2

Three Foundational Assumptions

Isn't profit enough?

If businesses focus on earning an honest profit—where "honest" reflects a sincere commitment to "play by the rules"—isn't that enough? Why should businesses, in addition to striving to maximize profits, be expected to commit resources to addressing social and environmental issues, and then expend time and energy preparing both traditional financial statements and detailed corporate responsibility reports?

The short answer to the opening question is this: "No, in many cases, an honest profit isn't enough."

In this chapter, we lay the groundwork for an explanation of why this is the case by examining three important assumptions often made by CSR advocates:

Business and society overlap in important ways and are mutually dependent.

Economic markets are social institutions. In order for markets to function properly, a number of supporting institutions are required, and certain conditions must be met.

> Societies expect certain outcomes from economic systems. If these outcomes aren't realized, then it's reasonable for societies to attempt to modify or change their economic systems so that these outcomes are obtained.

MUTUAL DEPENDENCE

In a 2006 article in the Harvard Business Review entitled "Strategy and Society: The Link Between Competitive Advantage and Corporate Social Responsibility," Michael E. Porter and Mark R. Kramer explain the relationship between business and society as follows:[i]

> Successful corporations need a healthy society. Education, health care, and equal opportunity are essential to a productive workforce. Safe products and working conditions not only attract customers but lower the internal costs of accidents. Efficient utilization of land, water, energy, and other natural resources makes business more productive. Good government, the rule of law, and property rights are essential for efficiency and innovation. Strong regulatory standards protect both consumers and competitive companies from exploitation. Ultimately, a healthy society creates expanding demand for business, as more human needs are met and aspirations grow. Any business that pursues its ends at the expense of the society in which it operates will find its success to be illusory and ultimately temporary.
>
> At the same time, a healthy society needs successful companies. No social program can rival the business sector when it comes to creating the jobs, wealth, and innovation that improve standards of living and social conditions over time. If governments, NGOs, and other participants in civil society weaken the ability of business to operate productively, they may win battles but will lose the war, as corporate and regional competitiveness fade, wages stagnate, jobs disappear, and the wealth that pays taxes and supports nonprofit contributions evaporates.

In addition to the mutual dependence that Porter and Kramer highlight, business and society are bound together in an even more fundamental way. The building blocks of society (e.g., language conventions, communication systems, shared understandings, behavioral norms, shared culture), are also the building blocks of business. In other words, businesses are built from the same raw materials as the larger social system in which they are embedded. While it is often claimed that businesses supply critical inputs to society (e.g., products and services of all kinds, employment, innovation), it is also true that society supplies businesses with equally critical inputs (e.g., an educated workforce, infrastructure, monetary system, police protection, access to courts).

In some circles, although there is begrudging acknowledgment of some degree of mutual dependence, it is often asserted that government and other social institutions are more dependent on the productive efforts of businesses than vice versa. For example, the following quote is from a leading textbook on strategic corporate social responsibility:

> Without the great wealth-producing engines of business, the taxes and charity needed to run government and nonprofits fade away, in time reducing our standard of living to some primitive level. A simple thought experiment underscores these points: Look around you and subtract everything that was produced by a business. What is left? Or another example: What is the difference between the poorest nation and the wealthiest nation? Is it not primarily the creativity and productivity of businesses embedded in a societal-defined context?[ii]

A careful assessment of the relationship between business and society challenges this view in at least two ways. First, economic value creation is not the exclusive domain of business. Loosely defined, economic value creation is achieved by acquiring control over resources with a certain value, and then combining or transforming these resources to produce products and/or services with a greater value than the resources used to produce them. For example, the economic value created by the production of an iPhone is the difference between its final value and the total value of all resources utilized in its production. Similarly, if a community were to pool its resources and build a public library, subtracting the total value of utilized resources from the final value of the library would yield a measure of the economic value created.

Although there are important differences between business activities in economic markets and the production of goods and services through governmental or social efforts, recognizing that economic value can be created through either approach suggests that neither should be viewed as derivative of the other.

