive to go beyond the law. If consumers have choices through competition, they may exercise those choices and favor responsible products. But, as in the case of financial markets described above, competition can also be detrimental to responsibility. If competition is strong and consumers do not have a direct impact (perhaps in wholesale or industrial products) or are not well informed, competition can lead managers to cut costs and reinforce the short-term vision of maximization of profits by reducing investment in responsibility. These decisions, while increasing the value of the firm, may have short-term costs that impact the competitive position. On the other hand, exposure to competition can help to curb managers' excessive generosity to social or philanthropic activities that are none of the corporation's business.

Needless to say, these markets for responsibility are rather underdeveloped, even in developed countries.<sup>68</sup> Some of the driving forces mentioned above are more developed than others, but it is unlikely that in the real world they would be sufficiently developed to elicit responsibility in the corporate world. If one considers the relatively underdeveloped situa-

68. Most of the Vogel book cited above is devoted to showing the underdevelopment of this market. See VOGEL, *supra* note 37.

tion of these markets in developed countries, there is little need for a detailed discussion of their situation in developing countries.

The imperfect markets that operate all over the world bring the benefit of economic efficiency but also bring unaccounted costs to society. A very difficult tradeoff must be achieved between these costs and benefits through the operation of government regulation and the market for corporate responsibility. This tradeoff in developing countries may tend even more toward the sacrifice of economic efficiency in order to enhance the welfare of the less well-off, which may come back to benefit the company through its operation in a more developed society.

### CONCLUSION

From the preceding discussion it should be clear that the corporation can and must go beyond the law, as it is very likely that the law will not be able to cover all aspects of responsible behavior. And while these responsible actions should enhance the value of the firm, measured over the long run and including all costs and benefits, the firm may engage in activities where this relation is not clear, provided these activities are significantly related to the corporation's business.

How can the corporation be responsible if doing so involves voluntary measures? We are confronted by a series of imperfect tools to foster responsibility. Laws and regulations alone cannot fully control corporate behavior to the extent that society may like, and in any case such control would be totally impractical because the rules and regulations would have to be so constricting in order to encompass all possible cases that they would impose extreme restrictions on the operation of corporations, and society's welfare would thereby be severely limited.

Complementary measures to a baseline level of compulsory and voluntary regulation include the operation of the market, i.e. stakeholders exercising their rights; shareholders demanding responsible behavior of managers, increasing demand for and hence the price of shares of responsible corporations; consumers favoring or shunning products according to the responsibility of the corporation; better employees choosing to work and work harder for responsible firms; suppliers and financial institutions refusing to supply or charging prices reflecting the responsibility of the corporation; and so on with other stakeholders. This market for responsibility is still imperfect and in many countries very underdeveloped.

The market may even send perverse signals, as in the case of the market for corporate control, where there is extreme pressure on managers to maximize earnings, or worse, short-term share price, lest they be bought

out and expelled from their positions. Competition policy, which seeks to promote society's welfare by stimulating competition and thereby enhancing economic efficiency, may promote the maximization of short-term benefits, undermining the efforts of managers who are responsible and pursue benefits for the corporation with a long-term view. Needless to say, responsible managers who use the discretion afforded them could counter many of these imperfections or restrictions, but they too face pressures for short-term results. A judicious blend of regulations and market forces, including responsible managers, can promote responsibility.

The line between law and market will be in a different place in every country and in every sector of the economy, depending on the relative development of each. Many times, particularly in developing countries, there will continue to be a gap between law and market, a gap that stakeholders must try to fill by expanding the scope of either law or market or both. The relative ingredients will be dictated by the relative development of the rule of law and the market. As in any endeavor, good judgment, a scarce commodity, is key.