Business Ethics and Corporate Social Responsibility

*Can Corporate Social Responsibility survive in the market economy? If it does will it be efficient?*

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All mistakes and shortcomings are mine and mine alone.
Abstract

Business Ethics and Corporate Social Responsibility (CSR) are a subject of very great present interest. Business ethics is not a special set of ethics, it is normal ethics applied to business and business situations. CSR is a firm’s contribution to the society; it can be anything from helping the poor to reducing CO₂ emissions.

The questions I try to look closer to in this thesis are the following: If the cost of CSR exceeds the profit it generates to the firm, will CSR be able to survive in the market economy? If CSR survives, is it efficient to the society as a whole?

I start in chapter one by defining Business Ethics and CSR, and introducing the debate around CSR. Some economists like Friedman and Shleifer are sceptical to CSR. They argue that CSR is a cost to the firm and will make a firm less competitive. While others like Porter and Kramer argue that CSR can help increase the competitiveness of a firm and chosen right CSR increase the profit of the business. In chapter two I look at ethical pressure from NGOs, activists and the government in a competitive market and chose to elaborate one example of unethical behaviour: Child labour. Chapter three is my simple economic illustration, in the first part I assume that the ethical standard is absolute and in the second part I assume that it is variable. My simple model shows that when an ethical standard is imposed the companies that can not bear this cost will go bankrupt. Sometimes the society’s punishment is not equal to all firms and can be either smaller or bigger than the cost of implementing the ethical standard. In this case, the results may be socially inefficient because some firms will be able to survive despite that their income is inferior to the cost of ethics and others will not survive despite that their income is greater than the income of the ones surviving. The model also shows a correlation between high moral standard and productivity but this should not be misinterpreted. A moral standard is a cost to the firm, but the correlation is due to the fact that productive firms can bear higher ethical cost. The conclusion is presented in chapter four.
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1. Introduction

1.1 Business Ethics

The word Ethics comes from the Greek word Ethos that can be defined as: “The disposition, character, or fundamental values peculiar to a specific person, people, culture, or movement”. According to Oxford dictionary\(^1\), the word Ethics is defined as moral principles governing or influencing a person’s conduct. Ethics is the concept of right and wrong conduct that tells us if our behaviour is moral or immoral.

Business is the biggest and most dominant institution in today’s society all around the world. Business decisions have a strong impact on people such as employees, stockholders, consumers, etc… This confirms that business ethics is important to many people and influence many lives. But what is Business Ethics?

Business ethics is not a special set of ethical ideas different from ethics in general and applicable only to business. “Business Ethics is the application of general ethical ideas to business behaviour”\(^2\). Business ethics is for everyone, not only for managers. Every worker, just as every manager, will be faced with issues that will require ethical decision making. Since not everything is covered by the company’s rules and regulations or the law, the decision lies on the person’s values and principles. That means that the company’s ethical standard relies on the ethical standard of its employees. Usually what is defined as the ethics of a business is limited to the ethical standard and guidelines the company is trying to follow within its activities. In some cases, the companies blame the employees for unethical conduct, but in many of the

\(^1\) [http://www.askoxford.com/concise_oed/ethics?view=uk](http://www.askoxford.com/concise_oed/ethics?view=uk) (13.05.08)

\(^2\) Lawrence and Weber (2008)
cases the employees were encouraged to do so, in a direct or indirect way just like in the Siemens case.³

There is no standard definition for Business Ethics everyone agrees on. According to the business network Bnet internet site, it can be defined as “a system of moral principles applied in the commercial world. Business ethics provide guidelines for acceptable behavior by organizations in both their strategy formulation and day-to-day operations”. Bnet also argues the necessity of business ethics: “An ethical approach is becoming necessary both for corporate success and a positive corporate image. Following pressure from consumers for more ethical and responsible business practices, many organizations are choosing to make a public commitment to ethical business by formulating codes of conduct and operating principles. In doing so, they must translate into action the concepts of personal and corporate accountability, corporate giving, corporate governance, and whistleblowing”.⁴

In January 2006, 4 238 executives in 116 countries were asked the following question: Which of the following statements best describes the role that large corporations (public and privates) should play in society? 84% chose the first alternative: “Generate high returns to investors but balance with contributions to the broader public good”. 16% chose the second alternative: “Focus solely on providing the highest possible returns to investors while obeying all laws and regulations”.⁵

This result clearly illustrates that most executives are aware of the crucial impact of ethics on a corporation.

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³ In 2006, a huge investigation of Siemens in Germany was done. It showed that the company had placed around 426 millions euros in secret accounts outside Germany. This money was used for corruption to ensure Siemens contracts in foreign countries. Siemens had also in the end of 2007 to pay a fine for defrauding the Norwegian military through over billing.

⁴ [http://dictionary.bnet.com/definition/Business+Ethics.html](http://dictionary.bnet.com/definition/Business+Ethics.html) (13.05.08)

1.1 The importance of ethics

On behalf of The Economist, a global online survey titled Global Business Barometer was conducted in November-December 2007 by Economist Intelligence Unit. The 1122 persons, who responded to this survey, all expected corporate responsibility to have higher priority for their company in the future. We can safely say that CSR is here to stay.

Businesses today have many reasons to pay attention to the ethics of the firm and of the employees. The main reason remains that the law requires it in many countries. In 2002, the US congress passed the Sarbanes-Oxley Act to address the waves of corporate and accounting scandals. Section 406 requires the corporations to have a Code of Ethics that includes:

- Honest and ethical conduct
- Full, fair, accurate, timely and understandable disclosure in the periodic reports required to be filed by the issuer
- Compliance with applicable governmental rules and regulations.

In the UK, the pending legislation would require every publicly listed company to disclose ethical, social, and environmental risks in its annual report.

