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Corporate Social Responsibility and Social Welfare. How to Promote Socially Responsible Business Strategies

Juan-José Ganuza*

1. Introduction

Which goals and values ought to determine corporate behaviour? This is a recurring question that is yet again a relevant issue due to recent extreme business conducts: on one side the Enron and Madoff frauds and on the other the proliferation of socially responsible business behaviours that are apparently dissociated from profit maximization. For example, Volkswagen plants a tree for every car it sells to combat climate change, Starbucks has a coffee purchasing system that rewards suppliers that offer better working conditions and respect the environment.

The Nobel Prize winner in economics, Milton Friedman, defended in a famous and provocative article that profit maximization should be the sole objective of businesses.

"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, which is to say, engages in open and free competition

without deception or fraud." (New York Times Magazine, 1970).[1]

Friedman's argument is based on the frequency with which business managers promote social corporate responsibility strategies motivated by personal interests (such as acknowledgement from others) rather than on arguments based on efficiency or the preferences of the company owners. Friedman, in accordance with the invisible hand of Adam Smith, associates the maximization of benefits to the efficient allocation of resources and defends that the shareholders and not the managers should decide how company profits are reverted into society.

It is not easy to attack Friedman's message with purely ethical arguments. Aside from efficiency, Friedman also defends small shareholders that are in some way dispossessed by executives with a much higher income. Furthermore, shareholders can invest their profits in philanthropic actions. This is the case of Microsoft, a company widely criticized by some consumers and competitors, and often accused of anticompetitive behaviour. However, the Bill and Melinda Gates Foundation invests a great part of Microsoft's profits into society. In particular, this foundation alone donates more money on malaria vaccine research than the European Union as a whole.

Nonetheless, the Volkswagen and Starbucks examples call into question Friedman's arguments. These companies seem to have reconciled their competitive advantage in their respective markets (e.g., obtaining higher returns than the market average) with socially responsible practices. Moreover, some companies make these practices a central element of their corporate strategy and of their search for a competitive advantage. Clear examples are those of Toyota with the launch of hybrid cars, and Iberdrola with a subsidiary dedicated to renewable energy.

These and other examples that will be discussed in this *opuscle* suggest that companies can be managed in a socially responsible way, leading to a virtuous circle where both the company and society as a whole increase their welfare. The objective of this *opuscle* is to study the business rationale for Corporate Social Responsibility (CSR), to determine the incentives behind socially responsible actions, and to study how public policies that promote CSR may be designed. We will argue that the public sector's major role should be to ensure that consumers have access to reliable information on the behaviour of firms. This "transparency" is crucial for the demand side to respond to the behaviour of firms, and for firms to have an incentive to adopt socially responsible practices.

From a welfare point of view, promoting CSR can be an alternative or complementary way for regulation to confront market failures. Regulation is costly, it has limitations originating from asymmetric information and political constraints. It also has a limited impact over global public goods (global warming, Amazon deforestation, biodiversity loss, or child labour). CSR can reach where national regulations fall short and have a great impact on our wellbeing. In this sense it is important to emphasize that the 122 largest multinationals are responsible for 80% of CO2 emissions, 70% of world trade and 90% of patents. However, we will also demonstrate how the emergence of CSR has the risk of changing the political balance that sustains regulation. This process may lead to the substitution of efficient formal regulations for a less effective self-regulation that could lead to loss in welfare.

This *opuscle* is organized as follows; in the following section I will formally introduce the concept of CSR. Section 3 discusses some of the principal mechanisms used to explain CSR, such as the feedback between supply and an "activ-

ist" demand which is sensitive to corporate social performance. Section 4 discusses the role that the quality of information on corporate governance, which is available to consumers, has in the CSR phenomenon. Section 5 examines the relationship between CSR and regulation. Section 6 shows other socially responsible strategies that are also compatible with profit maximization, and Section 7 presents conclusions.

2. The concept of Corporate Social Responsibility (CSR)

There are various definitions of Corporate Social Responsibility. The most widely used is the following one: the actions of a company are considered socially responsible if they are "voluntary" and contribute to increase social welfare.[2]

Therefore, two elements are crucial in determining whether the management of a company is socially responsible. First, a socially responsible company is concerned not only about the interests of shareholders but also about the stakeholders affected by the company's activities (employees, consumers, suppliers, society as a whole, etc.).

Second, in order to be considered socially responsible, actions must be voluntary and go beyond what is required by regulatory institutions on environment protection, workers rights, consumer protection, and the like.