Familiarity with economic markets and private goods often makes it difficult to see the process of economic value creation independent of how it is managed or controlled (i.e., through economic markets, or through governmental or social processes). The following question illustrates this point: From the perspective of an average American citizen, in 2011, how does the economic value created by Microsoft compare to the economic value created by the U.S. military? For the full year ending on June 30, 2012, Microsoft generated a profit of around $17 billion on revenue of approximately $74 billion. The U.S. military, in contrast, contributed $820 billion to the U.S. GDP in 2011 (or 5.4%). The economic value created in each case can be derived by subtracting the value of all inputs from the value of all outputs. In Microsoft's case, total economic value created is probably close to double Microsoft's annual profit (assuming the average price of each transaction was halfway between supplier cost and the full value attributed to the product by the buyer). In the case of the U.S. military, total value created is equal to the sum of the value each individual in the U.S. places on what the military produces (e.g., national security, military supremacy) less the total value of all inputs. Assuming attributed value is 50% higher than the total inputs (a conservative estimate), the military generated approximately $400 billion in economic value (or approximately thirteen times the economic value created by Microsoft). Note that determining the value of end products, both in the market, and in the case of public goods, like national defense, is a subjective process that requires a number of assumptions. Regardless, the process of value creation is the same in economic markets as it is in governmental or social contexts. In each case, the amount of economic value created is derived by subtracting the value of all inputs from the value of all outputs.

Second, as Figure 2.1 illustrates, in addition to producing significant economic value, a number of critical business inputs are produced through governmental or social processes. Likewise, businesses, in addition to creating significant economic value, generate critical governmental and social inputs. The mutual dependence of government and market activity is illustrated by these two questions: “Could businesses or markets function without the critical inputs produced by governmental or social efforts? and “Could governmental or social efforts be effective without market inputs?” The answer to each of these questions is “no.”

Based on Figure 2.1, the paragraph cited above asserting the primacy of market activity could be rewritten as follows:

> Without the critical inputs generated by collective or government efforts, including public goods such as national security, internal law and order, a system of property rights, access to courts, a monetary system, roads, airports, and other public infrastructure, public education, and regulatory efforts designed to constrain negative externalities and improve market functioning, economic markets would fade away and the value-creation efforts of business would become increasingly difficult. A simple thought experiment underscores this point: Look around you and subtract everything that was produced through governmental or social effort. Could businesses function without a monetary system, roads, an educated work force, and so on? Or another example: What is the difference between the poorest nations and the wealthiest nations? Is it not primarily the degree of law and order, safety and security, public infrastructure, and other public goods that make an efficient economic system possible?

MARKETS AS SOCIAL INSTITUTIONS

In addition to the idea that business and society are mutually dependent (see Figure 2.1), CSR advocates view economic markets as social institutions. From this perspective, markets are complex systems of social interaction that must be carefully structured and

