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Guest editorial

Responding to societal expectations

A special issue from the European Academy of Business in Society and Vlerick Leuven Gent Management School

Gilbert Lenssen, Lutgart Van Den Berghe and Céline Louche

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Céline Louche PhD is Senior Researcher at Vlerick Leuven Gent Management School at the Impulse Center Business in Society. In her work she explores the way processes of change take place. A major research interest is the construction of the CSR field with a special focus on socially responsible investment and stakeholders.

Changing societal expectations entail new challenges on businesses in terms of their legitimacy in society at large and particulary in their relationships with stakeholders. In the global information society, businesses are faced with a growing list of expectations from a large number of actors far beyond their traditional stakeholders. For today's managers, business competitiveness and financial results are no longer the only concerns. Certainly the power of civil society groups and their effect on the (re)positioning of traditional stakeholders like consumers, governments and trade unions, lead to a considerably more challenging decision and management environment, not least in a context of global competition. In the global business environment and the global knowledge economy, changing societal expectations are interdependent with political, economic and technological change and form part of the complexity faced by management.

Societal expectations are focussed largely (although not exclusively) on the wider social, environmental and hence governance responsibilities of business and as well as on the long term sustainability and viability of the firm, which includes its capability for sustained long term economic value creation. This special issue of *Corporate Governance, The international Journal of Business in Society* draws from the papers presented at the Third Colloquium of the European Academy of Business in Society (EABIS) organized at Vlerick Leuven Gent Management School in Belgium, September 2004.

The colloquium called for business relevant contributions in terms of the impact of changing societal expectations on management and organization at strategic, operational and governance levels. A business functional approach was choosen to group and discuss contributions in the areas of corporate governance, corporate and business strategy, marketing and market development, leadership and human resource management, operations and supply chain management, finance and accounting. In addition, a seventh group was concerned with the macro-policy background and the role of government.

The organizers of the colloquium and the editors of this special issue propose that the societal expectations towards business have so far been predominantly studied and discussed within the normative frameworks of business ethics (BE) and corporate social responsibility (CSR). They want to contribute to a shift in attention to corporate responsiveness and performance by focussing on issues and questions of managerial relevance, thereby taking a more descriptive, analytical and instrumental approach. This is not meant to diminish the importance of a normative background for description and analysis in terms of institutional legitimacy of business, public responsibility of companies and ethical choices of managers. Rather, the editors believe that in order for the field of business and society (B&S) to earn its place at the core of business theory and practice, it needs to address the ways in which responsiveness to society can be built into the core business functions. Processes of responsiveness and performance outcomes receive therefore more attention than principles of responsibility (Wood, 1991).

From a business and organizational change perspective one could have opted for a systemic rather than a functional approach by looking at the impact of changing societal

expectations on the purpose, strategy, culture, processes, systems, competencies and skills of business organizations. This might indeed become the framework for another colloquium of EABIS in future years. The functional approach was chosen, not only because it is an approach managers find easy to relate to, but also because it makes it easier to draw conclusions from both academic research and managerial practice for business education, since business school curricula are usually built around courses in strategy, marketing, finance and accounting, operations management, and HRM.

Another important choice for the colloquium and this special issue was to present both academic contributions and practitioner contributions in each functional area. The editors are concerned that the traditional academic peer review process does not necessarily produce contributions relevant to practitioners and, in turn, that business-to-business showcasing and benchmarking does not guarantee reflective and analytical quality. Therefore the two communities need to be connected in more meaningful ways than merely being guests at each other's events and in publications. This aspiration has been at the heart of EABIS's mission from the beginning. During the colloquium, it was repeatedly stressed that research and knowledge development requires a more collaborative approach between academics and corporates. In each of the following seven sections, we present a selected paper by an academic as well as a practitoner. The selection is a result of peer academic and practitioner review and reflects the dialogue necessary to bridge the two worlds of practice and theorisation. More than 70 papers and presentations (not including 17 papers by PhD students) were selected from more than 130 submissions to the colloquium. Genuinely, the selection process was not easy. We want to also recognize other excellent contributions to the colloquium. Abstracts of all papers presented as well as the position papers for the keynotes by Professor Ed Freeman and Professor John Kay can be viewed at www.vlerick.be/eabis

1. Governance

Within the corporate governance (CG) domain there is a clear need for a new paradigm which is different from the sole focus on shareholders' interest and value maximization. Financial corporate governance needs to be complemented (or challenged) by societal corporate governance. A new balance is needed between conformance with codes and regulations, corporate responsibility and corporate performance. This raises new types of conflict of interest which traditional corporate governance research does not consider: the relationship between societal and corporate value.

The following subjects were discussed through paper presentations by academics and practitioners: the role of the independent directors, corporate accountability and financial reporting for meeting stakeholder expectations, outsider perceptions of social responsibility of firms, breaking away from the American enterprise model, a teaching agenda on corporate governance and accountability, and corporate governance of family businesses. There was also considerable interest in the influence of social movements and campaigning NGO's on corporate governance and business practice. The two papers presented in this special issue investigate how corporate governance systems and practices are evolving in response to globalization and societal expectations. Cornelius looks at the interface of corporate governance at the country level and the company level in 23 high income countries as well as in the EU's recent accession countries in CEE. He analyzes the close relationship between the measured and the perceived quality of CG at the firm level and national competitiveness, but concludes that there are several countries whose companies on average outperform legal and regulatory requirements. He concludes that globalization will lead to greater convergence of CG practices leading to a greater dispersion of quality of CG at country and company level. Based on 18 company cases, Ricart, Rodríguez and Sánchez examine how the Dow JonesSI world leaders' corporate governance systems are evolving in response to societal expectations related to stakeholder management and sustainable development. Bases on their empirical research, the authors develop their model of sustainable corporate governance, a CG model that incorporates corporate responsibility and sustainable development.

From the papers and the dicussions, it is clear that many mainstream CG experts, academics and practitioners/consultants, have embraced the notion of corporate societal governance and the need to redefine the scope and standards of good CG. More research is required in the relationship between CG, stakeholder engagement and national competitiveness, between corporate value and societal value and in globally competing enterprise models and systems of CG.

2. Strategy

Ed Freeman's stakeholder theory, published more than 20 years ago was a contribution to the field of strategic management. However, research and practitioner reflection on the integration of societal expectations into corporate and business strategies has only intensified recently. Stakeholder management and stakeholder dialogue feature prominently in the debate, but also corporate strategic positioning within ''global issues arenas'', strategic change within companies, entrepreneurship and innovation in response to societal expectations, global and local responsiveness, integrated impact assessment of major investments, and integrated strategic risk management. There is a clear need for a change of mindset in scanning the complex new business environment and more sophisticated models for strategic response and change.

The following subjects were discussed through paper presentations by academics and practitioners: corporate responsibility as corporate strategic opportunity, social entrepreneurs as strategic actors/partners, strategic management of corporate reputation, strategic change and leadership for sustainability, and strategic partnerships with NGO's. Case studies were presented on German companies in stakeholder dialogue, CR and the tobacco industry, multinationals' responses to climate change, Nordic companies and CR. The two papers selected look at the way in which corporations respond to the growing complexity of changing operating conditions, markets, and expectations. Cumming, Bettridge and Toyne explore the complexity of the business environment as a possible source of business innovation. Innovation in responding to global issues offers opportunities for business transformation and competitive advantage in incremental ways, but it needs to overcome scepticism, practice radical lateral thinking, respond to the unexpected, thereby shaping the environment rather than merely reacting to it. Sachs, Rühli and Mittnacht focus on corporations' reactions to the challenge of responding to societal expectations in a complex multicultural global environment. They argue that broad societal concerns challenge the core strategies of corporations and require a strategic response, globally and locally. Managers need practical orientation in dealing with the paradoxes and ambiguities involved.