Although these actions are generally costly for the company — as we have seen in the examples used in the introduction, and which we will analyze in detail in the following section — the dilemma between profit maximization and social welfare is false for certain socially responsible strategies. Companies can "do well by doing good" and can even search for their competitive advantage in socially responsible strategies.

Figure 1. The stakeholders of the company

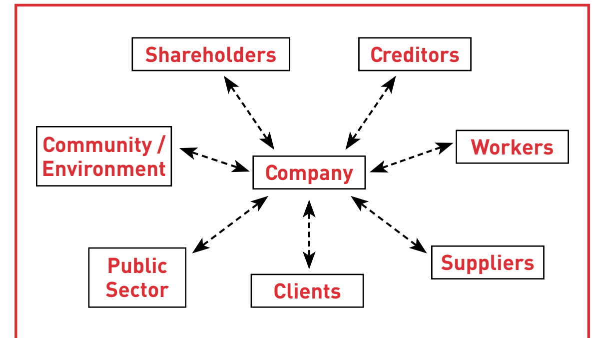

Figure 2 compares the profitability of a group of Dow Jones companies, that are considered socially responsible (the companies belong to the Dow Jones Sustainability Index DJSI), with the profitability of all the companies in the index (MSCI).

Although demonstrating the causality between CSR practices and higher profits is very complex, Figure 2 shows that there is no trade-off between the profitability of a company and its social behaviour.[3]

Baron (2001) gives a more restrictive definition of CSR and argues that to label a company as socially responsible, its behaviour and motivation must be considered. The "moral" criterion that Baron defends consists in that the only actions that should be labelled socially responsible must be those which reduce the value of the company, and may not be justifiable from a profit maximization perspective. This type of CSR may be important for firms with a concentrated ownership (e.g., family business) in which the shareholders prefer to undertake philanthropic actions through

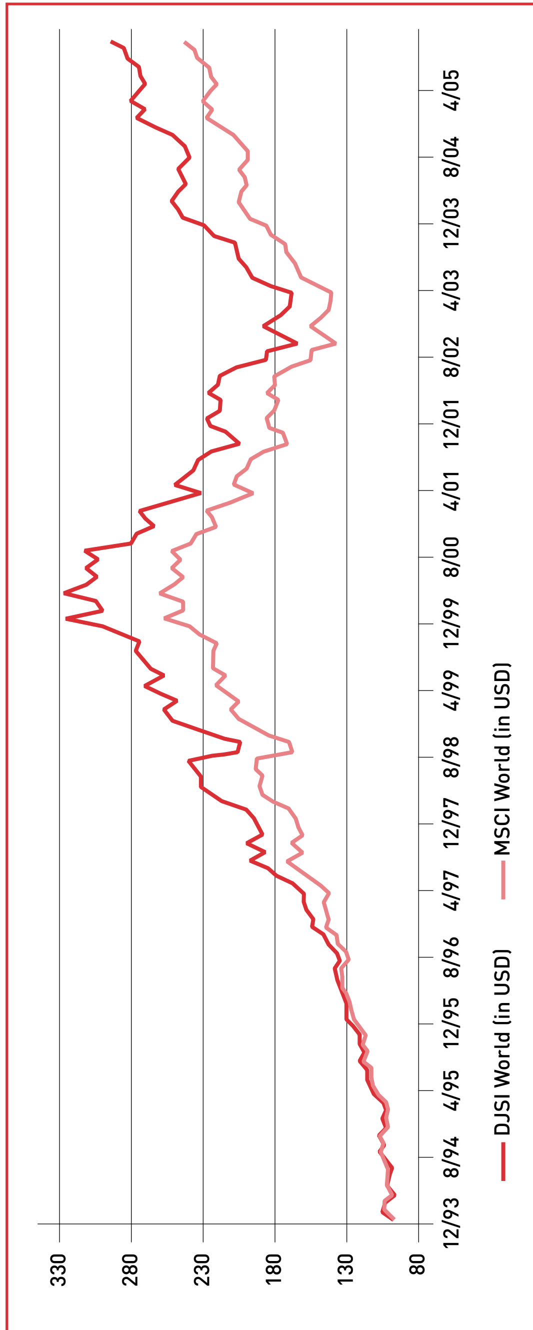

Figure 2. **The profitability of socially responsible companies**

the company, because, for example, the company is the most efficient one on a particular type of social action.[4]

We do not wish to enter the debate on the definition of CSR, in this *opuscle* we will focus on CSR practices that are compatible with profit maximization. There are two reasons for this: the first is that very few socially responsible practices would pass Baron's definition. As we shall see the majority of socially responsible actions that we observe have a potentially positive impact on profits. The second reason is that our main objective is to design public policies to promote CSR, and socially responsible practices that solely respond to intrinsic altruistic motives are by definition difficult to motivate through external incentives.