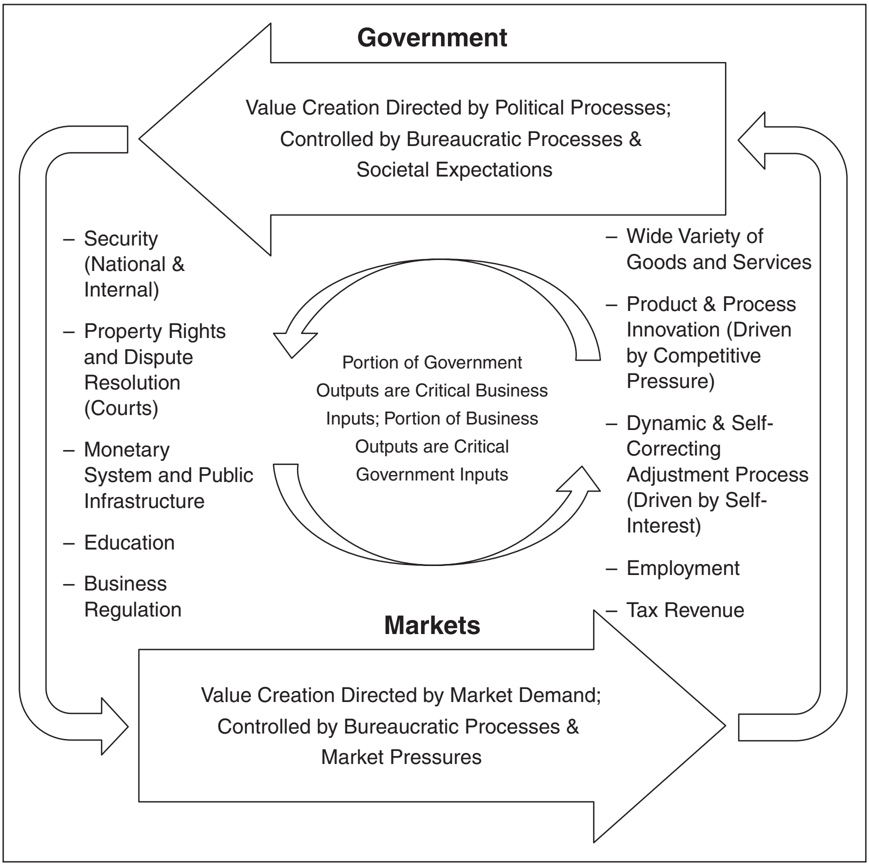

FIGURE 2.1 Mutual Dependence: Business & Government

maintained. To operate efficiently, markets require a mix of shared norms, enforceable rules, and supporting institutions. In almost all cases, public goods are necessary. Charles E. Lindblom, in his book entitled *The Market System: What It Is, How It Works, and What to Make of It,* identifies eight supporting institutions required by market systems: 1) Customs and laws that facilitate the exercise of personal liberty, 2) A stable system of broad property rights, 3) Customs and laws that make quid pro quo the primary basis of exchange (and therefore prohibit the use of violence or theft to obtain property), 4) A medium of exchange or money, 5) A societal shift from work within the household to the sale of objects and performances outside the household, 6) The emergence of economic intermediaries (i.e., market makers), 7) The emergence of entrepreneurs who specialize in establishing exchange linkages and exploiting market opportunities, and 8) The emergence of collectives that can operate on a capital and coordination scale that individuals cannot.[iii]

In addition to the supporting institutions identified by Lindblom, if economic markets are to yield optimal outcomes, certain structural conditions must be met, such as large numbers of buyers and sellers, each fully informed and acting independently.[iv] If these conditions are met, or at least reasonably approximated, the behavior of market participants will be constrained and channeled by competitive pressure. Constant competitive jockeying will result in the lowest price possible for a given product or service, which will ensure that the largest quantity possible is produced and consumed.

Because the emergence of supporting social institutions and the necessary conditions for efficient market functioning are unlikely to occur spontaneously, market systems should not be thought of as naturally-occurring social phenomena. Barter-based exchanges may emerge in the course of ongoing social interaction, but such exchanges are as far removed from market systems as playing catch with a football in one's backyard is from the National Football League. Bridging the gap between barter-based economic exchanges and market-based economic systems requires intentional societal intervention. Learning to establish and maintain efficient economic markets, in many ways, is one of the most impressive social achievements of modern civilization.

Although business and society may be mutually dependent in the sense that each produces key inputs required by the other (see Figure 2.1), in systemic terms, there is a clear hierarchy: Markets are defined and structured by society. As ongoing work in economic sociology—a field that focuses on the social causes and effects of different economic phenomena—demonstrates, the most efficient markets are often the most structured in terms of norms, codes of conduct, policies, and enforcement protocols. For example, the New York Stock Exchange is a carefully structured exchange environment with a long history of norms, precedents, policies, and rules.[v]

Although markets are a versatile, robust, and effective form of economic organization, there are situations in which the necessary conditions for efficient markets cannot be met. In some cases, for example, product characteristics or the structure of the market itself may prevent proper market functioning.[vi] In these cases, society may take steps to constrain or direct business behavior in order to improve outcomes. The role of CSR in these contexts is explored further in Chapter 3. Here it is sufficient to observe that societal intervention in these situations illustrates the hierarchical relationship between business and society; it is society that defines and structures the economic space in which businesses operate—not the other way around.

SOCIAL CONTROL

From a CSR perspective, economic systems are a means to an end. In other words, societies set up economic systems with the expectation of achieving certain outcomes. If these outcomes are not realized, societies may elect to alter or change their economic systems. Although CSR advocates may acknowledge the mutual dependence of business and society, they do not view it as an equal partnership. Business is a part of society and therefore subject to societal control. There is often open hostility to the notion that society should be correspondingly subject to corporate control.[vii]

Although the social control of economic activity is important to a broad understanding of CSR, it is, nonetheless, an abstraction that can be difficult for firms to incorporate into their day-to-day decision making. Two concepts help bridge this gap—license to operate, and the iron law of responsibility.

