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The Responsibility Paradox

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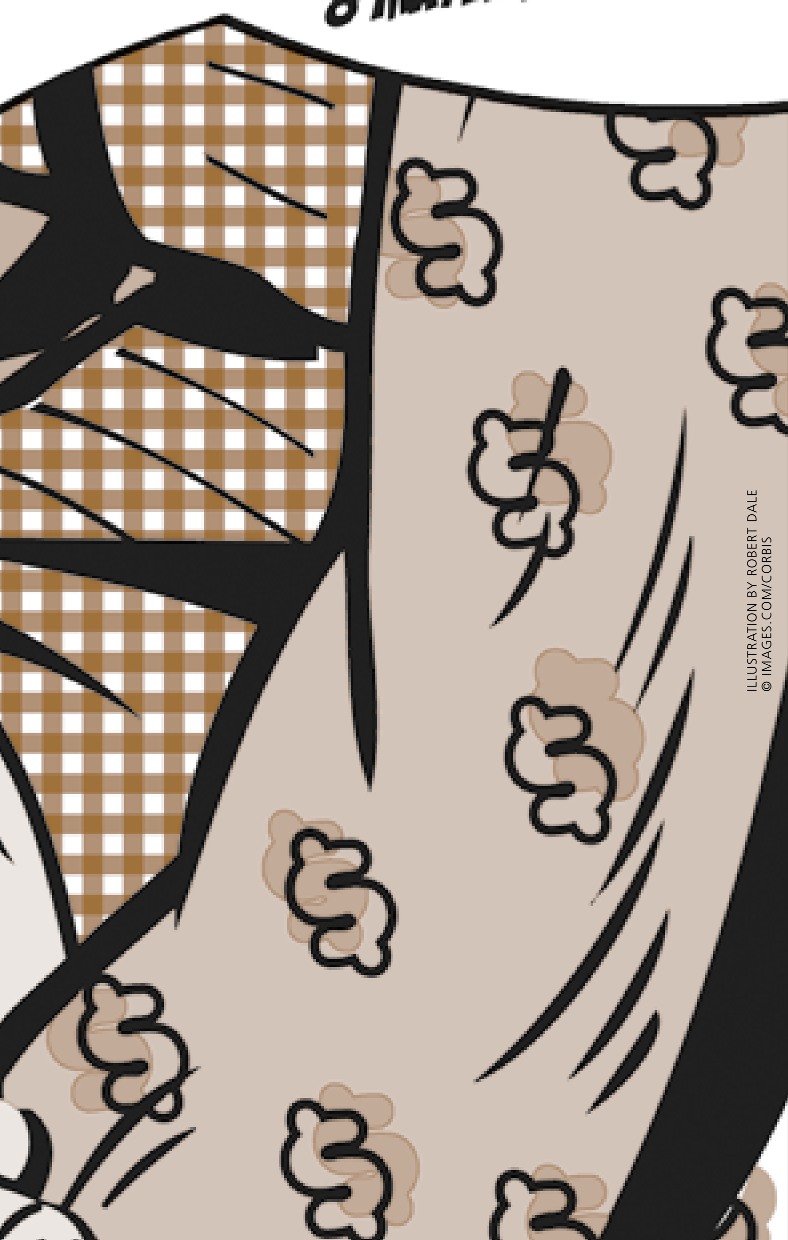

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With operations scattered around the globe, the modern corporation is a different animal from its predecessors. Yet the notion of corporate social responsibility (CSR) has not changed much over the years. As a result, just as stakeholders are holding corporations more responsible for their actions, corporations understand their responsibilities to stakeholders even less. To resolve this paradox, firms must update their CSR practices. The authors predict that the European Union will set the tone for product and environmental regulations, the United States will lead on governance guidelines, and international NGOs will drive human rights and labor laws.