3. Market competition and CSR

The main reason why it is possible to reconcile profit maximization with socially responsible behaviour is very simple. It is because the demand is sensitive to the social behaviour of companies. Evidence indicates that one part of consumers not only considers product attributes and price in their purchasing decisions, but also the externalities generated by its consumption, and indirectly the company's social behaviour. These consumers, which we will denominate as "activists", are willing to pay more for electricity sourced from renewable energy, or are willing to renounce their favourite shoe brand if they receive information that the company that produces them uses child labour.[5] Given this composition of demand, companies develop socially responsible actions to increase sales or to avoid possible boycotts. We will present a model based on Ganuza and Calveras (2008) that shows this idea in a simple manner.[6]

3.1. A model of CSR

A monopolist can produce a product using two types of technology: clean technology and dirty technology. Producing with clean technology is more expensive than producing with dirty technology, $c_C > c_D$ where c_C and c_D are the costs of producing one unit of output with clean technology and dirty technology respectively. However, producing one unit with the dirty technology also involves an externality B, which falls on all of society. B may represent very different types of externalities: Environmental externalities generated during the production process (for example, air or water pollution, deforestation), or it could also represent the child labour used in the production process. Although the company minimizes costs with the dirty technology, the clean technology is socially more efficient (assuming the effect of the externality), $c_C > c_D + B$

In the market there is a continuum of consumers that can consume one unit of the good produced by the company. There are two types of consumers: a proportion α of activists (*A*) and a proportion 1-α of non-activists (*NA*). Traditional buyers, non-activists, simply worry about the value and price of the good — they will buy the good as long as the utility from consuming the good is greater than its price. Or said differently, their willingness to pay for the good is simply the value of the good. We can represent these preferences in a simple way:

$$u_{NA} = v - p,$$

where v is the value of one unit and p is the price of the good. The activist consumers discount the value from the good, that is the externality that the company has produced, and will only buy the good if the price is less than the value of the good minus the externality. Their preferences will therefore be

$$u_A = v - p - \delta B,$$

where δ=1 if the good is produced with dirty technology and δ=0 otherwise.[7]

It is important to discuss the difference between these two types of consumers. A traditional consumer is rational, in the sense that although affected by the externality, he knows that his individual decision to buy or not to buy the product will not affect the behaviour of the company and will therefore purchase the product if the benefit of consumption is higher than its price. The activist consumer is somewhat irrational: despite his individual decision not having any impact, he internalizes the externality caused by his consumption, and has a higher willingness to pay for the product produced using clean technology (alternatively, he would only be willing to pay for the value of the good minus the externality).

We also assume, for the sake of simplicity, that the value of the good exceeds the cost of producing it with clean technology, but does not exceed the social cost of producing it with dirty technology, $c_C > v > c_D + B$. This hypothesis ensures that activist consumers will not buy the good when it is produced with dirty technology. Next, we will analyze the decision of the company on the type of technology it adopts.

The monopolist therefore has two possible strategies. If it adopts the clean technology, it will sell to all consumers and in this case its benefits will be $\pi_C = v - c_C$. If the monopolist adopts the dirty technology, activist consumers will not purchase the good (they will boycott the product in unison) and the profits of the company will be $\pi_D = (1 - \alpha)(v - c_D)$. Therefore, producing with

clean technology is more expensive but it gives access to a larger amount of consumers.

Consequently, the company will always adopt clean technology as long as its profits are superior to producing with dirty technology:

$$\pi_C = v - c_C > \pi_D = (1 - \alpha)(v - c_D).$$

We can rewrite this condition, obtaining

$$\alpha > \frac{c_C - c_D}{v - c_D}$$

That is to say, the company will adopt clean technology only when there is a sufficiently large proportion of activist consumers in the market. This simple model shows that the presence of activist consumers (the fear of boycott) induces the company, whose main concern is profit maximization, to have a socially responsible behaviour.[8]

This model is very simple, but the mechanism is general. If the demand is sensitive to the social behaviour of companies, companies can make their product attractive by increasing its quality, reducing the price, or being more socially responsible (reducing, for example, the environmental externalities associated with production or increasing its cultural patronage). Competition amongst companies will take place in these three dimensions, meaning that the more sensitive demand is to corporate social behaviour (the more consumers internalize the externalities of the production process), the more efforts companies will make to reduce these externalities. It is important to note that companies can benefit from the corporate social responsibility phenomenon, because social responsibility can lead to a more differentiated market and thus a less competitive one. For example, in the banking sector where services such as mortgages and loans are homogeneous, the possibility of firms to do social work helps them to differentiate, and consequently may relax competition and have a positive effect on the entire industry.