The Institute of Business, Technology and Ethics published in April 2002\textsuperscript{6} “Nine Good Reasons” to run a business ethically:

1. Litigation/indictment avoidance
2. Regulatory freedom
3. Public acceptance
4. Investor’s confidence
5. Supplier/partner trust
6. Employee’s performance

\textsuperscript{6} Ethix, no. 22 April 2002 p.11
Despite all those arguments, the list of businesses that have been involved with legal and ethical wrongdoing recently is long. After the collapse of the Enron Corporation in 2001 many other corporations followed. In the past years, there have been many scandals and boycotts due to unethical conduct. Some of the well-known firms were boycotted such as Nike, McDonald’s, Shell Oil, Gap, and Wall-Mart. This gave even the most sceptical business leaders a reason to pay attention to ethics.

1.2 Corporate Social Responsibility (CSR)

Business Ethics and CSR are a subject of very great present interest. Many newspapers and economic journals often have several pages consecrated to this topic. The Economist, for example, had a fourteen pages special report about Corporate Social Responsibility in their issue of the 19th of January 2008. There are also about sixteen academic books that have been published in the first five months of 2008 entitled Business Ethics or Corporate Social Responsibility. In addition to that, CSR is booming, in glossy reports, posters, screens… Anyhow the big companies want to tell the world about their good citizenship. Ethics and CSR are with no doubt a trendy topic.

CSR is actually a pretty fuzzy idea; it can be anything from helping the poor to saving the planet. The United Kingdom’s government defines CSR as: “the business contribution to our sustainable development goals. Essentially it is about how

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7  The University of Oslo library database (BIBSYS ask)
business takes account of its economic, social and environmental impacts in the way it operates – maximising the benefits and minimising the downsides”.

Daniel Franklin, the executive editor of The Economist, underlined in the special report on corporate social responsibility, that many companies allocated 1% of the pre-tax profits to worthy causes because giving something back to the community seemed a right thing to do. However nowadays, many feel that simply writing a check and straightforward cash donations is no longer enough since the shareholders, the clients and the employees expect better. The shareholders want to know that their money is being put to good use, and employees want to be actively involved in good works and feel proud of the things their firm is doing. The clients are also waiting for the “little extra” that differ a firm from the others. These reasons made CSR an important issue for many businesses and specially big businesses.

Corporate social responsibility means that a corporation should be held accountable for any of its actions that affect people, the communities, and the environment. Some companies and journals prefer to drop the social from CSR and call it only Corporate Responsibility. Others prefer Corporate Citizenship. “Building a sustainable business” is also a used term for it. The shortest version is Sustainability, and it has been defined in 1980s by Gro Harlem Brundtland as: “Meeting the needs of the present without compromising the ability of future generations to meet their own needs”. In this thesis, I will mostly use the abbreviation CSR.

Business Ethics and CSR are on the same page, but CSR goes further. You expect a firm that has a CSR goal and/or a program to already obey the law, and act “ethically”. CSR is an investment a firm can choose to take, to contribute positively to the development and the wellbeing of a society. Mirvis and Googins (2006) distinguish between five stages the firms typically pass through as they develop as

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8. http://www.csr.gov.uk/whatiscsr.shtml (14.03.08)
9. A Norwegian prime minister
10. In section 1.4, I argue that it is not always the case and that CSR can be “just ink on paper” or used for “commercial” purposes or “money burning”.

corporate citizens. The stages are: Elementary, Engaged, Innovative, Integrated and Transforming.

- At the elementary stage, citizenship is undeveloped. The firm obeys the law, but managers are uninterested in social issues. During this stage, CSR is still an unknown concept to the managers.

- At the second stage, the engaged stage, the firm becomes aware of the importance of the changing public expectations. Business Ethics finds its place on the company’s agenda.

- Once at the innovative stage, organizations may become aware that they lack the capacity to carry out new commitments. At this stage, most departments begin to coordinate and the firm starts reporting its efforts to shareholders. It is the stage where the company formulates their CSR or Code of Ethics and starts publishing it.

- As the firm moves to the fourth stage, it realises the need to build more coherent initiatives and start a kind of partnership with stakeholders. During this stage the CSR program is “adapted to the reality” and sometimes reformulated.

- At the highest stage, the transforming stage, the company has a visionary leader and is motivated by a higher sense of corporate purpose. It partners with organizations and individuals across business, industry, and national borders to address broad social problems and reach underserved markets. It is the optimal level of CSR.

CSR is more widespread in United Kingdom than in Continental Europe because firms and companies in the UK rely mostly on stockholders and not on banks to finance them. In Continental Europe, CSR is finding its place in the market less rapidly. However, it is difficult to distinguish between the companies being busy talking about CSR or acting by it. Even if CSR, as a concept, is more widespread in the UK, this does not mean that European companies in the continent are less ethical than in the UK. Below, I give some examples that illustrate the difference in presentation of CSR between Norwegian and English supermarkets.
If you visit some of Norway’s biggest firms’ internet site you can very often find a link on the front page to the pages where they present their CSR work. Coop AS has “Coop Norden Code of Conduct”. On the coffee house Friele’s internet site you can read about their “Samfunnsansvar”. Ica is focusing on helping Norwegians to eat healthier by making healthier alternatives more visible and cheaper in their stores. Kiwi’s slogan is cheaper fruits and vegetables to the people. While Rema1000’s slogan is only focusing on their price level: Only low prices.\footnote{Bare lave priser}

While CSR in Norway is more local, in the UK it is more global and drastic. Marks & Spencer (M&S), one of Britain’s leading retailers have a “Plan A, because there is no Plan B program”\footnote{http://plana.marksandspencer.com/?mnSBrand=core (12.06.08)}. Their ambitious plan includes goals for climate change, waste, sustainable raw materials, fair partner and health. In addition to the Plan A, M&S have five pillars; by 2012 they aim to 1) Become carbon neutral. 2) Send no waste to landfill. 3) Extend sustainable sourcing. 4) Help improve the lives of people in their supply chain. 5) Help customers and employees live a healthier lifestyle.

There has been a lot going on these past years when it comes to CSR in Norway but the publicity is not as impressive and straight forward as in the UK. Drastic slogans as the one Marks and Spencer is using, are not yet found in the Norwegian market.