License to Operate

Historically, the term "license to operate" has referred to situations in which firms or industries operated in areas controlled by indigenous people.[viii] In these cases, it is important that indigenous communities or populations be consulted and give their informed consent. In practical terms, this implies that firms must actively engage with indigenous populations and make sure that interactions are mutually beneficial. This is particularly important in extractive industries, such as mining, or oil and gas drilling. For example, Meridian Gold, a Nevada-based company, was recently forced to abandon a mine in Argentina and to take a write-down of nearly $400 million on the property because it failed to secure prior permission from local communities.[ix]

The term "license to operate" is now used to refer, in a general way, to the notion that firms should be cognizant of the level of support they enjoy in the communities and societies in which they operate. In practical terms, the greater the level of trust and support firms enjoy, the less likely they will be subjected to burdensome regulation. In this sense, "license to operate" is often used to refer to the idea that businesses should voluntarily comply with societal expectations in order to preserve their ability (or "license") to direct their own affairs. In cases in which firms fail to comply with societal expectations, this freedom (or "license") may be suspended or revoked. In other words, failure to voluntarily comply with societal expectations may result in firms being forced through regulatory and/or legal means to do so. In general, businesses are likely to prefer the former arrangement to the latter.[x]

Iron Law of Responsibility

The Iron Law of Responsibility, although similar to the notion of a license to operate, focuses more on the link between power and responsibility than the threat of regulation. This law can be expressed as follows: "In the long run, those who do not use power in a manner in which society considers responsible will tend to lose it."[xi]

The Iron Law of Responsibility is often referenced as one of the primary reasons why businesses should be careful to respond to changing societal norms and expectations. If businesses do not respond to changes in societal expectations, then the Iron Law of Responsibility suggests that over time, the responsibility and power now enjoyed by the business community will diminish. Keith Davis, in an influential article published in 1960, explained it this way:

> But what are the consequences of responsibility avoidance? If power and responsibility are to be relatively equal, then the avoidance of social responsibility leads to gradual erosion of social power. To the extent that businessmen

> [or businesswomen] do not accept social-responsibility opportunities as they arise, other groups will step in to assume these responsibilities. Historically, government and labor have been most active in the role of diluting business power, and probably they will continue to be the principal challenging groups. I am not proposing that this should happen, but on the basis of the evidence, it appears that this will tend to happen to the extent that businessmen do not keep their social responsibilities approximately equal with their social power.[xii]

The Iron Law of Responsibility draws attention to the important role that business has often played in societal evolution and development. To the degree that business continues to be perceived as a trustworthy advocate of societal interests, it will retain its current level of power and influence. On the other hand, if business is perceived to be promoting its own interest at the expense of broader society, its power and influence will almost certainly erode.

The mutual dependence of business and government, the fact that markets are social institutions, and the legitimacy of societal control of economic activity are often assumed in CSR contexts. Understanding these assumptions is important groundwork for understanding why, in many cases, a focus on profit is not enough to ensure that the actions of market participants will promote societal interests.

CHAPTER SUMMARY

In many cases, a focus on profit isn't enough to ensure that the actions of market participants will serve societal interests. As a foundation for understanding why this is the case, it is important to understand three important assumptions often made by CSR advocates.

First, business and society overlap in important ways. Economic value can be created through market activity as well as through governmental or social processes. These different approaches to value creation are mutually dependent. For example, it would be difficult for businesses to operate without security, property rights, a monetary system, public infrastructure, and regulatory oversight. Likewise, it would be difficult for government to function without inputs derived from the productive efforts of businesses.

Second, markets are social institutions. To operate efficiently, they require a mix of shared norms, enforceable rules, supporting institutions and public goods. In addition, certain structural conditions must be met, such as a large number of buyers and sellers. In some cases, however, product characteristics or the structure of the market itself may prevent proper market functioning. In these cases, intervention may be necessary to promote societal interests.