IN EARLY 2007, THOUSANDS OF CATS AND DOGS IN North America fell ill with kidney ailments. Many of the pets had dined chez Menu Foods Inc., a company in Ontario, Canada, that manufactures pet foods for more than 100 brands, including Procter & Gamble, Iams, Colgate-Palmolive's Science Diet, and Wal-Mart's Ol' Roy. By mid-April, investigators had traced the animals' illnesses to melamine, an industrial chemical that tainted a few of Menu Foods' raw ingredients. They then followed the thread to two suppliers in China, which had spiked the ingredients to cut costs and boost profits.

So where should the public point its finger? Procter & Gamble, Colgate-Palmolive, Wal-Mart, and the many other corporations that own the pet food brands? Menu Foods, which mixed the kibble? The Chinese manufacturers, which adulterated the ingredients? The U.S. Food and Drug Administration, which failed to detect anything amiss? The stores that didn't remove the foods from the shelves, even after Menu Foods recalled them?

Traditional notions of corporate social responsibility say that companies are beholden to the communities in which they are located. But globalization has made it difficult to discern exactly which communities to include. With far-flung value chains, decentralized governance, and churning employees, multinational corporations have become what British journalist Martin Wolf calls "rootless cosmopolitans."

Before it went private in 2006, for example, Tommy Hilfiger had its corporate headquarters in Hong Kong, its legal incorporation in the British Virgin Islands, its shares on the New York Stock Exchange, its annual meeting in Bermuda, and most of its manufacturing in Mexico and Asia.[1] Likewise, Royal Caribbean International has its headquarters in Miami; registers its ships in the Bahamas, Malta, and Ecuador; and is legally incorporated in Liberia, where it is subject to neither Liberian nor U.S. income taxes. The Liberian corporate registry, in turn, is a business housed in a nondescript office park near Washington Dulles International Airport in suburban Virginia.

What does Tommy Hilfiger owe to Hong Kong, Bermuda, New York, and Mexico – not to mention to the countless malls where its goods are sold? What are Royal Caribbean's responsibilities to Liberia, which few of its executives could locate on a map?

Although firms have changed drastically with globalization, their understandings of corporate social responsibility have not kept pace. This presents corporations with a paradox: At a time when more stakeholders than ever are calling them to account, firms have but a foggy notion of what, exactly, their obligations are.

We propose an updated notion of corporate social responsibility – *global corporate social responsibility* – that reflects the fact that people hold firms responsible for actions far beyond their boundaries, including the actions of suppliers, distributors, alliance partners, and even sovereign nations. Our research suggests that the standards for global CSR will be just as international as corporations themselves: the European Union will set the tone for product and environmental standards, the United States will largely shape governance guidelines, and international nongovernmental organizations (NGOs) will drive human rights and labor rules.

THE FIRM EVOLVES

The multinational corporation of the 21st century bears little resemblance to its forebears. In the 1950s and 1960s, U.S.-based corporations aimed for continuous growth in revenues and employment, which they often brought about through mergers and acquisitions. Employees of large American firms viewed their jobs as lifetime commitments, with regular raises and generous benefits upon retirement. Most large corporations had widely dispersed ownership, and so shareholders – mostly individuals – were relatively powerless.

By the early 1980s, however, two sets of changes eroded the sharp separation of corporate ownership and control that had characterized American-style capitalism for at least half a century. First, individuals began putting their savings into mutual funds rather than into savings accounts. Consequently, institutional investors began replacing individual investors as the direct owners of the nation's largest public companies. As institutional investors increased their ownership of corporate America, they exercised their new power by wringing better performance from companies – particularly the poorly performing manufacturing behemoths that had been assembled over the previous two decades.