The examples above clearly show that CSR can be anything and everything. It is almost impossible to compare CSR in different companies; when some focus on saving the planet while others on eating more fruit and vegetables. Out of the slogans and the explanations on the internet sites, we can conclude very little or nothing about the CSR’s impact on the economy and the society. It is also difficult to distinguish between CSR and own interest disguised as CSR. A good example is the commercial for healthy food.
1.3 Should firms pay attention to CSR?

The role of business in society has been discussed since Berle and Means wrote in the 1930s about the separation of ownership and control in large corporations. There has been a big debate about whether CSR is important and advantageous or not.

Milton Friedman (1970) argues that “The social responsibility of business is to increase profit”. His arguments are still used today by those who oppose CSR and strongly reject the idea that CSR is a responsibility of a business. The economist Andrei Shleifer agrees with Friedman on many things; he also argues that CSR is a cost to the firm, and that firms that introduce a CSR program will find themselves in a less competitive situation compared to other firms in the market. Being less competitive may cause the firms to get bankrupt. In their opinion, Business Ethics will not be able survive in today’s competitive market.

In his paper, “Does competition destroy ethical behaviour?” Shleifer (2004) also argues that unethical conduct is sometimes a consequence of market competition. In a competitive market, firms try to reduce their costs as much as possible and sometimes use unethical methods to do so.

The sceptical group to CSR argues that it imposes hidden costs that will be passed on to shareholders since the expenses of CSR are taken from the shareholder’s money. The managers are doing well on someone else’s expense. On the other hand, the partisans of CSR usually focus on big businesses and argue that these businesses should have responsibilities to go beyond profit maximisation and “towards a fair distribution of risks, losses and gains of corporate activity among stakeholders”\textsuperscript{13}.

According to “Friedman’s partisans” CSR lowers the economic efficiency of the business and its profits, since some of the business resources will be used for social purposes. The opposition group also adds that CSR imposes unequal costs among competitors, putting the social responsible firm at a competitive disadvantage. The

\textsuperscript{13} Mares (2008)
pro-CSR group explains how CSR improves business value and reputation. According to them, social reputation is often important and gives loyal consumers, helps to attract better employees, etc...

The first group explains how business people are not trained to solve social problems so CSR requires skills businesses may lack. While the fans, argue that being ethical helps retain and motivate employees. “People want to work at a company where they share the values and the ethos” said Mike Kelly. They also add that CSR corrects social problems caused by businesses. It balances corporate power with responsibility, it discourages government regulations, promotes long-term profits for business since consumers have preferences.

1.4 Strategy and society

Porter and Kramer (2007) won the McKinsey Award for their paper « Strategy and Society ». In the paper, they argue how CSR can be much more than a cost if corporations analyzed their prospects when it comes to CSR, using the same frameworks that guide their core business choices. According to the authors, most CSR investments are fragmented and not as productive as they could have been. The reason is that the focus is set on the tension between business and society rather than on their interdependence. They add that if the appropriate CSR to each firm’s strategy is chosen, CSR can become a source of opportunity, innovation and competitive advantage.

Companies are investing in CSR to get aggressive activists and media away from them, especially since companies are being held responsible for the damages they are causing. A good example for this is the fast-food and packaged food companies that are nowadays being held responsible for obesity and poor nutrition, something that

Mike Kelly is the head of CSR at the European arm of KPMG (an accounting firm).
was unthinkable ten years ago. Businesses are aware of the risks of being caught acting unethically, but they are less clear on what to do about them. Fragmented CSR and focusing on short-term solutions is costly. Porter and Kramer advice the companies to first look “inside-out” and map the social impact of the value chain, and second look “outside-in” at the social influences on competitiveness.

The authors of the paper try to get through a message to companies and economists; when looked at strategically, CSR can be used to promote the activity of the business, and can increase the profit. This message is clearly illustrated by the cases of DuPont and McDonalds. DuPont saved over $2 billion since 1990 from reductions in energy use\(^\text{15}\). While McDonalds reduced its solid waste with 30% by changing the material used to wrap its food\(^\text{16}\). These are typical examples showing how business decisions can be smart, increase the benefit of a firm and in addition have an environmental benefit. There is a clear “win-win situation”, both the society – in the examples more specifically the environment- and the companies won through introducing these new practices.

In the paper, Porter and Kramer give many examples of firms, that knew which CSR to choose to increase the firms benefit, are mentioned. One of the success examples is Nestlé’s milk districts in India. Integrating the company’s practice and the context was the key to success for Nestlé. Nestlé entered the Indian market in 1962 by building a dairy in the northern district of Moga. The farmers were extremely poor in the area, many kept one buffalo cow that produced just enough for their own consumption. The percentage of newborn calves that died was as high as sixty percent. Farmers lacked refrigeration and transportation. To be able to make business in that area, Nestlé had to invest in facilities that also benefited the poor farmers. In each town, they built refrigerated dairies as collection points for the milk. Trucks accompanied with veterinarians, nutritionists, agronomists and quality assurance experts collected the milk from the dairies. Nestlé also held monthly training sessions

\(^{15}\) Porter and Kramer (2006)

\(^{16}\) Porter and Kramer (2006)
for the local farmers and provided them medicines and nutritional supplements for sick animals. Farmers learned all they needed to know about how to get the best milk quality, they were also able to produce more and their standard of living rose. The authors conclude with: “Nestlé commitment to work with small farmers is central to its strategy. It enables the company to obtain a stable supply of high quality commodities without paying middlemen”. Nestlé has prospered, so has the community in Moga.

As Nestlé’s example shows, the interdependence of a company and society gives a company that chooses a particular CSR agenda to be able to produce maximum social benefits as well as gains for the business. This CSR agenda usually only include one or just few social initiatives that are directly linked to the activities of the firm. “Effective CSR requires an understanding of the social dimensions of the company’s competitive context”\textsuperscript{17}.