Finally, from a CSR perspective, societies set up economic systems with the expectation of achieving certain outcomes. If these outcomes aren't realized, then societies may elect to alter or change their economic systems. Social control of economic systems is explicitly reflected in two important concepts—license to operate, and the Iron Law of Responsibility.

REVIEW QUESTIONS

1. How are business and society mutually dependent? Provide some specific examples.
2. Why shouldn't markets be thought of as naturally-occurring phenomena? What supporting social institutions do markets require?
3. Explain this statement: "From a CSR perspective, economic systems are a means to an end."
4. What is "license to operate?" What is the Iron Law of Responsibility? How are they similar? How are they different?

ENDNOTES

[i] See Porter, M. E. and Kramer, M. R. 2006. Strategy & society: The link between competitive advantage and corporate social responsibility. *Harvard Business Review*, 84(12): 78–92, page 83.

[ii] Werther, W. B. and Chandler, D. 2011. *Strategic corporate social responsibility: Stakeholders in a global environment.* Thousand Oaks, CA: SAGE Publications, Inc., pg. xxiii.

[iii]See Lindblom, C. E. 2001. *The market system: What it is, how it works, and what to make of it.* New Haven: Yale University Press, particularly Chapter 4, pages 52–60.

[iv]For an accessible, but thorough, discussion of the perfect competition market model, see Chapter 2 of Walters, S. J. K. 1993. *Enterprise, government, and the public.* New York: McGraw-Hill. For a more advanced treatment of the same, see Bator, F. M. 1957. The simple analytics of welfare maximization. *American Economic Review,* 47(1): 22–59, and Bator, F. M. 1958. The anatomy of market failure. *The Quarterly Journal of Economics,* 72(3): 351–379.

[v]Fligstein, N. 2001. *The architecture of markets: An economic sociology of twenty-first century capitalist societies.* Princeton: Princeton University Press.

[vi]Stiglitz, J. E. 2000. *Economics of the public sector* (3rd ed.). New York: W. W. Norton & Company; Pepall, L., Richards, D. J., and Norman, G. 2005. *Industrial organization: Contemporary theory and practice* (3rd ed.). Mason, OH: South-Western; For a thorough popular press treatment of market failure, see Cassidy, J. 2009. *How markets fail: The logic of economic calamities.* New York: Farrar, Straus and Giroux, particularly Chapter 10.

[vii]For an interesting discussion of corporate social responsibility and economic ideology, see Scherer, A. G. and Palazzo, G. 2007. Toward a political conception of corporate social responsibility: Business and society seen from a Habermasian perspective. *Academy of Management Review,* 32(4): 1096–1120.

[viii]For a discussion of the evolution of the phrase "license to operate," see Wilburn, K. M. and Wilburn, R. 2011. Achieving social license to operate using stakeholder theory. *Journal of International Business Ethics,* 4(2): 3–16; The Declaration on the Rights of Indigenous Peoples, passed by the United Nations in 2007, can be found here: http://social.un.org/index/IndigenousPeoples/DeclarationontheRightsofIndigenousPeoples.aspx.

[ix]Wilburn, K. M. and Wilburn, R. 2011. Achieving social license to operate using stakeholder theory. *Journal of International Business Ethics,* 4(2): 3–16.

[x]See Breitbarth, T., Harris, P., and Aitken, R. 2009. Corporate social responsibility in the European Union: A new trade barrier? *Journal of Public Affairs,* 9(4): 239–255; Porter, M. E. and Kramer, M. R. 2006. Strategy & society: The link between competitive advantage and corporate social responsibility. *Harvard Business Review,* 84(12): 78–92; Zinkin, J. 2004. Maximising the 'licence to operate.' *Journal of Corporate Citizenship*(14): 67–80.

[xi]See Davis, K. and Blomstrom, R. L. 1975. *Business and society: Environment and responsibility* (3rd ed.). New York: McGraw-Hill, pg. 50. See also Davis, K. 1960. Can business afford to ignore social responsibilities? *California Management Review,* 2: 70–76 and Davis, K. 1973. The case for and against business assumption of social responsibilities. *Academy of Management Journal,* 16(2): 312–322.

[xii]See Davis, K. 1960. Can business afford to ignore social responsibilities? *California Management Review,* 2: 70–76, page 73.