Corporate responsibility and sustainability research has made major contributions to the field of strategic management. The stakeholder view of the firm complements the resource base view of the firm and together form a robust framework for strategic management overall and in particular for the management of intangible firm assets. The way firms respond strategically to societal expectations is of vital importance to their legitimacy and performance. And yet, the mainstream strategic management literature continues to separate economic and technological market factors from political, social and cultural ''non-market'' factors without succeeding in an integration of both. More research that contributes to this integration is desirable.

3. Marketing

The debate on the ''business case'' for corporate social and environmental performance is continuing. While an increasing number of research and case studies show a positive relationship with corporate financial performance, the nature of this relationship is far from clear. Reputation driven strategies by firms, especially those that aim to win the trust of consumers by communicating social or environmental commitment, remain a weak platform for building this ''business case''. From the practitioners' point-of-view, the knowledge frontier is now in the development of new business models for sustainable development (SD). Companies should move on from strategies of minimising risk and reducing negative impacts on society and the environment (and expect to be rewarded for it), to creating

market based solutions for pressing social and environmental problems. By attempting this, they can move away from a mindset of ‘‘being part of the problems’’ to ‘‘being part of the solutions’’. This shift in mindset was also triggered by the appeal to corporate leaders to make a business contribution to the UN millenium goals. Companies that foster a managerial culture of commitment to long term value creation and entrepreneurial dynamism have an advantage over others in capitalizing on the new opportunities arising from changing societal expectations.

The following subjects were discussed through paper presentations by academics and practitioners: integrated marketing communications, stakeholder communication needs, the use of the internet for providing information, engaging the marketers, and business models for SD. Case studies were presented on Nutreco, Procter and Gamble, EDF and BP.

The two selected papers look at how cause commitment can effect stakeholders' perception of firm performance. Aqueveque demonstrates that knowledge of this cause commitment does not necessarily affect the consumer's perception of trustworthiness, integrity or ability of the firm in positive ways. In fact, there can be negative effects. Denby-Wilkes reflects on the EDF Group's Access to Energy Programme which attempts to create a business model for providing access to electricity and reducing poverty in developing countries. This model only works under specific institutional and financial conditions. Both papers highlight that a firm's cause commitment may deliver both firm-value and societal-value but only if it is based on sound strategic and operational choices. More research needs to be directed at the role of CR in corporate branding in terms of both opportunities and risks. Also research case studies need to be developed on the newly emerging business models for SD in developing countries.

4. Leadership

Today's business environment has become increasingly dynamic and paradoxical and is characterised by a high degree of social and environmental awareness, which requires corporations to be innovative and responsive in order to suceed. This new environment requires a different type and style of leadership. Indeed, the quality of leadership at the individual, team, and organisational level is key for effective corporate responsiveness to society. ‘‘Servant leadership’’ (as opposed to ‘‘heroic leadership’’) accepts the limitations of individuals in the face of all the intricacies of a complex global system in transition. Leadership is increasingly defined as a collective organizational capacity. However, individual leadership development is still important and needs to address the new leadership skills required for individual and organizational change and learning, for aligning systems and structures as well as shifting corporate cultures and values.

The following subjects were discussed through paper presentations by academics and practitioners: new leadership styles: learning from nature, managers' perceptions on CR, a relational approach to enterprise, leadership and institutional myth building on CR, and setting a metaphorical context for aligning different values. Case studies were presented on IBM and PLIVA.

The selected papers are from Martin and Ernst and from Roper and Cheney. Based on empirical research, Martin and Ernst argue that the nature of leadership has changed substantially over the last five years. Organizational leadership capability needs more attention as opposed to traditional attention to individual (top) leadership characteristics. Collective leadership processes at the middle of the organization around direction setting, alignment and commitment are key to effective responsiveness to the increasing complexity of society. It is at the middle level of the organization that corporate strategic intent and values/norms can de alligned with stakeholder expectations.

It is probably also at the middle of the organization that firms can connect with the value driven and charismatic social entrepreneurs. Roper and Cheney describe in their paper on the historical development and contemporary understanding of the concept of social entrepreneurship. Private sector entrepreneurs, nonprofit sector entrepreneurs and public sector entrepreneurs are emerging actors marrying rational economic calculation with

socially inspired vision. Therefore they also have a leading role in the diffusion of new concepts and their practical implications. Social entrepreneurs can inspire corporate leadership and they can be partners in bridging the pursuit of corporate and societal value between the private and public sector. More research is still required in the leadership of systemic corporate change in response to societal expectations. Also, new research is required in the leadership of change in practices and standards of entire business sectors (creating level playing fields for individual firms).

5. Operations

Corporations are what they do: corporate policies and commitments to values get enacted (or not) in business processes: the processes that deliver value to customers and society at large through the supply-to-customer value chain. At every point of the value chain there are decisions and trade offs to be made between conflicting objectives. The debate on corporate responsibility ''gets real'' when considering how responsiveness to societal expectations becomes integrated in operational decision-making and in managing the supply chain. Risk and opportunity management become especially challenging when operations and supply chains are located in the developing world. Integrating corporate responsibility and sustainability into business processes is a long and laborious task and it requires aligning management systems, information systems as well as organizational structures. Apart from this ''hardwiring'' the effort, ''softwiring'' (terms used at Shell) a social and environmental performance culture as part of the overall performance culture forms the real challenge. The following subjects were discussed through paper presentations by academics and practitioners: operational stakeholder management, integrating CR into quality management frameworks and management systems, social reporting and intangible resources, the economics of corporate sustainability, and a framework for corporate action. Case studies was presented on Shell and on Chiquita.

The first selected paper describes how Shell enacts its commitment to sustainable development into a single performance management system of economic, social and environmental indicators. The social performance (SP) management framework is an integral part of this management system. Based on stakeholder involvement, SP plans, SP guidance notes and SP reviews, Fossgard-Moser describes how the company attempts to allocate resources in an efficient way in order to strengthen the license to operate by addressing broader social issues in operational environments, by enhancing positive impacts and reducing negative impacts. This is a systematic and integrated approach for managing social risks and opportunities by carefully considered social investment.

In his selected paper, Blowfield lookes at the supply chain as a model of governance where companies that act as gatekeepers to the most lucrative markets can and are expected to exert influence over the behaviour of other companies in the chain. The nature of this power and influence becomes visible in the enforcement of codes of conduct through auditing/monitoring processes. More important however is attention to the effective management of change (as opposed to enforcement) through the cross cultural complexities of any global supply chain. How power is exerted affects events and whose values are prioritized affects the final impact. Understanding value differences and the power relationships are key. More research is required in integrating CR into performance management structures and processes at different levels within the firm internally and within entire supply chains.

6. Finance

In this group of papers, the debate predominantly focused on socially responsible investment (SRI), alternatively named sustainable responsible investment. The name game points to a significant shift in the debate on SRI. SRI has grown significantly during the last decade yet it faces a number of challenges if it is to become a mainstream activity. The definition, and consequently the performance, of SRI funds is still subject to considerable controversy. There is a need for better education on sustainable and responsible investment, for more transparency in fund management and for the development of appropriate legal frameworks. The following subjects were discussed through paper presentations by

academics and practitioners: risk and return characteristics of sustainable indices, a neo-institutional approach to social accounting, contingent variables in performance management, and psychometrics in fund structures. Case studies were presented on SRI and pensions (Eurosif), social and financial performance in the telecommunications industry, ethical investment in The Netherlands.