Porter and Kramer stress the idea of how important it is for business to focus on one thing or few things, since no one can solve all the planet’s problems, and no business can afford it either. A company should choose the thing that intersects with its particular business. They wrote: “The essential test that should guide CSR is not whether a cause is worthy but whether it presents an opportunity to create shared value that is, a meaningful benefit for society that is also valuable to the business”. This illustrates how the activity of the company should be linked to the CSR case they choose to concentrate on.

Another example of success in doing that is Toyota. Toyota was able to get a competitive advantage on other cars by creation the hybrid engines for its vehicle Prius. This car was at the same time consuming half as much gas as a normal car and emitting only 10% of the harmful pollutants.

The authors’ message to firms and companies is to create a social dimension to the value proposition, and not try to look from what the media can harm them when it

\textsuperscript{17} Porter and Kramer (2007)
finds. They conclude: “Efforts to find shared value in operating practices and in the social dimensions of competitive context have the potential not only to foster economic and social development but to change the way companies and society think about one another”. They challenge and ask the NGOs, the governments and the companies to start thinking in terms of “corporate social integration” instead of “corporate social responsibility”.

If CSR pays back; meaning if a CSR decision or action actually increases the profit of the firm or at least compensates for the expenses of the decision or action in question, can we still call it CSR? Or would it only be pure business self-interest? This issue is discussed and many good arguments for both yes and no answers are found. Unfortunately due to lack of time, I do not have the opportunity to go in details into this point.

1.5 CSR: a commercial, just ink on paper or signalling method (money burning)?

A commercial

The glossy CSR reports published by companies give the impression that CSR is just for commercial purposes. Big companies are also pushing out the message on their websites, on big electronic screens, on posters and in advertising campaigns. With no doubt, CSR is being used as a commercial.

Reputation is used by many companies to justify CSR initiatives on the grounds. Companies are ranked on the performance of their corporate social responsibility, by Myriad organizations.\(^\text{18}\) The methodologies used for these ranking are questionable, but despite that they attract considerable publicity and attention. The winners in the

\(^{18}\) Myriad International Inc., based in Toronto, Canada, provides executive and professional search and organizational development.
ranking expect the publicity to improve the company’s image, strengthen its brand, enliven morale, and even raise the value of its stock.

**Ink on paper**

The notion of sustainability can sometimes become vague to the extent of becoming meaningless. In a CSR agenda of a firm: “*transparency may be said to be more sustainable than corruption and good employment practices are more “sustainable” than sweatshop*”\(^{19}\), words are being defined very widely and used to help the companies purposes and image. We get sometimes the impression that CSR is only ink on paper and fancy formulations.

There is also a difference between what companies publish on their CSR pages, in their own magazines, in their commercials and the reality. A good example of that is Wal-Mart, the world’s largest retailer\(^ {20}\).

Wal-Mart’s annual revenue represents “*a sum greater than the economies of all but 30 of the world’s nations*”\(^ {21}\) and is growing fast. On the internet site of this successful and influential company, we can read about their “sustainability 360”\(^ {22}\) program and how they take the environmental problem very seriously. We also find information about their Ethical Standards team\(^ {23}\) of more than 200 associates, who is monitoring factories, educating suppliers and buyers, and works with others in the industry to implement effective ethical sourcing programs.

The movie “Wal-Mart: The high cost of low prices” was realised in the US in November 2005. It shows that the reality is the opposite of what is written on the

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20 Wal-Mart is three time the size of the No.2 retailer, France’s Carrefour.
22 [http://walmartstores.com/Sustainability/](http://walmartstores.com/Sustainability/) (16.06.08)
23 [http://walmartstores.com/Sustainability/7785.aspx](http://walmartstores.com/Sustainability/7785.aspx) (16.06.08)
Statement of ethics of Wal-Mart. This statement was revised in January 2005 and can be found on the retailer’s website\textsuperscript{24}. The first thing we can read in this Statement of Ethics is the “Three basic Beliefs” and the first of them is: Respect of the individual.

In the movie, many former and current employees talk about how they were and are discriminated in Wal-Mart, especially women. They also explain how they were forced to work overtime not to lose their jobs, and they never got paid for these extra hours. The movie also shows that many of the full time workers at Wal-Mart were forced to ask for governmental assistance, because their salaries were too low\textsuperscript{25}. The movie makers estimates that Wal-Mart costs taxpayers in the US $1,557,000,000 to support its employees. Generally, the movie is presenting the opposite picture the TV commercials of Wal-Mart present.

**Money Burning (signalling method)**

Companies in the United Kingdom rely mostly on shareholders to finance their investments, while in Continental Europe they rely on banks. The fact that CSR is more widespread in the United Kingdom than in Continental Europe does of course not mean that shareholders are more “ethical” than the rest of the people in the society. This makes us wonder if a CSR program is a sign of quality. Is it how high quality firms distinguish themselves from the rest? Said differently: Is CSR used for money burning?

To illustrate my point, I assume that there are two kinds of firms in the market: high quality firms although economically strong firms and low quality firms (weak firms). The investors can at first not distinguish between the two. I also assume that the CSR investment costs C. The low quality firm cannot afford to invest C, and this is known by the shareholders. The high quality firm will invest since it will be able to sell its

\textsuperscript{24} \url{http://walmartstores.com/media/resources/r_2032.pdf} (16.06.08)

\textsuperscript{25} Average Wal-Mart salary for a year is $13,861
shares for a higher price once the shareholders are aware of its high quality. To distinguish themselves from low quality firms, the high quality firms signal their quality by having a CSR investment. The signal distinguish between the two types since only the high quality firm can afford to “burn money” for CSR, and this is known by the shareholders.