Second, the Reagan administration relaxed its antitrust standards, and several court decisions facilitated hostile takeovers. As a result, a wave of buyouts and takeovers dissolved many of the conglomerates that had started the decade.[2] To cut costs, corporations focused on a narrower range of activities, outsourcing and off-shoring many of their processes. And it wasn't only

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the rank-and-file employees who saw their jobs go to temporary employees and contract business services: Executives also received pink slips when their companies' earnings disappointed or stock prices sagged.[3]

Meanwhile, globalization, international economic deregulation, and new information and communications technologies intensified competition between corporations. American firms watched their profit margins decline decade by decade from the 1950s to the 1990s. To cut costs and increase profits, corporations amped up their outsourcing and downsizing throughout the '90s, aided by technological advances. Firms like General Motors and Ford, which once viewed their vertical integration as a source of strength, spun off new companies to manufacture their parts and components, thereby unburdening themselves of costly union labor. Following a model pioneered by Nike, companies like Sara Lee sold off nearly all their manufacturing plants and became, in essence, "virtual" manufacturers, taking charge of design, marketing, and distribution but outsourcing the actual manufacturing to suppliers. Indeed, by the turn of the century, a number of large "manufacturing" firms were in fact manufacturing nothing at all.

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At the same time, the actual manufacturers began handling production for many different companies. Ingram Micro, for instance, assembled personal computers for four of the five largest PC manufacturers on the same assembly lines in the 1990s. And the Canadian factory responsible for the tainted pet food of summer 2007 was cooking kibble for more than 100 brands.

Well into the 21st century, corporations continue adding more links to their supply chains, stretching ever farther across the globe for cheaper materials and labor. Consequently, consumers can no longer unambiguously define a car as "American" or a tool as "Japanese" when their raw materials, production, and assembly often take place in several different countries. Indeed, by 2003, nearly half of the United States' total imports reflected transactions between different parts of a single firm rather than arm's-length sales to final consumers, according to the A.T. Kearney/Foreign Policy Globalization Index.

CORPORATIONS TAKE RESPONSIBILITY

This blurring of corporations' institutional and national boundaries has complicated the question of what their responsibilities are. Is the corporation simply a nexus of contracts, with "no soul to damn, no body to kick," as Baron Thurlow, lord chancellor of England in the late 18th century, is quoted as saying,[4] and therefore responsible only to its shareholders? Or is the modern multinational corporation, with its global reach in both production and sales, a social being with responsibilities to all its stakeholders – employees, customers, shareholders, creditors, suppliers, communities, even society as a whole? And if so, what are the scope and limits of these responsibilities?

History has favored the latter interpretation. Corporate social responsibility – meaning the voluntary actions a corporation takes to improve the lot of its various stakeholders – is a relatively recent term. But firms have practiced CSR almost from the beginning of the industrial revolution. In the late 18th century, for example, factory owners had to provide both physical and social infrastructure – everything from roads, canals, and housing to worker education and health care – to support large-scale manufacturing.

Well into the late 19th century, owners still provided housing and community services, both out of beneficence and out of the desire to control and discipline their workers. As noted by one observer of Pullman, Ill., the company town created for workers who manufactured Pullman railroad cars: "It is benevolent, well-wishing feudalism, which desires the happiness of the people, but in such way as shall please the authorities."[5] (In 1894, "pleasing the authorities" apparently fell out of favor when Pullman became the site of one of the most brutal labor disputes in U.S. history.) Company towns still feature prominently in some developing economies. For example, the Tata conglomerate in India continues to operate the town of Jamshedpur on behalf of its steel manufacturing facility.

The great fortunes created in the late 19th and early 20th centuries inspired CSR that went beyond the communities where corporations were located. Andrew Carnegie, for instance, funded public libraries across the country, far from the origins of his steel fortune. Carnegie also started TIAA, which became the major vehicle for academic faculty pension support in the United States.

By the early part of the 20th century, corporate-sponsored welfare capitalism provided employees with health care, pensions, and many other services Europeans would increasingly consider to be the province of the state. During the post-World War II era, however, Americans began to debate how much responsibility corporations should assume beyond their own boundaries. On the one hand, as the Michigan Supreme Court's decision in *Dodge v. Ford Motor Company* in 1919 plainly stated, corporations could not justify expenditures for anything other than improving profits: "A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end."

On the other hand, commentators such as economist Carl Kaysen noted that the modern corporation is "the single strongest social force shaping its career members," and that it should strive to be "soulful."[6] "No longer the agent of proprietorship seeking to maximize return on investment," Kaysen wrote of the soulful corporation, "management sees itself as responsible to stockholders, employees, customers, the general public, and, perhaps most important, the firm itself as an institution."