In summary, companies provide socially responsible goods as a response to the demand of activist consumers who internalize the consequences of corporate behaviour in their purchasing decisions. An example of how this mechanism works is the gradual awareness amongst consumers on global warming, and how this awareness has led companies to try to reduce their emissions. Other examples like this are seen in DuPont, which has voluntarily reduced its greenhouse gas emissions by 65% since 1991 or PepsiCo which pays an additional amount to ensure that all electricity consumed comes from renewable sources.[9]

4. Information on company behaviour

This feedback between activist consumers and the socially responsible behaviour of the company depends on a key aspect: the information that consumers have on the social behaviour of the company. Even if consumers are willing to internalize the externalities that companies produce, they will only do so to the extent that information is made available. Companies for their part will not assume the costs of developing socially responsible strategies if they do not succeed in changing consumers' willingness to pay. Therefore, the asymmetry of information between businesses and consumers can eliminate the market for socially responsible goods. This problem is known in economics as the problem of adverse selection and occurs in markets where there are problems of asymmetric information (this will be explained in more detail later).

In addition, the market for socially responsible goods is particularly fragile because such goods are often *credence goods*. We say that a good is a credence good when its quality is not observable, and it is also difficult to measure after consumption. This is the case of most socially responsible goods where quality refers to the conditions under which the goods have been produced, or how the workers were treated in the production process.

Although the good is a credence good, consumers can obtain information from various actors: the media that informs us on companies activities, NGOs (associations of people affected by the activity of enterprises, associations defending the environment, human rights, etc.), companies that have an interest in publishing their social behaviour when it is considered "positive" or to clarify negative information about the company, private intermediaries (auditors and experts) that award labels when companies meet certain standards. All these sources provide consumers with information on the behaviour of the company. Nevertheless, this information is often incomplete or noisy, since some of the actors previously mentioned may have an incentive to provide biased information.

Let us try to analyze this situation by using the model from the previous section. Imagine that consumers cannot observe the technology the company used. Instead they observe a signal about it. We will assume that the signal can be positive (clean) or negative (dirty), $S \in \{S_C, S_D\}$. The signal has the following characteristics: if the company has used a clean technology, the signal will always be positive S_C. We assume that there is no interest to manipulate the information since the company is doing the correct thing.

The problem arises when the company has used a dirty technology: in this case consumers will receive the dirty signal, S_D, with γ probability, and the clean signal, S_C, with probability 1- γ. This probabilistic approach reflects the fact that, when the company uses the dirty technology, the information that reaches consumers might not be true: the company can invest in advertising and some media can convey positive information on the company due to their advertising interests. Therefore, if consumers observe the bad signal, S_D, they will know that the technology is dirty, but if they observe S_C they will not be sure about the type of technology used.

The parameter γ reflects the precision of the signal, the quality of the information that consumers receive. If γ=1, the information is perfect: by observing the signal consumers will be able to perfectly deduce which technology was used. If γ=0, the signal does not provide information, consumers always observe the clean signal and will not know which technology was used by the company.

Calveras and Ganuza (2010) show in a more general environment that, the more accurate the signal is, the more likely will be that companies use the clean technology. The intuition is simple: the greater γ is, the higher will be the consumers' willingness to pay for the good when they receive a good signal. In other words, when consumers know that the information is truthful, they react more to good news about the company. This increases the benefits of producing socially responsible goods with respect to benefits obtained by producing with a dirty technology.

An important conclusion for the public sector, which we can obtain from the previous result, is that an effective way to promote corporate social responsibility is to improve consumer information on the behaviour of firms. The public sector can, for example, regulate the provision of information

from the parties involved, by setting transparency rules on corporate behaviour and mechanisms to verify the information. In addition, the public sector can do an important job in selecting and disseminating the information. Although we are referring to information and externality as if they were one-dimensional phenomena, there are many dimensions in the social behaviour of firms. In addition, information is greatly scattered: businesses, for example, work in diverse areas — regional, national, European — and each one provides information. Plenty of measures are therefore available, which does not necessarily translate into better or additional information. Generating or selecting a limited number of indices that are based on reliable standards can improve the information consumers receive and, as a consequence, can increase the incentives for firms to adopt a socially responsible behaviour. The work of the public sector is complementary to the work done by private intermediaries, who can also play an important role in improving the available information on businesses.[10] There are independent associations that provide information on businesses, such as stock exchange indices for socially responsible companies (Dow Jones Sustainability Index, FTSE4Good) or standards for the provision of business information, such as the Global Reporting Index (GRI).