CSR programs may be used as a signalling element. Shareholders try to distinguish between the different firms to find out in which one they should invest. A firm or a company that has a developed CSR program is believed to be a profitable one and the one without a less profitable one. Without money burning, the shareholders will not be able to distinguish between the two firms so high quality firm will be undervalued and the low quality firm will be overvalued.
2. CSR in a competitive market

Shleifer (2004) argues that competition in a market can prevent firms from being ethical, since ethics cost and the firm will find itself in less competitive position. Other economists argue that “Ethics pay”, it enhances business performance since being ethical makes others trust the business more. They also argue that it usually promotes positive alliances among business partners. Having a CSR program is a cost to the firm. If the costs of CSR exceed the gains from introducing it, will CSR survive in a competitive market?

I assume that the firms are profit maximizing. What I would like to find out is if ethical decisions will be chosen when they imply a net cost to the firm, but a net benefit for the society. When there is a “win-win situation”, meaning that the decision is profitable for both the firm and the society, we expect the “ethical” decision to be chosen for sure, since it is also the profit maximizing decision. The interesting situation is if this “ethical” decision will be chosen when it costs more than what it generates to the business.

If the business choose another alternative than the profit maximizing one there should than be other costs and/or benefits that counts for the owners. This cost/benefit can be for example the owner or the manager own moral cost when acting unethically, eventual joy/happiness an ethical act procure or a pressure the business is feeling from outside. When such a pressure exists, the business may risk a punishment when acting unethically, the punishment can be bad publicity, a boycott, etc....

2.1 Ethical pressure

Many companies are feeling the pressure to be ethical from consumers, shareholders and especially from NGOs. In response to that, the firms may protect themselves, by
putting several middlemen between the producing factory and their company. This is the case for some shoe-labels such as Nike and Puma. Instead of owning the producing firm in the developing country themselves, big shoe labels are buying their shoes from “brokers” who buy the shoes from the fabrics in China, India and other developing countries. Doing it this way, companies minimize the risk of bad publicity if the media tries to blame them for the bad working conditions or the extremely low wages the employees are getting in these fabrics.

Other companies choose to take ethics into consideration. They make a Code of Ethics that they follow themselves and ask all the firms that produce items for them to follow. Ikea, the well known Swedish furnishings retailer, did that and also engaged agents to control if these codes are being followed in each factory. Unfortunately, this proved to be insufficient. Le Monde Diplomatique published an article titled “Low prices, high social costs. Secret hidden behind Ikea’s wardrobes”\(^\text{26}\). The authors of the article, the journalists Olivier Bailly, Jean-Marc Caudron and Denis Lambert, tell the story about Shiva and Manjula, two women, working in a fabric producing products for Ikea near Karur in India. The women describe their lives and tell how little they are paid in the fabric. They earn between thirty and forty euros a month, working six days a week. The fabric is not following the IWAY\(^\text{27}\) – Ikea Way on Purchasing Home Furnishing Products- especially when it comes to paying the overtime. IWAY is Ikea’s code of conduct that defines what suppliers can expect from Ikea and specifies what Ikea requires from its suppliers. Few agents have the responsibility to check if IWAY is followed and the control is done approximately once a year in each fabric. The agents can only afford to spend one to maximum two days on each fabric. There are ninety different things to check, so to be able to go through everything in so little time, the agents can afford ten minutes on every point. To get all the answers they need, the agents go to the manager of the firm, to the firm’s documents or they ask the employees while on duty. The conditions under which these controls are done


\(^{27}\) [http://www.ikea-group.ikea.com/repository/documents/1293.pdf](http://www.ikea-group.ikea.com/repository/documents/1293.pdf) (12.06.08)
and the information the two workers gave made the authors of the article doubt the sincerity of the results.

2.2 Child Labour

Child labour reduces production costs even taking into account that children are less productive than adults. According to Shleifer, in developing countries, where child labour is not forbidden by the law, the competitive firm will feel obliged to hire children to be as competitive as the other firms that already are benefiting from the cost reduction child labour offers.

There is another recent paper about child labour titled “Are Fair trade labels effective against child labour?” written by Baland and Duprez (2007). The authors investigate the conditions under which labels can be effective against this “unethical conduct”. Baland and Duprez doubt that the child free labels (like Care&Fair, Pro-Child institute, Step, etc...) have an impact on the working conditions in the south. They show how labelling can be ineffective under some conditions; like when adult labour can replace child labour in the exporting industry while the children take over in the local industry. This generates only a displacement effect.

In their model, Baland and Duprez assume that there are only 2 countries in the economy North N and South S where there are L identical households. In each country, the L identical households are made up of one parent and one child. Every person has just one unit of time. In country N, children do not work and spend all their time on leisure, while in the country S households have to choose how much time a child works and how much time he spends on leisure. S exports goods produced with child labour to N’s consumers, who prefer goods produced without any child labour.
The authors of the paper, found out that when the label is accessible to all qualifying households in S, and the demand for the labelled good is not too large, the label will not create a price differential between labelled and unlabelled products. It only results in a displacement effect, whereby adults replace children in the export sector, while children take over in the domestic sector. In this case, the price of the product rises only if the presence of the label, increases at the initial prices the demand for products by the households in N, and falls otherwise. The label will be able to increase the welfare in the South if and only if, at the initial prices, the demand from the Northern consumers increases with the label.

If the label is restricted to few Southern households and the demand for labelled goods is large, the two types of products are available in N, and labelled products enjoy a price premium compared to unlabelled products as so to make Northern consumers indifferent between the two. In this case, the welfare of labelled households in S rises while the welfare of unlabelled households may fall provided the price elasticity of the demand for the product is in the North.

After a study of the impact of a “Child free labour” label, Baland and Duprez distinguished between two situations, in the one where label is unrestricted; the demand for labelled goods in the North is small, so there is enough adult labour in the south to produce the amounts required. The label causes a displacement effect. In this case, the label is unable to create a price differential between labelled and unlabelled production, as otherwise adult workers would produce highest priced good. The label will increase the welfare in the South if and only if at initial prices the demand from Northern consumers increases with the label.

While when the label is restricted and demand in the North for labelled products exceed the production possibilities of the South, in this case, the labelled export producers enjoy a higher real income with the label, while the rest of the producers in the South suffer from the creation of the label.
Baland and Duprez conclude with: “The impact on child labour is in general ambiguous, as the reaction of child labour to higher or lower adult and children wages depends on the strength of income and substitution effects.”