In the first selected paper, Van De Velde, Vermeir and Corten bring clarity into the bewildering range of definitions of SRI by distinguishing between three generations of SRI. The third generation funds use a wide and balanced range of non-financial criteria including ''sound management'' and can be labeled as sustainable investment funds (as opposed to the more narrow based ethical investment funds). These funds have attracted the highest growth. The authors expect these funds to continue to grow because institutional investors will increasingly be persuaded by the positive relationship between sustainable corporate strategy and long term financial corporate performance.

In the second selected paper, Guyatt is less optimistic because in her view the rational case for growth of sustainable investment might be less forceful than the conservatism of dominant arket conventions and the instincts of ''institutional herding behavior''. Behavioral impediments might be overcome by institutional investors if they can create and reinforce certain conditions and conventions through collective actions. By (re)designing and implementing ''internal conventions'' and exporting them to the market, they can reduce the influence of the prevalent market conventions. These two papers contribute to solving some of the challenges mentioned earlier by addressing SRI funds performance and investors' behavior. Research in the performance and growth of the broader defined sustainable investment funds needs to be encouraged. Also more research is required in corporate decision making on and post project financial appraisals of sustainable investments in firms.

7. Policy making and the role of government

The role of government in fostering positive responses from companies to changing expectations from society is currently widely debated. The European Commission is committed to a policy agenda and has demonstrated this by a number of initiatives and programs like the Multi Stakeholder Forum on CSR. Debates in this Forum, and in other places, are often dominated by the appropriateness of a regulatory framework. The voluntary versus mandatory approaches seem to polarize the debate. And yet, there is no real understanding of the impact of CSR at the macro level in terms of governance. Both at EU level and at national level, Europe seems to evolve towards a governance model in which corporate responsibility is a major building block. In total nine papers of high quality were presented under this section. This speaks for itself when one considers that only a few years ago, it was hard to get any papers of adequate quality on policy and the role of government at all. Practitioner and academic papers were presented on the following subjects: EU policy goals and programs, the OECD guidelines, the role of governments on CR and in the CR debate, scaling up corporate social and environmental performance, non-economic dimensions of national competitiveness, measuring public value, and ethics and the law in the US and in the EU.

The two selected papers are excellent contributions to a better understanding of the changing nature of governance and the implications for policy at the macro level. Körner uses systems analysis and comes to view the concept of ''CSR'' as a different form of corporate governance that links to a different form of public governance. He argues that a change of mindset of economic actors and their stakeholders is a necessary condition for integrating the normative concept of CSR within the framework and processes of corporate governance. Midttun describes how the changing roles of, and relationships between, civil society, business and government might lead to a new form of governance or political economy. This new model of governance should be juxtaposed to the old opposition between the liberal market model and the welfare state model to gain a deeper understanding of the changing nature of governance.

The research agenda in this domain has come a long way in a short period of time. More research is needed in the boundaries between corporate and government responsibilities.

Also, major questions remain unanswered with respect to the role and legitimacy of NGO's in the democratic process, the effectiveness of different national policies on CR, different regulatory approaches in different industry sectors and the effectiveness of public-private partnerships (PPP).

8. Overall conclusions

The structure of this special issue reflects the choice that was made for structuring the call for papers sent out in the spring of 2004 and the EABIS colloquium in September 2004. The functional approach was considered to be an effective structure:

- for taking stock of the state-of-the-art of academic research with respect to addressing business relevant issues;
- for bringing in reflective contributions from practitioners allowing for assessment of the existing gaps between academic research and practitioner concerns; and
- for contributing to the ''mainstreaming'' of corporate responsiveness to society from a largely peripheral matter to the core of business theory and practice.

The broad scope of papers presented at the colloquium and the selected ones for this special issue provide a state of the art on the three accounts. Whilst the scope and quality of academic research in the field of business and society is undoubtedly growing as evidenced here, there are still considerable gaps with corporate knowledge needs with respect to managing processes of responsiveness and performance outcomes. Collaborative research design should address these gaps and we look forward to seeing more of these design models taking shape in the future.

We could notice complementary views and approaches of academics and practitioners in the areas of governance, strategy, leadership and governance; as well as the marked differences in perceptions and approaches in the areas of marketing, operations and finance. Whilst the quality and relevance of academic research has increased considerably (albeit only recently); there is still progress to be made with respect to the setting of and adhering to standards of reflective quality of practitioner contributions. Whilst still more business relevance of content is required from academics, more reflective quality of method is required from practitioners. Both requirements form the basis for a more fruitful dialogue and co-operation between the two communities. In each functional area, we have commented on the needs for further research that result from comparing academic and practitioner inputs and from points made during the discussions. Some links to the mainstream management literature are clearly missing:

- comparative strategic analysis between industry sectors;
- strategic accounting and the balanced scorecard; and
- human resource management (across the board, with the exception of leadership development).

The collection of colloquium papers and the selected ones for this publication illustrate the considerable progress that has recently been made with respect to mainstreaming corporate responsibility and sustainability into the core of the functional management disciplines (albeit to different degrees). It is now appropriate to start asking why the achievements of academic research and practitioner knowledge development are hardly noticeable in the core courses at most business schools. This should be addressed in a forthcoming special issue of this journal on CR and business education. Overall, a functional approach has served us well in pursuing the three objectives mentioned above; but it also presents some drawbacks. Issues related to corporate responsiveness to growing societal expectations are often multi-functional and require a multi-disciplinary approach. Some of the papers presented at the colloquium do indeed highlight this.

One may also regret the lack of fundamental research in the colloquium program and in this special issue. Especially the need to better understand the economic, political and cultural drivers and consequences of globalization and how these affect and will affect societal

expectations is left largely unaddressed. Equally, the effect of CR on the overall theory of the firm was hardly touched on. Our choice for a functional structure to bridge the academic-practitioner divide should not have been an impediment to addressing fundamental questions, but it might have been. The business community is keenly interested in fundamental questions that go beyond questions for instrumental and applied knowledge (Lenssen and Dentchev, 2005). This is clearly food for thought whilst planning the next colloquia and special publication issues.

We wish to thank all who contributed to a successful colloquium and to the preparation of this special journal edition.

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Governance

Good corporate practices in poor corporate governance systems

Some evidence from the Global Competitiveness Report

Peter Cornelius

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Abstract

Purpose – *Attempts to benchmark corporate governance practices have focused primarily on developed capital markets, whereas cross-country comparisons remain difficult for emerging markets. Given the growing importance of emerging markets as an asset class, this paper attempts to shed some light on the quality of governance practices in a large sample of countries and the extent to which that quality may offset perceived weaknesses in the institutional framework in which companies operate.*

Design/methodology/approach – *In the absence of comparable data for many emerging markets, the paper employs new survey evidence from the World Economic Forum's Global Competitiveness Report.*

Findings – *The analysis suggests the following: first, legal institutions play a key role for corporate governance, but other factors, such as politics and cultural and historical roots, matter too. While corporate governance practices in emerging markets tend to be weaker than in developed capital markets, several emerging markets have already made substantial progress in upgrading their practices and, as their institutions continue to emerge, the existing quality gap looks set to narrow further. There are several countries whose companies on average appear to follow better practices than the quality of their legal and regulatory environments would suggest.*

Research limitations/implications – *Good corporate governance at the company level need not be tied or constrained by its local environment. That good company practices may at least partly offset weak framework conditions and could have important implications for the mode of entry foreign investors choose, an issue to be left for further research.*

Originality/value – *Overall, the paper's main contribution lies in its novel approach to disaggregate different levels of corporate governance, thus allowing a more textured assessment of corporate governance risk.*

Keywords *Strategic management, Emerging markets, Competitive strategy, Direct investment*

Paper type *Research paper*

The author would like to thank Marco Becht, George Dallas, Klaus Deutsch, Bruce Kogut, Theodore Moran, and Joel Kurtzman as well as participants in a workshop at the Third EABIS Symposium on The Challenge of Sustainable Growth: Integrating Societal Expectations in Business, Gent, September 27-28, 2004. All remaining errors are the authors. The views expressed in this paper are not necessarily those of the Royal Dutch/Shell Group of Companies.