The Three Sectors Collide

While corporate executives debated how much social responsibility they should voluntarily assume, the U.S. federal government – often at the urging of domestic NGOs – began codifying what had been the corporation's spontaneous beneficence. Thus the three sectors began their delicate dance over which obligations corporations must fulfill and which they can ignore. For instance, the Equal Employment Opportunity Act of 1972, the Occupational Safety and Health Act of 1970, and the establishment of the Environmental Protection Agency in 1970 aimed to reduce discrimination on the job, to create safer products and workplaces, and to improve environmental quality.

As production and markets shipped overseas, so too did efforts to hold corporations accountable for their actions. NGOs went international, and international lawmaking bodies went into the business of regulating business. In 1977, for example, European NGOs banded together to protest Nestlé's marketing of infant formula to low-income nations of the global south. The Infant Formula Action Coalition (INFACT) argued that Nestlé's marketing efforts were unethical: Mother's milk is more healthful than formula, and consumers often used unclean or too much water to mix the formula, resulting in disease and malnutrition for their infants. Nestlé's inaction in response to INFACT prompted the latter to call for an international boycott of Nestlé. By 1981, the boycott had resulted in U.S. Senate hearings and the development of a UNICEF/World Health Organization code that prohibited the advertising, promotion, and provision of samples of infant formula. The boycott ended in 1984, when Nestlé agreed to abide by the new code. The Nestlé boycott became a model for subsequent global consumer boycotts.

In the 1990s, international NGOs and lawmaking bodies began holding corporations responsible not only for their own behavior, but also for the behavior of their suppliers. Nike was one of the first corporations to discover that its legal boundaries no longer set the limits of its responsibilities. In a highly publicized campaign, a number of NGOs alleged that the apparel giant's suppliers in Southeast Asia violated labor rights. More recently, several plaintiff groups have used the Alien Tort Claims Act to sue American firms in American courts for allegedly helping foreign governments violate human rights. The case against Unocal in Myanmar was settled out of court, and the case against ExxonMobil in Nigeria is still in litigation (see "Getting Human Rights Right" on p. 54 for more on these cases).

To stave off further outside regulation, a growing number of American firms are attempting to regulate themselves. As early as 1972, when GM published its first public interest report, corporations began to study and report on their own practices. By 2005, 52 percent of the Fortune Global 250 firms produced corporate responsibility reports. And the growing demand for third-party monitoring has ushered in a long and growing list of monitoring organizations and processes. Some of these monitoring efforts are partnerships between firms, NGOs, and, in some cases, governments. Others fall strictly under the control of one group, often creating mutual antagonism and suspicion.

But figuring out how to deal with the expanding boundaries of corporate social responsibility remains very much a work in progress. Our research gives some hints on whence corporations should take their cues. Traditionally, corporations have followed the standards set by local and national regulators and stakeholder groups. But successful multinational corporations will soon have to look beyond national boundaries to discover which standards to follow, and perhaps to exceed.

Europe Pushes Product Safety

When it comes to product safety and environmental standards, corporations should look to the European Union for the shape of things to come. With the recent addition of 10 new members, the European Union's 25 nations together constitute the world's largest market – surpassing the United States. Non-E.U. companies that compete in the global marketplace, or hope to do so, must therefore design and manufacture their products to conform to E.U. requirements. This is because customizing products to meet different rules and standards in different countries vastly increases complexity and expense.

Because the European Union's environmental and product safety standards tend to be the strictest, the race for lowest production costs will ironically spur the adoption of more responsible processes and products. In the past, firms often chased the lowest-cost labor forces housed in the most lax regulatory environments, thus inducing states to provide a docile labor force and to turn a blind eye to pollution. But the European Union strongly abides by the precautionary principle, which holds that, in cases where the likelihood of harm is unknown, rules and standards should err on the side of caution.