From the above analysis, we deduce that the quality of information is endogenous and that it depends on the actions of various actors. Calveras and Ganuza (2010) take this fact into consideration and demonstrate that the ability of companies to manipulate information has a negative effect on welfare. As mentioned earlier, the profits of a company implementing socially responsible strategies increase as consumers receive better information. The opposite can happen when the producing technology is dirty: in this case the company's profits decrease as the quality of the information increases. Due to this reason a company that does not adopt socially responsible strategies has an incentive to distort the information (introducing noise) that consumers receive. We can illustrate this in the following simple manner. Suppose that the probability that consumers will receive a clean signal comes from the ratio between good news and total news,

$$\frac{n_G}{n_G + n_B}$$

This is a simple way to illustrate that the agents, which we referred to earlier, give information about the company, and sometimes this information is positive and sometimes negative — the conclusion that ultimately stays with the consumer is given by the ratio between good and bad news.

For example, if the technology is clean, no agent will have an interest in sending out a negative message: all the news will be positive and the clean signal will be received with probability one. If on the contrary the technology is dirty, there will be a conflict of interests, and the company may try to offset the negative news through marketing or advertising, or indirectly through the media, which can be influenced by the possible loss of advertising revenue. In short, the company may adopt a strategy based on not bearing the costs of socially responsible strategies and invest resources in marketing, making more noise and reducing the precision of the signal γ.

Calveras and Ganuza (2010) show that this strategy reduces consumer welfare, but what is even more surprising is that it may also reduce the company's profits. It is possible that the company would be better off if it may commit to not manipulate information. It could be that a company would find it optimal to invest on socially responsible actions when the quality of information is high. Since consumers cannot easily distin-

guish between accurate and inaccurate information, the possibility of manipulating information simply reduces activism in the demand as well as the profits when adopting a socially responsible strategy, so the company waives it. In other words, companies can also benefit from regulations that promote more transparency. They can also solve the problem of lack of commitment by setting alliances with NGOs that will serve as a proof to consumers that information is not being manipulated.

5. CSR requires us to rethink the role of regulation

In the previous sections we have seen how, under determined conditions, CSR can prevent market failures — such as an environmental externality — associated with the production of goods, making regulation unnecessary. The regulation of companies has been the traditional instrument used to prevent market failure, but the emergence of the CSR phenomenon makes us reconsider its utility and redesign regulatory policies.

We can therefore ask ourselves: why not force companies, through regulation, to be socially responsible? What advantages, if any, does CSR or market self-regulation have over a formal public regulation? We will continue to discuss a series of ideas on the relationship of CSR and regulation, and then we will focus on Calveras, Ganuza and Llobet (2007), which is the first theoretical work of its kind that studies this issue.

- **Regulation and CSR are substitute instruments**. In the model developed in Section 2, competition in the market would lead to an inefficient solution, in the absence of regulation and CSR. Companies would opt for a technology with lower private costs but with higher social costs caused by environmental externalities. Regulation and CSR are substitutes because both can restore efficiency. We have seen that a sufficient number of activist consumers can provide companies with incentives to use clean technologies. Likewise, technological standards and pigouvian taxes, the two most common regulatory mechanisms, can implement an efficient solution. Technological standards simply prohibit the use of certain technologies, in our case the technology that generates higher environmental costs. Pigouvian taxes tax companies for the externalities they generate. Companies would therefore internalize all social costs and have incentives to use a clean technology. Although regulation and CSR are substitute instruments, in many contexts they can coexist. For example, it may be impractical to set a rigorous technology standard because it would imply a sharp increase in industry costs and possibly the disappearance of some companies. In this context CSR may be an option for the most efficient companies to diversify and create value. Finally, in the previous section, we saw that CSR can complement regulations that aim at improving information to consumers.