1. Introduction

In the broadest sense, corporate governance can be defined as the stewardship responsibility of corporate directors to provide oversight for the goals and strategies of a company and to foster their implementation. Corporate governance may thus be perceived as the set of interlocking rules by which corporations, shareholders and management govern their behavior. These rules refer to individual firm attributes and the factors that allow companies to maintain sound governance practices even where public institutions are relatively weak. Such factors may include a corporation's ownership structure, its relationships with stakeholders, financial transparency and information disclosure practices as well as the configuration of its managing boards.

While there exist numerous approaches to assess the quality of the legal and institutional framework of countries (e.g. Kaufmann *et al.*, 2003), investors have shown a growing demand for a global benchmark of good corporate behavior, which can help create shareholder value regardless of the particular system (Gompers *et al.*, 2003). In response to this demand, important efforts have been made to create a new index, including the corporate governance index, which was recently developed by the *Financial Times* and *International Shareholder Services* (ISS). However, these benchmarking attempts have focused primarily on developed capital markets, whereas cross-country comparisons remain difficult for emerging markets.

Given the growing importance of emerging markets as an asset class, this paper attempts to shed some light on the quality of governance practices in a large sample of countries and the extent to which that quality may offset perceived weaknesses in the institutional framework companies operate in. Unfortunately, for many countries we consider here ''objective'' data on corporate governance criteria used by the FT/ISS index do not exist.

In studying the relationship between the quality of corporate governance at the ''macro level'' and the ''firm level,'' we therefore employ new survey evidence from the World Economic Forum's Global Competitiveness Report. Section 2 defines corporate governance systems, discusses some standard legal and regulatory indicators of corporate governance and presents the survey evidence on the perceived quality of institutions in a large cross-section of countries. Section 3 focuses on the perceived quality of corporate governance practices at the firm level. Section 4 compares the macro and firm level evidence in order to identify ''overachievers'' and ''underachievers'' – i.e. countries whose companies tend to show superior (inferior) governance practices relative to their environment. Section 5 concludes.

2. Corporate governance systems and the perceived quality of institutions

In any given country, the legal system helps set some corporate governance standards. These may vary, and while absolute conformity of corporate governance systems is both unnecessary and unlikely to be very healthy, there is near universal recognition of the need to preserve investor confidence through transparency, accountability, fairness and responsibility (van den Berghe, 2002). Nations compete for investment capital, and the assurances investors seek as they decide whether to provide that capital are universal. Investors ultimately choose to place their capital where they can understand the risks and believe their investment is most likely to be protected from fraud or other misuse. This recognition has driven and continues to drive convergence on notions of governance and what constitutes best practice.

Country factors can play a key role in setting the framework for corporate governance practices at the individual company level. Two companies with the same risk profile but domiciled in countries with contrasting legal, regulatory and market standards therefore present different risk profiles should their governance practices deteriorate. In other words, in the event of deterioration in a specific company's governance standards, investors and stakeholders are likely to receive better protection in a country with stronger and better enforced laws and regulations.

Broadly speaking:

> A system of corporate governance consists of those formal and informal institutions, laws, values, and rules that generate the menu of legal and organizational forms available in a country and which in turn determine the distribution of power – how ownership is assigned, managerial decisions are made and monitored, information is audited and released, and profits and benefits allocated and distributed (Cornelius and Kogut, 2003, p. 2).

The quality of the legal system is seen as playing a particularly important role, with strong investor protection laws generally linked with broader and deeper capital markets, a more dispersed shareholder base, and a more efficient allocation of capital across firms (La Porta *et al.*, 2002). According to the ''law matters'' school, the legal origin is one of the most important variables for explaining different levels of regulatory intervention (La Porta *et al.*, 1997, 1998; World Bank, 2004). Specifically, it is argued that legal origin is associated with

differing degrees of greater procedural formalism and complexity (Djankov *et al.*, 2003), and, more provocatively, it has claimed that civil law is less effective in protecting shareholder rights than common law.

However, this view has not remained undisputed. Instead, it has been argued that the influence of law must be viewed in a wider context. Other factors may be equally, if not more relevant in determining legal and governance systems, such as the stage of economic development, the political environment, and even broader cultural issues (Dallas, 2004). But although the cultural and historical backgrounds of countries differ – and hence their corporate governance systems – it has been argued (Cornelius and Kogut, 2003) that for a given type of form one can identify specific practices that are better than others. According to this view, corporate governance practices are those rules that apply to specific financial markets and organizational forms and establish the rights of owners, and the information and mechanisms at their disposal, to control management and employees. These practices for the public firm include the determination of the board of directors and its powers and voting rules, protection of minority investors, the publication of audited accounts, covenants restricting managerial actions such as the sale of assets, and the distribution of profits.

While recent benchmarking attempts have focused on criteria such as the market infrastructure, legal infrastructure, regulatory infrastructure, and informational infrastructure, there may be a gap between ''the law on the books'' and how laws and regulations are actually applied and enforced (Pistor and Berkowitz, 2003). Therefore, most attempts to measure the quality of public and corporate governance also include survey data. A widely used source is the World Economic Forum's (WEF) executive opinion survey for its Global Competitiveness Report (World Economic Forum, 2004), which includes a particularly large sample of countries and reflects the views of more than 8,000 senior executives.

One of the sub-indexes the WEF uses to calculate its overall competitiveness rankings reflects the quality of the legal environment. The Contracts and Law Index mirrors responses to four questions focusing on the independence of the judiciary, the protection of property rights, favoritism, and the prevalence of organized crime (Box 1). In addition to these

Box 1

GCR contracts and law index

The judiciary in your country is independent of political influences of members of government, citizens, or firms (1 = no, heavily influenced, 7 = yes, entirely independent).

Financial assets and wealth (1 = are poorly delineated and not protected by law, 7 = are clearly delineated and well protected by law).

When deciding on policies and contracts, government officials (1 = usually favor well-connected firms and individuals, 7 = are neutral among firms and individuals).

Organized crime (e.g. Mafia-oriented racketeering, extortion) in your country (1 = imposes significant costs on businesses, 7 = does not impose significant costs on business).

GCR survey questions on corporate governance framework

Law protection of minority shareholders' interests in your country is (1 = non-existent and seldom recognized by majority shareholders, 7 = total and actively enforced).

Financial auditing and accounting standards in your country are (1 = extremely weak, 7 = extremely strong, among the best in the world).

Access to reliable and timely information regarding company financial performance is (1 = often insufficient, delayed, and difficult to obtain, 7 = regular and easy).