In his paper, Shleifer (2004) argues that reducing child labour needs a strong public opinion that turns against firms using this practice. According to him, what is needed is people who are willing to pay more for products made by adults, so the firms that do not hire children will be able to charge higher prices. Concerning this point, the paper of Baland and Duprez give us clear results; for the “child free labour” to increase the welfare in the south, in addition to higher willingness to pay for the “ethical” product, the label should be restricted and not available to everyone. In my opinion, information to the consumers is also very important; I will discuss this point in 2.3. In his arguments, Shleifer does not take the displacement effect into consideration. Baland and Duprez showed how even if all imported goods are adult-made, this does not imply that the children are not working producing the domestic consumed goods.

Taking in consideration the assumptions in the paper of Baland and Duprez, we can expect that when the parents in South earn enough for both members of the household, children may be able to spend the unit of time they have on leisure instead of work. They will actually have the choice to do so. When the income of the adult in the South increases to the point where the income of the child is no longer needed, we can imagine that the child labour decreases and in the long run almost disappears.

### 2.3 Information problem

The information problem is not taken into account in any of the two papers I refer to. In most economic models, we assume that consumers are rational and well informed. However, these assumptions do not always hold. Not all consumers are rational. They may for example be fooled by clever marketing. Consumers will also rarely be well
informed in today’s society. A standard consumer will never take the time to find out what all different stores and companies have to offer each time he needs to purchase a good.

In Norway, we hear and read about ethics and CSR frequently. Like in the speech of the governor of the Norwegian Bank (Norges Bank), during the conference “Investing for the future”, he said: “…there should indeed be barriers against certain acts and investments, no matter how profitable, basically because ethical behaviour is a goal in itself”\(^{28}\).

There are few data to be found in Norway when it comes to the firm’s CSR investments. A study, accomplished by Opinion in 2002 for Kaffehuset Friele AS, showed that 84% of the Norwegians are willing to pay 2-3 kroners more for their 250g pack of coffee knowing that the money went to the farmers to assure them a minimum income that give them safer social conditions. Only 9% answered No to the same question and 7% answered Maybe\(^{29}\). The brand manager retail at Kaffehuset Friele was very helpful and gave me the quantities in kilos of coffee they totally sold in 2007 and the quantity of Fair Trade coffee sold. The Fair Trade coffee represented less than 2.5% of the total amount of coffee sold by this important Norwegian coffee house. To have a clearer image of the market I also asked few of the grocery stores brands in Norway how much fair trade coffee they sold. The answers were; under 3% of the total sale of coffee. The numbers of Fair Trade bananas were not more impressive.

This was surprising, given the result of the study made in 2002. It is after all the same consumers that are mentioned. Is it easier to say that you are willing to pay those few kroners than to do it? Or is it only an information problem? Do Norwegians know that Fair Trade products exist in their supermarkets? Do they know what the label

\(^{28}\) The title of the speech is « Ethics and government pension fund » Oslo, 16th of January 2008.

\(^{29}\) See Appendix A
mean if they see it on a product? Some of these questions are answered by the report made by Zapera in 2008.

Zapera did a Health and Food Nordic Report in Sweden, Denmark, Norway and Finland in 2008. One of objectives of the study was to measure how different kinds of labels and expressions on food packaging affect the Nordic people’s interest in consuming the product. Question nr 5 was: *Do you normally look for the following symbols when you are shopping?* 52% of the Norwegians answered **Never** when looking at the Fairtrade symbol. (48% of the Swedish, 38% of the Danish and only 28% of the Finish also answered Never). Only 6% of Norwegians answered **Often** to this same question and 3% answered **Always**. The Norwegians percentage never looking at other symbols like; EU ecologically farmed, KRAV and Ømærket (økologisk) was highest among the Nordic countries.

Question nr 6 clarifies the information problem I mentioned earlier. The question is: *How familiar are you with the following symbols?* 45% of the Norwegians were **Not familiar** with the Fairtrade symbol and 7% **Recognise it but do not know what the symbol means**. The Norwegian results were significantly lower than other Nordic countries. The answers of this question also show that Norwegians had the least knowledge about the different symbols and their meaning.

In the report’s summary one can read: “*Compared to other countries, Norway have the least knowledge about the different food symbols. Regarding the environment, Norway agree the least with the statement that the choice of food-stuffs affects the environment.*”

There is an evident lack of information problem when it comes to Norwegians knowledge about “ethical” products. The majority does not recognise the symbols or they do not know what they stand for. In a situation like this one, it is difficult to expect the demand of “ethical” products to increase and to expect the public opinion to react strongly when unethical behaviour occur.
3. Economic model

3.1 Absolute ethical standard

What happens when an ethical standard is absolute in a market? I will illustrate a market with five firms to try to answer this question.

Let us denote the profit $\pi$, where $\pi$ varies between the firms. $s$ is the cost of acting ethically. I assume that the cost $s$ is the same for all five firms in this economy. $m$ is the “punishment” a firm gets if caught not following this ethical standard. $m$ is also interpreted as the expected moral cost. This moral cost can be for example negative publicity or a consumer boycott. $m$ can also be “moral discomfort” for the owners, but this will be less important if there are many small shareholders who can sell their shares, in case they feel uncomfortable with the actions of the firm. I also assume that $m$ varies exogenously between the firms.

Each firm produces one unit and has a cost $c$. The unit is sold for a price $p$. Without any ethical or moral cost the income of a firm is equal to $p-c$. Once the ethical standard is introduced in the market, the profit can be written as $\pi = p-c - \min(m,s)$. The firm will survive if this profit is non negative.

The social optimal is when the firm survives if and only if $p-c-s \geq 0$. The income of the firm should be superior to the cost of ethics.

If the punishment faced by a firm is bigger than the ethical cost ($m > s$), the firm will survive if and only if it is socially optimal.