- **Advantages and disadvantages of CSR and regulation**. Regulation is costly: whether a standard is imposed or a tax is fixed, it is necessary to develop a system for inspections and penalties. CSR is a voluntary action that has no costs for the Administration, and can lead to a virtuous circle that benefits businesses, consumers and society in general. To implement an efficient solution, regulators must have access to considerable amounts of information on the costs of the company and its externalities. CSR works in a decentralized manner, and incorporates both business costs and the costs that externalities have on consumers into the

market equilibrium. However, the cost of the externality is only partially internalized: activist consumers are only a fraction of total consumers and, of course, are only a fraction of all those affected by the externality. We have also seen that CSR relies heavily on the fact that consumers have access to solid information about the company. Finally, regulation can be imposed independently from market structure and demand composition, but it has limitations. For example, it may not be effective on global public goods or on the actions taken, by the company or by its suppliers, in other countries. CSR can potentially have effects on all company decisions wherever they are taken. It can for example penalize the company for using child labour in India or causing deforestation in the Amazon. Its effectiveness, however, depends on factors which are often beyond the control of the Administration, such as the composition of demand, reason why it is not always an effective instrument.

Even though CSR and regulation are substitutes, they do have different characteristics and can coexist in the same market. CSR does not address all market failures, it depends on the composition of demand and therefore it is not observable in all markets. When it is effective, it is a way to increase social welfare with no cost to the public sector, reducing the need and therefore the costs of regulation.

However, Calveras et al., (2007) showed that CSR could lead to an excessive and inefficient reduction in regulation. The argument is very simple, and is based on the response of regulation to a political equilibrium that is affected by the existence of CSR.

Consider a market like the one described in Section 2, composed of more companies and in which an environmental externality exists. Furthermore, suppose that there were no activist consumers and therefore the virtuous circle of CSR is not produced. Consumers in their role as voters would agree to resolve the market failure through regulation, prohibiting dirty technology or imposing a tax equal to the externality it causes. Both instruments would achieve an efficient equilibrium. Consider that, in this market, a proportion of activist consumers emerges, and a proportion of companies begins to produce goods with clean technology. In other words the virtuous circle will partially appear. In this situation an inefficient equilibrium may be created in which the majority of consumers/voters are non-activists, and decide not to implement efficient regulations and to continue consuming cheap goods since the cost of not implementing the regulation diminishes because activist consumers will consume socially responsible goods.

In other words, CSR and self-regulation reduce the need of a formal regulation, and can avoid the implementation of regulations that would result in greater social welfare. In the real world the risk of eliminating efficient regulations is even more important, as in the argument we have made we have not taken into account the possible pressure that businesses may place on the public sector in order to reduce regulation. This is because businesses always prefer a self-regulatory environment to a formal regulation.

6. Other virtuous circles associated with CSR

Until now we have focused on the incentives for a socially responsible management, generated by an activist demand that is sensitive to business behaviours. In this section we will describe

other virtuous circles and other ways of making CSR compatible with profit maximization. Some of these virtuous circles respond to the same logic of feedback between activist demand and supply, but others originate from a different principle: the ability to establish a cooperative relationship with stakeholders (consumers, employees, suppliers, etc.). Cooperation with stakeholders is based on a repeated relationship with the company over time, and requires that the company is not short-sighted and has the objective of maximizing long-term profits.

6.1. Management of risks to boycott and lawsuits

We have put particular emphasis on how CSR incentives originate from consumers that reward socially responsible actions, but they may also come from reducing the risk of a negative response from consumers and NGOs. The risk is fundamentally associated to possible boycotts and legal demands against the company.

The boycotts that are normally promoted by non-governmental associations help to disseminate information about the company and coordinate the actions of activist consumers, making them more effective. They reduce the short-run demand of the company, but they can also erode the company's image and have an impact in the long run. For example, Nike suffered a boycott due to the poor working conditions of its overseas providers and Shell Oil suffered a boycott, promoted by Greenpeace, for its attempt to get rid of an oil rig that was no longer productive.

Legal demands are also another source of risk for a company. Tobacco companies have paid billions of dollars in legal settlements; Firestone has paid large sums of money for the Ford Explorer accidents caused by their tyres. A responsible management reduces the causes of claims, but it also improves the image of the company, reducing the likelihood of filing a claim due to an accident or to unexpected costs when using the product.

6.2. Improving financing: socially responsible investment funds

The cost of capital can be lower for socially responsible companies due to socially responsible investment funds. There are collective investment institutions and private investors that, in a similar way to activist consumers in their purchasing decisions, take into account the social behaviour of companies to make their investment decisions.