The regulation of securities exchanges in your country is (1 = non-transparent, ineffective, and subject to excessive industry and government influences, 7 = transparent, effective, and independent of excessive industry and government influences).

In your country, mergers and acquisitions – particularly hostile takeovers – are (1 = rare and face serious legal impediments, 7 = common and allowed by law).

questions, last year's survey introduced several new questions on corporate governance, some dealing with institutional and legal issues (e.g. protection of minority shareholders), others with firm-specific factors (e.g. control of corporate boards). The results are shown in the appendix.

Unsurprisingly, public institutions in developed capital markets are perceived to provide a superior framework than in emerging market economies. On the contracts and law index, Finland, Denmark and Sweden enjoy particularly high scores. Australia and New Zealand, two common law countries, are also ranked highly. While Italy and Spain, two civil law countries of French origin, score lowest, there appears to be no systematic differences between common law and civil law countries. France and Canada, for instance, are indistinguishable on this account, and Germany and Switzerland as civil law countries enjoy higher rankings than the UK and the US, two countries with a common law tradition.

As far as the protection of minority shareholders are concerned, common law countries are generally perceived to provide better protection. This applies especially to Australia and the UK. However, the Nordic countries are not much behind, with Finland and Denmark scoring higher than the US. As regards to the latter, the high-profile scandals such as Enron and WorldCom might have affected respondents' views. The perceived degree of protection of minority shareholders in civil law countries varies considerably, with those of French origin generally scoring comparatively lower. Again, among the high-income countries Italy and Spain have the lowest rankings. Japan, a civil law country with German roots, scores equally poorly.

Australia and the UK also lead the rankings in terms of the perceived strength of auditing and accounting standards, the availability of company financial information, the regulation of security exchanges and the prevalence of mergers and acquisitions. Overall, they both score an unweighted average of 6.5 on a scale ranging from 1 to 7. At the other end of the spectrum is Japan with an overall score of 4.5. Some civil law countries of French origin, such as Italy, Greece, Portugal and Spain, also have relatively low scores, which appears to be consistent with La Porta *et al.*'s hypothesis discussed above. However, most of the countries cluster in the 5-6 range, suggesting that any systematic impact from the legal origin of a country appears relatively weak. Moreover, from the survey results it is not clear to what extent differences across countries are driven by legal factors as opposed to other variables, including income levels, political preferences and cultural and historical roots.

As far as emerging market economies are concerned, a similar picture emerges. While overall they tend to score worse than developed market countries – a finding which is hardly surprising, given that their institutions are still emerging – the relationship between their legal roots and the perceived quality of their institutional framework appears substantially more complex that La Porta *et al.*'s analysis seem to suggest. Chile, Jordan and Morocco, for instance, enjoy relatively high scores across the different dimensions of corporate governance at the macro level, despite their French legal roots. By contrast, their English legal heritage does not appear to prevent several countries, including Bangladesh, Pakistan, Tanzania, Trinidad and Tobago, and Uganda, from having sub-par corporate governance standards, normalized by their level of economic development.

3. Benchmarking firm-level corporate governance

While the country environment can influence the articulation and practical protection of ownership rights and the norms of transparency and disclosure, positive framework conditions are no guarantee that all companies in a given framework will demonstrate strong corporate governance standards. Thus, investors do not regard the quality of the macro framework of corporate governance as a floor. Conversely, it is conceivable that companies operating in weak country environments transcend local practice. However, companies whose corporate governance standards are perceived to be high are generally seen as less risky than companies with low standards, irrespective of the country of domicile.

Firm-level corporate governance provisions matter especially in countries with weak legal environments, potentially compensating for ineffective laws and enforcement by providing credible investor protection (Klapper and Love, 2003). According to a recent survey by McKinsey among 200 institutional investors, well over 70 percent of the respondents in each region are willing to pay more for a well-governed company, all other things being equal (McKinsey and Company, 2002). The demand for benchmarking good corporate governance practices has therefore risen noticeably, in response to which a new corporate governance index has recently been developed by the *Financial Times* and *Institutional Shareholder Services* (ISS). This index focuses on five areas:

1. Board composition and independence.
2. Executive and director compensation.
3. Company ownership.
4. Audit independence.
5. Takeover defenses and shareholder rights.

Unfortunately, the FTSE/ISS index does not (yet) exist for less developed capital markets so that we need to rely on subjective assessments of corporate governance practices at the firm level in emerging market countries. The WEF's executive survey includes three questions that are particularly relevant, dealing with corporate ethics, appointments of directors and insider control (Box 2). The survey results are shown in the appendix.

The survey results are largely in line with the FTSE/ISS index for those countries for which this index exists. Several countries score well across the board, including the UK, Australia, and Finland. By contrast, considerable deficiencies are perceived to exist on average in Greek, Portuguese and Italian companies. Japanese companies score relatively well in terms of their reliance on professional management but are perceived to be considerably weaker with regard to the efficacy of their boards as well as their ethical behavior. Most other developed market economies countries cluster again in the 5 to 6 range on a 1 to 7 scale.

As is the case at the macro level, corporate governance practices at the firm level tend to be weaker in emerging markets. However, there are some notable exceptions, which include for example, Chile, Estonia, Israel, Malaysia, South Africa, and Taiwan. In these countries, the average quality of governance practices as measured by the three survey questions is actually higher than in some more advanced OECD markets. Interestingly, their companies tend to perform well across the different governance dimensions, with corporate boards perceived to be driven by outside shareholders and ethically behaving managers recruited on the basis of superior qualities. At the low end of the spectrum are companies from Angola, Chad, Nicaragua, Pakistan, and Paraguay, with their governance practices perceived to be weak across the board.

Interestingly, there is considerable variation of corporate governance practices within different regions, an observation that includes the new EU members in central and eastern Europe. Whereas Estonia scores on average 5.07, Polish companies are given on average a 3.97 on the 1-7 scale. However, compared with most other regions, companies in the accession countries appear to employ superior practices, implying a relatively limited gap against companies in western Europe. This bodes well for further market integration in an enlarged EU.

Box 2 GCR survey questions on firm-level governance

The corporate ethics (ethical behavior in interactions with public officials, politicians, and other enterprises) of your country's firms in your industry are (1 = among the world's worst, 7 = among the world's best).

Senior management positions in your country are (1 = usually held by relatives, 7 = held by professional managers chosen based on superior qualification).

Corporate boards in your country are (1 = controlled by management, 7 = powerful and represent outside shareholders).

4. Offsetting poor governance standards by good practices?

The survey evidence presented in the previous sections suggests that there is a strong correlation between the perceived quality of corporate governance at the macro and firm levels. Indeed, this assumption is confirmed by a very high correlation coefficient of 0.93 (Figure 1). In other words, in most countries whose institutional framework is perceived to be underdeveloped, corporate governance practices tend to be weak. Conversely, corporate governance practices tend to improve as a predictable and reliable legal and institutional framework emerges.

Nevertheless, in principle it is conceivable that individual companies transcend national standards, thus reducing corporate governance risk for investors. Several investment banks as well as the credit rating agencies have therefore upgraded their research capacity to examine corporate governance risk in individual companies. According to this research, there exist a significant number of cases, especially in emerging market economies, where corporate governance practices outperform national institutions. Vice versa, a well-developed legal and institutional framework does not rule out serious corporate governance risk at the firm level, as a series of corporate governance scandals on both sides of the Atlantic has recently shown.