On the other hand, if the punishment the firm faces when acting unethically is lower than the ethical cost ($m < s$), the firm can survive even if $p-c-s < 0$. This means that its survival will be socially unprofitable. We assume although that the socially optimal is when the firm is ethical and pays $s$. 
When $m$ varies between the firms, the actual ranking of the firms will follow the costs $(c+m)$ and this ranking is different from the social cost ranking $(c+s)$. The firms with low $m$ will have a cost benefit. That’s why some firms that optimally should not survive will be able to survive and some others that are more productive will not be able to do so.

The model illustrates a problem with the shareholders approach to CSR. When all firms are confronted with the same expected ethical punishment $m$ when acting unethically, the social optimum and the actual ranking by cost will be the same. Since $m=s$ we will have $(c+s) = (c+m)$.

Activists usually target the most visible or successful companies merely to draw attention to an issue, even if those corporations actually have had little impact on the problem at hand. It is reasonable for the activists to concentrate their efforts towards the companies where the “campaigns” gets most attention. “Target companies” as they are called are the big known labels as McDonalds, Nike, H&M. Their $m$ is expected to be higher than for smaller less known companies.

![Figure 1](image-url)
As the simple figure above shows; firm 1 and 2 will not be able to survive if a standard of ethics is expected and $m$ is the same for all firms. Firm’s 1 and 2 profit will be lower than the cost of the standard $s$. While firms 3, 4 and 5 will still produce as before because they can afford this ethical cost.

When the punishment $m$ varies exogenously between the firms, the socially most efficient firms may not be the ones that survive. Firm 2 can have $m > s$ and not survive. While the less productive firm 1 can have $m < s$ and survive since this firm will not take $s$ into account. When the public opinion punishes the companies differently for the same ethical violation, the survival of the firms will not depend on their social productivity. This is economically inefficient.

If $m$ is interpreted as the manager/owner own moral standard, the firm that will survive the easiest is the less ethical one. The ethics and efficiency will be mismatched. For the firm to be efficient and competitive, the manager will feel obliged to have a low moral standard.

### 3.2 Variable ethical standard

When the ethical standard is not absolute but variable, the situation differs. In this case too, I assume that the firms are profit maximising. Their profit function can be written as:

$$\pi = p-c - \theta b(e) - \beta m(e)$$

where $e$ is ethical effort.

$e^*$ is the optimal ethical effort that maximize the profit.

$\theta b(e)$ is the cost of ethical effort $e$.

$\theta$ and $\beta$ are parameters.
The firm will want to maximize the profit function:

$$\max \pi = p - c - \theta b(e) - \beta m(e)$$

The first order conditions of this maximizing problem are:

$$\frac{d\pi}{de} = 0 \iff \alpha' e^*(e) = -\beta m'(e) \iff e^* = e\left(\frac{\beta}{\theta}\right)$$

where $e^*$ is increasing in $\beta/\theta$.

By differentiating the maximized profit with respect to $\beta$ and $\theta$ we get

$$\frac{d\pi}{d\beta} = -m(e^*)$$

and

$$\frac{d\pi}{d\theta} = -c(e^*)$$.

Hence, the maximized profit is decreasing in both $\beta$ and $\theta$.

Let $a$ be the productivity of the firm, i.e. the production per unit of the production factor, for example labour. If $w$ is the unit cost of labour, the relation between $e$ and $a$ is $c = w/a$.

Figure 2
The vertical axe in figure 2 represent the productivity $a$ of the firm. The horizontal axe is the firm’s moral $\beta$. The increasing curve shows the combinations of $\beta$ and $a$, that yields zero profit, hereafter this diagonal line is called the survival-curve. Only firms with combinations of $\beta$ and $a$ above the curve will survive in the market.

The following interpretation can be taken from figure 2: The higher the firm’s productivity, the higher moral cost it can bear. The higher $a$ is, the higher $\beta$ can be without that the firm go bankrupt. Or the opposite, the firm with low productivity needs low moral to be able to survive.

Another interpretation can take into account the impact of the exogenous factors that decide how easy it is for the firm to be judged in the market. Those exogenous factors are the public opinion, activists, the government etc... We can expect these exogenous factors to be powerful in wealthy economies and less powerful in poor economies. With a powerful government, activists and public opinion the judgment an “unethical” company risks is severe. With less powerful exogenous factors the judgment is expected to be gentler and the chance of being judged is also expected to be lower. By judgment, I mean a punishment the company has to undertake. This punishment imposes costs like bad publicity in the press, a case in court, a boycott etc... Taking these exogenous factors into account the situation will be different in different countries.

If we compare the average ethical standard among firms with high productivity $a_H$ and low productivity $a_L$ we get the following:
The grey area of the graph illustrates as in figure 2 the combinations of $a$ and $\beta$ where the firm is able to survive. From the graph we can see that for a given $\beta$ on the horizontal axe we can draw a line up to diagonal line and further to the vertical $a$-axe that will tell us which $a$ correspond to the given $\beta$. If the $a$ is in the grey area the firm will survive if it is under the grey area the firm will go bankrupt.

From figure 3 we can see that the average ethical standard is higher among the high productive firms. We notice that there is higher productivity, on average, among those with high ethical standard compared to those with low ethical standard. This can be misinterpreted as if acting ethically is profitable. According to our model it is not the explanation of this correlation, but contrary, it is because it costs and does NOT pay to act ethically that only those with high productivity can afford a high ethical standard. The selection in the market gives this positive correlation between the productivity and a high ethical standard.
3.3 Conclusion of the model

When a market introduces an absolute ethical standard, the simple model I used showed that some firms will go bankrupt since they can not afford the ethical cost. The social optimal is when the firm pays the ethical cost. The firms that have a profit lower than this cost should optimally not survive. In the economy, the punishment may differ from a firm to another. When the expected punishment of a given firm is higher than the ethical cost, the firm will invest in ethics, if it can afford to do so, and will survive. This is the social optimum. In the case where the punishment a firm faces is lower than the cost of ethics, the firm in question will not take the cost of ethics into account, and will survive despite the fact that its profit may be lower than the cost of ethics. This is not socially optimal. The ranking of the firms will not follow the productivity anymore and this result with the survival of socially unprofitable firms.