These "ethical" funds restrict their investments to those they consider Socially Responsible Investments (SRI), by not investing in certain markets (alcohol, tobacco, etc) and focusing on companies well positioned in CSR rakings. SRI approximately represents 10% of investment funds in the USA and its importance is increasing in Europe.[11]

6.3. Brand value

The brand of a product helps to identify and to differentiate the product itself. It is also used as a commitment to produce high quality goods when quality is not easily observable. For example, consumers can not assess at the time of purchase the reliability of a car or an electronic device, and therefore rely on the reputation of the brand. The mechanism behind this is based on a repeated relationship with consumers. If the relationship were static, consumers would not be able to observe the quality and therefore the company would minimize costs, affecting the quality of the product; consumers would anticipate this choice of the company and would not be willing to pay for the quality.

This is the problem of adverse selection by Akerlof (1970), which leads to the disappearance of high-quality markets. The fact that it becomes a repeated relationship (through the brand) makes consumers believe that the quality is high and makes them willing to pay for it. This is because producing with a low quality may negatively affect the sales of the company in the future. Somehow the brand encourages a cooperative relationship between businesses and consumers, and avoids the problem of adverse selection.[12]

This commitment to quality through the brand leads to socially responsible actions. For example, Volvo recently decided to change at no cost the radiators in one of its luxury models because one of its production batches had a deficiency. Contractually Volvo was not obliged to do this. Some of the cars did not have any anomaly and some of them will have it in the future when their guarantee expires. Thus, here it is clearly shown how this socially responsible behaviour by Volvo is geared towards safeguarding the brand's image and maintaining its commitment to high quality.

6.4. Relationship with the regulator

Formal regulation is costly, but we have seen how CSR reduces the need for regulation and can therefore become a way to avoid it. In an industry, companies can commit to voluntary codes of conduct to prevent the government from creating a formal regulation. For example, television stations recently established a code of conduct for television content to protect children, the government agreed not to introduce a formal regulation as long as companies complied with the code of conduct. Moreover, being a socially responsible company can also help in winning licenses and projects, since the public sector can introduce criteria for awards based on social welfare.

6.5. Cooperative behaviour with workers and talent retention

Improving labour conditions (higher wages relative to the industry, maternity leave, general training facilities, etc.) is a way to retain talent and to establish a cooperative relationship with the workforce which can lead to higher productivity. The relationship between the employee and the company has many conflicts of interest related to effort, training, cooperation with other workers, etc. Some of these conflicts can be resolved with incentives and mechanisms for promotion, but imperfectly because it is very difficult to measure productivity, especially when working in teams.

The fact that the relationship between the workers and the company is repeated helps to solve problems without resorting to high-cost controls. The idea is simple: a worker who perceives that he has better working conditions than those he could have in another company of the sector, has an incentive to behave cooperatively in order to preserve his long-term relationship with the company.[13]

6.6. Cooperative behaviour with suppliers

As with workers, there are many conflicts of interest with suppliers which are tackled through contracts. However, contracts are incomplete, and mutual distrust between the company and the supplier creates numerous inefficiencies. For example, suppliers waive investments to improve the efficiency of the transactions because they fear that the clients will renegotiate the contract to their benefit after the investment has been made. This problem, known in economic literature as the "hold-up" problem, can be solved as in previously discussed cases, by encouraging a cooperative behaviour with the provider based on their long term relationship.

This strategy has been a key factor for Mercadona to gain competitive advantage and to become the market leader in distribution chains in Spain. Mercadona bases its strategy on private label products, which traditionally have been seen as cheap and low quality products. Mercadona has developed private label products that compete in quality with those of established brands, even though their price is lower due to lower marketing costs.

The strategy is based on signing long term contracts with the suppliers of these products and building a reputation of abiding by these contracts. The aim is to generate a long-term cooperative relationship with the supplier that encourages the latter to invest, mainly in R&D, boosting the products competitiveness.

6.7. The double dividend: CSR minimizes social and private costs

This *opuscle* has focused on the traditional examples where the technology that minimizes firm's costs is not the one that also maximizes social welfare. On the other hand, in some cases and due to technological innovations and some regulations that impose pigouvian taxes (e.g., for polluting), the technology with lower private costs was also efficient from a social point of view.

For example, Du Pont argues that its program to reduce greenhouse gas emissions has produced important savings in energy. Opting for a socially responsible management can also help the company to develop skills and open new lines of business. Du Pont launched an internal waste management program that worked very well. The acquired experience allowed them to offer other companies a similar service for which it foresees to collect one billion dollars a year.

All these strategies show that the socially responsible management of companies is not inconsistent with the hypothesis of profit maximization. Companies should not view CSR as a threat, but rather as an opportunity to redesign their global strategy and their pursuit for a comparative advantage. In this sense, the two fundamental principles that we can obtain from the previous analysis is that a socially responsible company should primarily be based on first, the response to a demand that is increasingly sensitive to the social behaviour of the company; and second, investments in long-term cooperative relationships with stakeholders.