Rather than focusing on individual firms, in this paper we are more interested in the overall relationship between corporate governance practices and the perceived quality of institutions across a large cross-section of countries. Specially, we ask whether there exist countries whose enterprise sector is perceived to systematically outperform national standards at the macro level. This would suggest that companies are ''ahead of the regulatory curve'' by adopting best practices faster than the legal and institutional framework in their countries evolves. One important motivation for transcending national standards is of course getting access to international capital markets. Conversely, we are also interested in countries whose companies systematically under-perform in the sense that their practices are perceived to be inferior compared with the legal and institutional framework they operate in.

Indeed, there exist a number of outliers, defined as those countries where there is a (positive or negative) deviation of at least 10 percent between the survey responses regarding the perceived quality of corporate governance at the country and firm levels (Table I). The following observations are particularly worth noting: first, there are outliers at every income level, ranging from Chad with a per capita income of US$465 to Hong Kong with a per capita income of US$24,100. Second, there is no particular geographical concentration. It is interesting, however, that three EU members are perceived to enjoy legal and institutional frameworks that are significantly better than the governance practices of companies

Figure 1 Perceived quality of corporate governance at the macro and firm levels

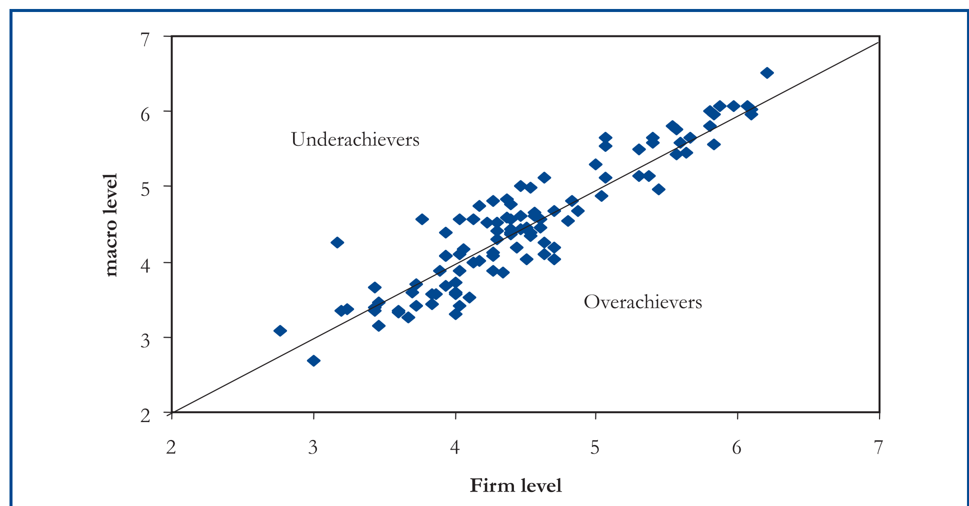

Table I Overachievers and underachievers in corporate governance

Overachievers	*Underachievers*
Algeria	Chad
Angola	Cyprus
Bosnia	Greece
China	Hong Kong
Gambia	Jordan
Madagascar	Namibia
Nigeria	Pakistan
Russia	Panama
Slovak Republic	Peru
United Arab Emirates	Portugal
Ukraine	Tunisia
Vietnam	

operating in these frameworks. Third, there does not seem to be a systematic relationship between the direction of deviation and the legal origin of outliers. To the extent that the German and French legal systems provide lesser protection for shareholders, it does not seem that the companies in countries with such systems systematically outperform with regard to their own practices.

Perceived quality gaps at different levels of corporate governance may have important implications for foreign investment and the mode of entry. Firms are in themselves substitutes for the market and will extent their borders whenever they encounter missing or inefficient markets (Williamson, 1985). Foreign companies dealing with such markets will want to have hierarchical control in those environments where transaction costs are high due to inadequate contract enforcement, poor protection of property rights or inappropriate board procedures. Markets may be attractive for other reasons, for example, because of a rapidly expanding consumer base or natural resource endowments. But whereas a poor macroeconomic governance infrastructure may deter foreign investment altogether, weak corporate governance standards may discourage portfolio investors to a relatively larger extent. By comparison, foreign investors who acquire a controlling stake in a foreign company or undertake greenfield investment tend to be less affected.

Other things being equal, one might thus expect outperformers to enjoy a relatively higher share of portfolio investment relative to FDI. Underperformers, by contrast, are more likely to have a relatively high share of FDI in total capital inflows. While this hypothesis is consistent with recent analysis by Hausmann and Fernández-Arias (2000) for Latin America, we leave its empirical investigation to further research.

5. Conclusions

That good corporate governance can help create shareholder value is hardly disputed today. Motivated by numerous academic studies that showed that well governed companies tend to outperform others by a significant margin, many institutional investors have substantially upgraded their in-house research capabilities on corporate governance. At the same time, corporate governance has become an integral part of credit research by the leading ratings agencies, and the number of external consultants on corporate governance has risen noticeably.

Given that corporate governance matters regardless of the particular system – the legal and institutional framework conditions – investors have shown growing interest in a global benchmark of good behavior. While much work has been done in benchmarking governance systems at the macroeconomic level, relatively little has been produced with regard to benchmarking corporate governance practices at the company level. And even less analysis is available at the interface of corporate governance at the country level and the company level. This is an important gap, for companies operating in weak country environments may transcend local practice.

This paper has aimed at contributing to fill the existing gap. In so doing, we have first looked at the perceived quality of corporate governance in a large sample of countries on the basis of new survey evidence from the World Economic Forum's Global Competitiveness Report. Then, we have focused on corporate governance at the company level, hypothesizing that good corporate practices are most valuable to investors where the disclosure and legal framework protecting shareholders is weakest. In juxtaposing survey evidence for individual companies and the corporate governance framework in which they operate, we have finally identified ''overachievers'' and ''underachievers.''

Three main conclusions emerge from our analysis: first, although perceptions about the quality of corporate governance appear to be consistent with the propositions of the ''law matters'' school, there exist important outliers, suggesting that other factors such as politics and cultural and historical roots play an important role, too. Second, corporate governance practices in emerging markets tend to be weaker than in developed capital markets. However, several emerging markets have already made substantial progress in upgrading their practices, and as their institutions continue to emerge the existing quality gap looks set to narrow further. Third, there are several countries whose companies on average appear to follow better practices than the quality of their legal and regulatory environments would suggest. Good corporate governance at the company level need not be tied or constrained by its local environment, and to the extent that company practices may compensate for weak framework conditions, a purely systems-focused view may lead to excessive risk aversion.