The European Union's precautionary principle has not always prevailed in cases brought before the World Trade Organization. But its success in creating de facto global law is impressive. As Jeffrey Immelt, CEO of General Electric, put it: "Europe in many ways is the global regulatory superpower. It can speak with one voice and a degree of certainty."[7]

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For example, the European Union's 2006 ban on lead, cadmium, and mercury in electronic products is forcing the electronics industry to eradicate these heavy metals from their supply chains, affecting thousands of firms around the world. Similarly, European cradle-to-grave standards, which require producers to recycle their own products, led U.S.-based Dell to design more easily disassembled computers. Dell now also offers free computer pickup and recycling in both the European Union and the United States.

Perhaps the greatest impact of the European Union's precautionary principle is on farmers, primarily but not exclusively American, who grow genetically modified crops. The European Union has stringent restrictions on genetically altered foods. Fearing marketing problems in the European Union, multinational food processors increasingly refuse to buy genetically modified crops. The global reach of such decisions is broad: Food-scarce African nations allegedly avoid planting higher-yield genetically modified seeds because they fear that they cannot export the resulting crops to E.U. countries.

European pressures also influence the processes involved in international commerce. For instance, over the past few years, some 200 U.S. companies, including Microsoft, have signed agreements to abide by E.U. Internet privacy rules. These rules affect the transfer and use of online data, and thus virtually every firm that has workers, suppliers, or customers within the European Union.

The European Union has also raised environmental standards. When the United States announced that it would not ratify the Kyoto Protocol in 2002, the European Union built a consensus among enough countries to ratify the treaty. As a result, companies are adopting the protocol's standards, even though the United States did not sign it. In fact, though, most E.U. countries are not meeting their emissions-reduction benchmarks. This failure has led its critics to argue that the overall goals set for 2012 are unlikely to be met. Furthermore, they note that as long as such large, fast-growing countries as China and India are under no similar obligations, even successful progress toward the protocol's targets would not prevent a substantial increase in global CO_2 emissions.

More generally, critics of the European Union's strict product standards argue that, in a number of cases, they are unnecessarily costly and without scientific basis.

THE UNITED STATES GUIDES GOVERNANCE

Although product and environmental regulations will reflect European standards, corporate governance will reflect an American-style orientation to transparency, consistent profitability, and shareholder protection. When companies list their shares in the United States, they must meet all the rules of the market on which they are listed, as well as U.S. securities regulations. Because the quest for capital and industry dominance is leading global corporations to list their shares in the United States, American standards have become international standards for capital markets.

By 2005, all but two of the world's 25 largest corporations were listed on the New York Stock Exchange (the exceptions are Germany's Volkswagen and France's Carrefour). Indeed, more foreign firms were listed on U.S. markets than German firms were listed on the Deutsche Börse. Although anecdotal evidence says that the Sarbanes-Oxley Act's rigorous demands may have slowed this process, and may even lead some foreign firms to delist, so far there has been more grumbling than action, and relatively few firms have defected.

The consequences of not complying with American securities rules and regulations can be dire. For example, in 2004, the Royal Dutch/Shell Group paid the U.S. Securities and Exchange Commission (SEC) $120 million in penalties to settle charges that the firm had inflated its reported oil reserves. And then in 2006, the owner and top executive of Mexico's U.S.-traded TV Azteca paid $7.5 million to settle fraud charges. In both cases, the SEC was far more aggressive than home-country regulators in its pursuit of fraud charges.

At the same time, foreign funders are pressing other industrialized nations to pay more attention to governance, accountability, and profitability. By 2000, for example, Americans owned roughly $1 trillion in European equities. Institutions such as TIAA-CREF and Fidelity used their new clout to intervene in matters traditionally left to management. TIAA-CREF, for instance, stepped in to prevent Telecom Italia's plan to spin off its wireless unit, and Fidelity publicly opposed the same firm's proposed merger with Olivetti.