The simple illustration also shows unwanted consequences of campaigns against “target companies”. These companies are usually big known labels and their expected punishment is higher than the punishment of other less known companies. The activists and the media are more interested in this kind of companies to draw most attention to the issue in question (an example can be child labour).

A market can also introduce a variable ethical standard. In this case, the firms will try to maximise their profit taking into account both the cost of ethical effort and the firm’s moral. The first order condition of this maximization problem shows that the optimal ethical effort that maximizes the profit is decreasing in both parameters $\beta$ and $\theta$. The results show that a firm with low productivity needs low moral to be able to survive while the firm with high productivity can bear a high moral cost.

The model’s result can be misinterpreted, since it shows a positive correlation between productivity and high ethical standard. It looks like the firm with high ethical standard enjoys high productivity. According to the model, it does not pay to be ethical since ethics cost, but it is just those with high productivity that can bear a high
ethical standard. The positive correlation between productivity and the high ethical standard is only due to the selection in the market.
4. Conclusion

The aim of this thesis is to try to find out if Ethics and Corporate Social Responsibility (CSR) can survive in the market economy and if they do if it will be efficient.

Acting ethically is not always efficient for a firm or a company. Ethical behaviour and efficiency go together in the case where ethics promote Social Corporation but the relation between ethics and efficiency is a complex relation. In some situations, there is a clear mismatch between the two. Sometimes this mismatch is there because the idealized ethical behaviour makes matters worse in the real world or because the ethics are no longer up to date. By that I mean that an ethical standard that have had efficiency justifications long time ago no longer does. Child labour fits this mismatch perfectly. In some countries where the children have a bad access or no access at all to education, for many families the consequences of not sending their children to work is too little food on the table.

Shleifer (2004) argues that a strong public opinion and a higher willingness to pay for adult-made products will solve the problem of child labour. Baland and Duprez (2007) showed that Shleifer may be wrong since a displacement effect may occur in the economy, where all adult workforces take over in the exporting industry and children produce only locally consumed goods. Labelling alone is although not sufficient to fight child labour.

Shleifer also argues that when the competition is less keen, moral persuasion is likely to work by convincing firms not to hire children. Logically, the richer the competitor the more it would pay to be ethical. The picture is unfortunately not all white because when competitors have no rents, moral suasion can rarely stand up to the forces of competition. In most cases today, moral suasion is yet not able to stop the pressures of competition.
Porter and Kramer explain how chosen right CSR may give an important competitive advantage to a firm. To do so, the firm should concentrate on one shared value in its operating practices and in the social dimensions of competitive context. This has the potential to foster economic and social development and to change the way companies and society think about each other.

My simple economic illustration showed that an absolute ethical standard introduced in an economy may cause the firms that can not afford this ethical cost to go bankrupt. The punishment may differ between the firms and this is socially not optimal. A firm with a punishment cost lower than the cost of ethics will be able to survive since it can ignore the cost of ethics. The survival of the firms will not depend on their productivity anymore.

A variable ethical standard will make the firm maximize its profit taking the cost of ethical effort and the firm’s moral into account. It showed that the higher a firm’s productivity the higher moral cost it can bear and vice versa. A misunderstanding may occur while looking at the result of the model when it comes to the correlation between the productivity and the ethical standard. Higher ethical standard does not affect productivity. This positive correlation is only due to the selection in the market.

The expected ethical standard of a firm may be different for each firm, although differ from my assumptions. We can expect the ethical expectations to be higher the higher the income of the firm is. It would have been interesting to look at the results when this is the case, but due to lack of time, I did not look closely at it.

The Economist’s special report about CSR concludes with: “Done badly, CSR is often just a figleaf and can be positively harmful. Done well, though, it is not some separate activity that companies do on the side, a corner of corporate life reserved for virtue: it is just good business”. 
Bibliography


Appendix

Pressemelding:

Fra Kaffehuset Friele

Dato 8. mars 2002

84 prosent sier de vil betale mer for kaffen

Folk flest vil betale noe mer for kaffen dersom de vet at bøndene og arbeiderne på kaffeplantasjene på denne måten blir sikret en minsteinntekt som gir dem tryggere sosiale vilkår. I en intervjuundersøkelse svarer hele 84 prosent at de er villige til å betale 2-3 kroner mer for en kvartkilo kaffe i solidaritet med de fattige.


- For Friele er det viktig å gi forbrukerne en mulighet til å være samfunnsengasjerte og opptre etisk bevisst i handelen med kaffebøndene, sier administrerende direktør Jan Gustav Andersen i Kaffehuset Friele. Utsalgsprisen til elefantmerket kaffe fra Kaffehuset Friele kommer til å være 2-3 kroner høyere enn vanlig Friele Frokost kaffe.

- De kafferåvarene som vi benytter i den nye elefantmerkede kaffen i Max Havelaar-ordningen kostet Friele nesten dobbelt så mye som den kaffeblandingen vi benytter i vår Friele Frokost kaffe. Dette forklarer at elefantmerket kaffe koster mer i utsalg. Likevel har Kaffehuset Friele en lavere fortjeneste på elefantmerket kaffe i forhold til Friele Frokost kaffe, påpeker Andersen.

Kaffehuset Friele har siden mai 2000 deltatt i Max Havelaar-ordningen, men da med en 125g økologisk kaffe. Denne kombinasjonen ble for dyr for forbrukerne, og produktet er nå trukket tilbake fra markedet.

Kaffehuset Friele tilbyr også elefantmerket kaffe der posene inneholder hele kaffebønner.

1000 personer deltok i spørreundersøkelsen som ble utført per telefon i uke 7/02.

Kontaktperson i Kaffehuset Friele:

Administrerende direktør Jan Gustav Andersen, telefon 55 92 66 21 / 91 38 35 63