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Appendix

Table AI Perceived quality of public institutions

	Contracts and law index (1)	*Law protection of minority shareholders (2)*	*Strength of audit and accounting standards (3)*	*Effectiveness of bankruptcy law (4)*	*Regulation of security exchanges (5)*	*Prevalence of mergers and acquisitions (6)*	*Average (2)-(6)*
Algeria	3.88	4.7	3	3.8	3.4	3.1	3.6
Angola	2.93	3.1	2.4	2.2	3.5	2.2	2.68
Argentina	2.59	3.7	3.7	3.7	4.8	3.5	3.88
Australia	5.72	6.1	6.2	6.2	6.3	5.6	6.08
Austria	5.55	5.1	5.8	6.2	5.9	4.1	5.42
Bahrain	5.01	5.1	5.7	5.3	5.6	3.2	4.98
Bangladesh	2.76	3.9	3.5	2.9	3.9	2.6	3.36
Belgium	5.34	5.6	5.8	5.8	5.7	4.4	5.46
Bolivia	2.8	3.3	3.2	3.3	4.2	2.9	3.38
Bosnia	3.13	3.1	3.4	3.1	3.4	3.3	3.26
Botswana	4.83	4.7	4.6	4.2	4.8	3.6	4.38
Brazil	4.03	4.5	5	4.3	5.2	3.7	4.54
Bulgaria	2.94	2.9	4.4	3.4	3.7	3.5	3.58
Canada	5.2	5.9	6.3	6.3	5.9	5.6	6
Chad	2.44	3.7	2.6	2.9	3.1	3.1	3.08
Chile	5.07	5.2	5.3	5.3	5.9	4	5.14
China	4.02	3.7	4.4	3.9	3.7	3.6	3.86
Colombia	3.11	4.1	4.2	4.9	5	3.5	4.34
Costa Rica	4.47	4.2	4.5	4.9	5.4	3	4.4
Croatia	2.97	3.2	4.2	2.9	4	3.6	3.58
Cyprus	4.93	4.5	5.4	4.5	4.6	3.8	4.56
Czech Republic	4.05	4.1	4.3	4	4	3.7	4.02
Denmark	6.3	6.3	5.9	6.5	6.4	5.3	6.08
Dominican Republic	3.59	3.5	3.4	3.1	4.3	3.7	3.6
Ecuador	2.57	3.7	3.5	2.7	4	2.9	3.36
Egypt	3.96	4.8	4.8	4.7	4.5	4.3	4.62
El Salvador	3.8	4	4.7	3.2	5	3.5	4.08
Estonia	5.15	4.6	5.6	5.2	5.6	4.6	5.12
Ethiopia	3.59	4.6	3.6	4	3.4	2.9	3.7
Finland	6.3	6.4	6.1	6.2	6.3	4.8	5.96
France	5.11	5	6.1	6	5.9	4.9	5.58
(The) Gambia	4.41	4.7	3.9	4.1	4.6	3.2	4.1
Georgia	3.04	3.7	3.6	3	3.5	3.4	3.44
Germany	5.89	6.1	6.1	6.5	6.2	4.9	5.96
Ghana	4.65	5.6	5.2	4.1	5.8	3.3	4.8
Greece	4.62	5.1	4.8	4.6	5	4.2	4.74
Guatemala	2.73	3.4	3.6	2.9	4.2	3	3.42
Honduras	2.79	3.3	3.5	2.7	3.1	3.2	3.16
Hong Kong	5.74	4.9	5.9	6.3	5.8	5.3	5.64
Hungary	4.37	4.6	4.9	4.5	5	3.8	4.56
Iceland	6.18	5.7	6.2	5.9	6	5	5.76
India	4.67	4.4	5.4	4.2	5.4	3.9	4.66
Indonesia	3.91	4.1	4.1	4.3	4.4	3.7	4.12
Ireland	5.47	5.3	6	5.7	5.9	4.6	5.5
Israel	5.1	5.9	5.8	5.5	6	4.5	5.54
Italy	3.57	3.5	3.7	4	4.2	4	3.88
Jamaica	3.51	4.5	5.3	4.3	5.1	3.8	4.6
Japan	5.26	5	5.6	5.6	5.5	4	5.14
Jordan	5.17	4.9	5.4	4.8	5.4	3.6	4.82
Kenya	3.45	4.4	4.8	4.7	4.6	3.8	4.46
Korea	4.54	4.1	4.8	4.9	4.8	4	4.52
Latvia	3.98	3.9	4.8	4.3	4.8	4	4.36
Lithuania	3.92	3.8	4.9	4.5	4.9	4.2	4.46
Luxembourg	5.78	4	5.7	5	6.1	4	4.96

(*Continued*)

Table AI

	Contracts and law index (1)	*Law protection of minority shareholders (2)*	*Strength of audit and accounting standards (3)*	*Effective-ness of bankruptcy law (4)*	*Regulation of security exchanges (5)*	*Prevalence of mergers and acquisitions (6)*	*Average (2)-(6)*
Macedonia	2.78	3.5	4.4	3.1	3.9	3.4	3.66
Madagascar	3.27	3.8	3.5	3.1	3.3	3.4	3.42
Malawi	4.33	4.8	5.1	4.5	5.1	3.4	4.58
Malaysia	4.91	5.4	5.6	5.2	5.3	5	5.3
Mali	3.88	4.6	3.7	4.5	3.6	3	3.88
Malta	5.05	4.9	5.5	4.1	5.5	2.8	4.56
Mauritius	4.13	4.2	5.1	4.6	5.2	3.5	4.52
Mexico	3.6	4.5	4.5	4.4	5.3	3.4	4.42
Morocco	4.65	4.5	4.5	4.5	4.6	4.7	4.56
Mozambique	3.11	3.7	3.6	3	3.7	3.3	3.46
Namibia	4.88	5.3	5.9	5.4	5.3	3.7	5.12
(The) Netherlands	5.78	5.2	6	6.3	6	4.3	5.56
New Zealand	6	6.1	6.2	6.3	6.1	5.4	6.02
Nicaragua	2.91	3.1	3.6	3.1	4.4	2.8	3.4
Nigeria	3.35	4.1	3.9	4	4.6	3.6	4.04
Norway	6.2	6.2	5.9	6.3	5.9	4.7	5.8
Pakistan	3.06	5	3.9	3.6	5.4	3.4	4.26
Panama	3.46	4.2	4.6	3.5	5.4	4.3	4.4
Paraguay	2.59	3.3	3	3.7	3.8	3	3.36
Peru	3.05	4.2	4.6	4.8	5.5	3.7	4.56
(The) Philippines	3.16	4.3	5.1	4.2	4.2	3.7	4.3
Poland	3.01	3.7	4.3	4.2	4.3	3.9	4.08
Portugal	5.31	5.1	5.1	4.8	5.6	4.4	5
Romania	3.5	3.7	4.1	4.2	4.4	4.1	4.1
Russia	2.95	2.8	3.8	3.2	3.3	4.5	3.52
Serbia Montenegro	3.09	2.8	3.5	3.1	3.5	3.7	3.32
Singapore	5.86	5.5	5.9	6.1	6	4.7	5.64
Slovak Republic	3.81	3.7	4.5	4	4.2	4.6	4.2
Slovenia	4.38	4.3	5	4.2	4.5	4.2	4.44
South Africa	4.8	5.5	6.2	5.5	6.2	4.8	5.64
Spain	4.58	4.5	4.9	4.7	5.1	4.2	4.68
Sri Lanka	3.88	4.4	5.2	3.8	5	3.8	4.44
Sweden	5.95	5.9	6.2	6.3	6	4.6	5.8
Switzerland	5.9	4.9	5.9	6.2	6.1	4.8	5.58
Taiwan	4.95	4.8	5.3	5	5.2	4.1	4.88
Tanzania	3.85	4	4.1	4	4.2	4.1	4.08
Thailand	4.42	4.7	5	4.8	5.1	4.2	4.76
Trinidad and Tobago	3.91	4.1	4.8	3.9	4.4	3.8	4.2
Tunisia	5.07	5.4	4.9	5.2	4.8	3.9	4.84
Turkey	3.88	4.1	4.3	3.9	4.8	3.7	4.16
UAE	5.19	4.6	4.8	3.7	4.4	2.7	4.04
Uganda	3.73	4	3.8	4.2	4.6	3.4	4
UK	5.96	6.3	6.6	6.6	6.6	6.5	6.52
Ukraine	2.65	2.6	3.6	3.2	2.9	4.2	3.3
Uruguay	4.74	4.1	3.7	3.6	4.3	2.9	3.72
USA	5.28	6.1	6.1	6.3	5.8	6.1	6.08
Venezuela	2.41	3.6	3.9	3.3	4.1	3.5	3.68
Vietnam	3.98	4.3	3.2	3.2	4.2	2.9	3.56
Zambia	4.06	4.5	4.2	4.1	5	3.5	4.26
Zimbabwe	3.08	4.9	5	4.7	4.7	4.1	4.68