In addition, foreign pension funds, mutual funds, and other intermediaries have begun to emulate the shareholder activism of their American counterparts. For example, Jang Ha Sung, the dean of the Korea University business school, has sought to improve the governance of opaque, family-dominated South Korean firms for more than a decade. His group, People's Solidarity for Participatory Democracy, convinced SK Telecom to create an independent audit committee and Samsung Electronics to make its accounting more transparent. Through his current work with Lazard's $280 million Korea Corporate Governance Fund, he hopes to reduce the "Korea discount" – the undervaluation of Korean stocks relative to those in other Asian nations, which Jang attributes to poor corporate governance.

DESPITE ITS RAGTAG ORIGINS, THE ANTIGLOBALIZATION MOVEMENT HAS FORCED GLOBAL ISSUES ONTO BOTH CORPORATE AND PUBLIC AGENDAS.

One result of the global spread of profitability pressures is that the American boardroom revolution of the 1990s appears to be going global. A study of the world's 2,500 largest listed companies by the consulting firm Booz Allen Hamilton revealed that the number of chief executives dismissed worldwide rose significantly in 2002, increasing from 2.3 percent in 2001 to 3.9 percent in 2002, as compared with only 1 percent in 1995. Board and shareholder impatience with poor financial performance underlay these dismissals: Companies that dismissed their CEOs generated 6.2 percentage points lower total shareholder returns than did companies whose CEOs retired voluntarily.

Shareholder-oriented governance can bring its own issues. The corporate scandals that inspired Sarbanes-Oxley, and the more recent imbroglios about stock options at dozens of U.S. companies, show that commitment to shareholder value can have unintended consequences. Moreover, emphasis on shareholder value sometimes translates into a short-term orientation that puts companies at odds with other emerging global standards. This is yet another reason why both firms and financial analysts should shift their focus toward longer-term viability and profitability.

NGOS HEAD HUMAN RIGHTS

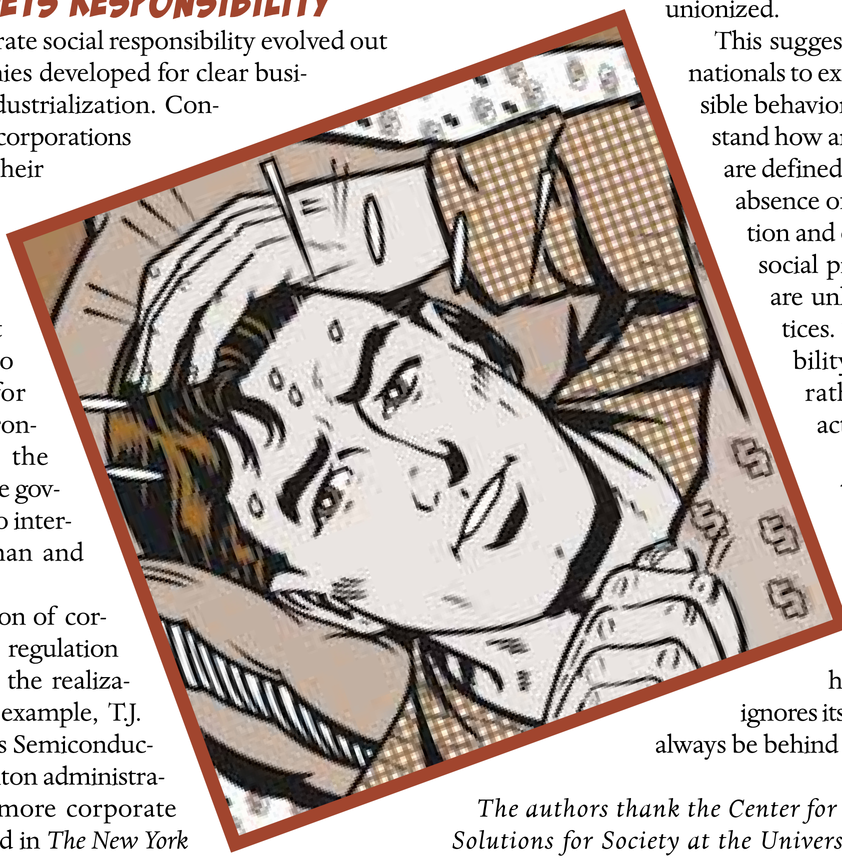
As globalization increases, international and indigenous NGOs are developing their presences in low-income countries and demanding changes in corporate policies. These demands can not only disrupt local production, but also sully the reputations of corporations in their home countries. For example, in the early 1990s, the Ogoni people of Nigeria began a series of protests against Shell and Nigerian National Petroleum. Shell's environmental impact on the Ogoni, coupled with its lack of economic impact, prompted large-scale protests at Shell facilities in 1993. In response, the Nigerian military destroyed more than three dozen villages and executed nine Ogoni protest leaders. Global social movements supported the Ogoni by launching an international boycott and a shareholder campaign against the oil giant.[8]