7. Conclusions

We have shown that the phenomenon of corporate social responsibility opens the possibility of creating virtuous circles where everyone wins. The company can maximize profits and gain a competitive advantage while increasing the welfare of stakeholders (consumers, employees, suppliers, etc.) and of society in general. Given this positive effect of CSR on society, it is important to consider the role that the public sector can play to promote the development of socially responsible management. From the analysis we obtain three important ideas:

1. **The public sector must be an activist consumer**. The basic mechanism that induces responsible corporate management is that part of the consumer demand is made up of activist consumers whose willingness to pay is affected by the social behaviour of the company. The public sector is a major consumer that can contribute to CSR by incorporating socially responsible management criteria in their procurement processes.

2. The public sector must guarantee "transparency" in the information that consumers receive on business management. For there to be feedback between business behaviour and activist consumers it is essential that the latter have access to reliable information on corporate governance. Companies will have incentives to manipulate the information that reaches consumers through media and advertising. The public sector can play an important role by promoting CSR by improving the information available to consumers: by creating indices, standards, or regulating the transparency and reliability of existing ones.

3. The public sector must rethink market regulation. The analysis shows that CSR is another way to solve market failures, an alternative to regulation. We have demonstrated that in some markets CSR and regulation are imperfect substitutes: one instrument can be more effective than the other but, because of their differences, both can optimally coexist in the same market. We have also noted that a risk exists that CSR will inefficiently replace some form of regulation.

Notes

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(1) Alan Greenspan has a more recent quote with the same message "By law, shareholders own our corporations and, ideally, corporate managers should be working on behalf of shareholders to allocate business resources to their optimum use".

(2) The Department of Commerce and Industry of the United Kingdom uses a similar definition for socially responsible actions: "The voluntary actions that business can take over and above compliance with minimum legal requirements, to address both its own competitive interests and those interests of the wider society."

(3) Obviously, an alternative explanation (to CSR being the one that increases the profitability of the company) would be that CSR is a "luxury good". That is, it could be that only the most profitable companies can afford to adopt CSR practices.

(4) Calveras, Ganuza and Llobet (2010) conducted an analysis on the role that philanthropy can play in providing public goods. See also Andreoni (2006), for a thorough review of the literature on philanthropy.

(5) There are many empirical papers that provide evidence for the existence of consumer activists, see for example Casadesus-Masanell et al., (2009), Elfenbein and McManus (2007) or Mohr, Webb and Harris (2001).

(6) Arora and Gangopadhyay (1995) were the first to formally develop this idea by using a standard model of vertical competition, where two companies produced goods of different quality (different levels of environmental-pollution externality) and consumers valued the quality differently.

(7) We use two extreme values, $\delta=1$ *and* $\delta=0$*, to simplify the presentation. However, we could rewrite the model taking into account that some consumers will partially internalize the externality* $0<\delta<1$*, and even that some will overstate the externality* $\delta>1$*. Calveras and Ganuza (2010) analyze a model with these characteristics that (in the case of perfect information) perfectly matches the model developed in this* opuscle.

(8) It is interesting to highlight that if we follow Baron's definition of CSR, we would only be able to talk about socially responsible business practices when there are few activists consumers.

(9) Data collected by Lyon and Maxwell (2007), who also provide numerous examples.

(10) Private intermediaries are very important in professional markets, such as doctors and lawyers. Professionals can also be considered trustworthy goods: immediately after seeing a lawyer or a doctor one can not fully assess the quality of the service they have provided. Wolinsky (1993), examines such markets and characterizes the equilibrium, highlighting the inefficiencies that the lack of information can generate. Taylor (1995) and Lizzeri (1999) show that the existence of informed intermediaries, that lessen the asymmetry in information between supply and demand, can increase the global surplus.

(11) The first collective investment funds that boycotted certain companies appeared in the 1950's. These "activist" funds had religious motivations (Quakers) and did not invest in so-called "sin values", or in companies with business related to alcohol, gambling and tobacco, see Calveras and Ganuza (2008) and Lafuente et al., (2003).

(12) The idea that a dynamic relationship with consumers gave the company incentives to avoid opportunism (producing in low quality), was formalized first by Klein and Leffler (1991).

(13) The argument is known in literature as relational contracts, see Baker, Gibbons and Murphy (1994) and Bull (1987), as well as the theory of efficiency wages, see Shapiro and Stiglitz (1984).

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