A number of NGOs and freelance activists have also mounted an international antiglobalization movement. Believing that transnational trade agreements benefit multinational corporations to the detriment of ordinary working people, the poor, and the environment, these activists kicked off the antiglobalization movement in 2000 with their disruptive demonstrations against the World Trade Organization meeting in Seattle. Since that time, they have regularly protested other international financial and trade arrangements, including the North American Free Trade Agreement in 2004. Although these protestors seem united in a single global justice movement, they are in fact transient teams of activists from a number of disparate movements. Despite its ragtag origins, the antiglobalization movement has forced global issues onto both corporate and public agendas. For example, NGOs have put pressure on a number of multinational consumer goods producers, beginning with Nike, to take responsibility not only for their own behavior regarding workers' rights, but also for the behavior of their globally dispersed suppliers.

To respond to heightened human rights standards, managers and executives must not only respond in a forthright matter to the complaints of local residents and NGOs; they must also develop a systematic way of thinking about the possible impacts of the corporation on local populations. Some corporations have joined international certifying agencies that measure compliance with voluntary standards. Others are learning on their own – and sometimes the hard way – how to mitigate possible damages from their operations.

Regulation Begets Responsibility

What we now call corporate social responsibility evolved out of practices that companies developed for clear business purposes during industrialization. Contemporary multinational corporations are vastly different from their predecessors, and so are the standards that they are expected to meet. For the future of global CSR, we suggest that corporations look to the European Union for product safety and environmental standards, to the United States for corporate governance guidelines, and to international NGOs for human and labor rights rules.



Critics of the regulation of corporate activities fear that regulation will ultimately undercut the realization of social goals. For example, T.J. Rodgers, CEO of Cypress Semiconductor, responded to the Clinton administration's efforts to induce more corporate good works with an op-ed in *The New York Times* (April 29, 1997): "When good works cease to be voluntary and become compulsory, charity becomes confiscation and freedom becomes servitude. Philanthropy is a byproduct of wealth, and wealth is best created in free markets whose workings embody a fundamental and true moral principle long forgotten in Washington."

We disagree with Rodgers. Although the literature on CSR supplies plenty of anecdotal evidence of corporate altruism – for example, the oft-repeated story of Merck's development of its river blindness drug (see "Sharing Power" in the fall 2005 issue of the *Stanford Social Innovation Review*) – our research shows that regulation is the surer path to soulful corporate behavior. Using KLD Research & Analytics' annual ratings of several hundred public corporations, we find the following patterns: 1) the corporations most engaged with their communities, particularly through corporate philanthropy, are financial institutions whose contributions are effectively mandated by the Community Reinvestment Act of 1977; 2) corporations with the best environmental records, which include petroleum refining, primary metals, rubber and plastic, and utilities, are those with the most contact with the Environmental Protection Agency; and 3) the industries with the best employment practices, which include metal extraction, airlines, petroleum refining, and transportation, are among the most heavily unionized.

This suggests that if we want multinationals to exceed standards of responsible behavior, then we need to understand how and where those standards are defined. It also means that, in the absence of such standards – regulation and other forms of organized social pressures – multinationals are unlikely to adopt best practices. The paradox of responsibility may paralyze them, rather than move them to action.

CSR has been a contested concept, as many have argued that the responsibility of the corporation is solely to make a profit. Now and in the future, however, management that ignores its social responsibilities will always be behind the curve. □

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