Source: World Economic Forum (2004)

Table AII Perceived quality of firm-level governance

	Efficacy corporate boards (1)	Ethical behavior of firms (2)	Reliance professional management (3)	Average (1)-(3)
Algeria	3.8	3.7	4.5	4
Angola	3.2	2.5	3.3	3.00
Argentina	4.4	3.8	4.6	4.27
Australia	5.9	6	6.3	6.07
Austria	5.2	5.9	5.6	5.57
Bahrain	4.6	4.4	4.6	4.53
Bangladesh	3.8	2.9	3.6	3.43
Belgium	5.3	5.8	5.8	5.63
Bolivia	3.5	3.2	3	3.23
Bosnia	4	3.4	3.6	3.67
Botswana	4.5	4	4.7	4.40
Brazil	4.4	4.7	5.3	4.80
Bulgaria	4.2	3.8	3.6	3.87
Canada	5.5	5.9	6	5.80
Chad	3.1	2.7	2.5	2.77
Chile	5.1	5.5	5.3	5.30
China	4.1	4.2	4.7	4.33
Colombia	4.7	4.4	4.5	4.53
Costa Rica	4.5	4.6	4.5	4.53
Croatia	4	3.6	3.9	3.83
Cyprus	3.8	4.2	3.3	3.77
Czech Republic	3.9	3.8	4.8	4.17
Denmark	5.6	6.2	6.1	5.97
Dominican Republic	4	3.6	3.5	3.70
Ecuador	4	3.5	3.3	3.60
Egypt	4.5	4.2	4.7	4.47
El Salvador	4.7	4.4	3.7	4.27
Estonia	4.9	4.8	5.5	5.07
Ethiopia	4.2	3.4	3.6	3.73
Finland	5.7	6.3	6.3	6.10
France	5	5.6	5.6	5.40
(The) Gambia	5	4.1	4.8	4.63
Georgia	4.2	3.4	3.9	3.83
Germany	5.4	6	6.1	5.83
Ghana	5.1	4.4	5	4.83
Greece	4.2	4.2	4.1	4.17
Guatemala	4.1	3.5	3.6	3.73
Honduras	3.8	3.3	3.3	3.47
Hong Kong	4.9	5.1	5.2	5.07
Hungary	4.8	4.2	4.8	4.60
Iceland	5.2	5.7	5.8	5.57
India	4.5	4.1	5.1	4.57
Indonesia	4.2	4	4.6	4.27
Ireland	4.9	5.1	5.9	5.30
Israel	4.9	5.1	5.2	5.07
Italy	4	4	3.7	3.90
Jamaica	4.7	4.2	4.8	4.57
Japan	4.8	5.4	5.9	5.37
Jordan	4.4	4.5	3.9	4.27
Kenya	4.7	3.9	4.9	4.50
Korea	4.2	4	4.7	4.30
Latvia	4.6	3.9	4.7	4.40
Lithuania	4.7	4.6	4.5	4.60
Luxembourg	5.2	5.7	5.4	5.43
Macedonia	4	3.1	3.2	3.43
Madagascar	4.3	3.8	4	4.03
Malawi	4.5	4	4.6	4.37
Malaysia	5.1	5	4.9	5.00
Mali	4.3	4.1	3.7	4.03
Malta	4.3	4.4	3.7	4.13
Mauritius	4.4	4.1	4.2	4.23

(*Continued*)

Table AII

	Efficacy corporate boards (1)	*Ethical behavior of firms (2)*	*Reliance professional management (3)*	*Average (1)-(3)*
Mexico	4.4	4.2	4.3	4.30
Morocco	4.4	4.5	4.3	4.40
Mozambique	4.1	2.8	3.5	3.47
Namibia	4.6	4.4	4.9	4.63
(The) Netherlands	5.4	5.9	6.2	5.83
New Zealand	5.8	6.1	6.4	6.10
Nicaragua	3.8	3.5	3	3.43
Nigeria	4.8	4	4.7	4.50
Norway	5	5.6	6	5.53
Pakistan	2.9	3	3.6	3.17
Panama	4.3	3.9	3.6	3.93
Paraguay	3.7	3.1	2.8	3.20
Peru	4.2	3.8	4.1	4.03
(The) Philippines	4.6	3.7	4.6	4.30
Poland	3.9	4	3.9	3.93
Portugal	4.4	4.4	4.6	4.47
Romania	4.2	3.5	4.4	4.03
Russia	4.6	3.7	4	4.10
Serbia Montenegro	3.7	3.5	3.6	3.60
Singapore	5.4	5.9	5.7	5.67
Slovak Republic	5.2	4.1	4.8	4.70
Slovenia	4.5	4.3	4.6	4.47
South Africa	5.4	5.1	5.7	5.40
Spain	4.5	5.1	5	4.87
Sri Lanka	4.4	3.8	5	4.40
Sweden	5.2	6.1	6.1	5.80
Switzerland	5.3	5.7	5.8	5.60
Taiwan	5	4.9	5.2	5.03
Tanzania	4.5	3	4.3	3.93
Thailand	4.4	4.3	4.5	4.40
Trinidad/Tobago	4.5	4	4.8	4.43
Tunisia	4.1	4.8	4.2	4.37
Turkey	4.2	3.9	4.1	4.07
UAE	4.5	4.8	4.8	4.70
Uganda	4.4	3.9	4.1	4.13
UK	6.1	6.2	6.3	6.20
Ukraine	4.7	3.5	3.8	4.00
Uruguay	3.8	4.6	3.6	4.00
USA	5.6	5.8	6.2	5.87
Venezuela	3.9	3.6	4.3	3.93
Vietnam	4.2	3.7	4.1	4.00
Zambia	5.2	3.9	4.8	4.63
Zimbabwe	4.9	3.8	5.4	4.70

Source: World Economic Forum (2004)

Sustainability in the boardroom

An empirical examination of Dow Jones Sustainability World Index leaders

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Abstract

Purpose – *Although an extensive body of research treats the fields of corporate governance and sustainable development separately, less attention has been paid to the interaction between both fields. This paper attempts to bridge this gap by examining how corporate governance systems are evolving in order to integrate sustainable development thinking into them.*

Design/methodology/approach – *Drawing from corporate governance, sustainable development, and stakeholder theory literature, an analysis is performed of the governance systems of the 18 corporations that are leading the market sectors considered by the Dow Jones Sustainability World Index.*

Findings – *The results of our in-depth analysis of the 18 cases are presented and the sustainable corporate governance model that emerges from that analysis is proposed.*

Research limitations/implications – *This model does not attempt to question or replace the previous recommendation and frameworks suggested in the literature on corporate governance and codes of governance. On the contrary, the model should be viewed as a way of integrating sustainable development/corporate responsibility into the fabric of already existing governance models suggested elsewhere.*

Originality/value – *The suggested model seems to be a good framework both for managers and for researchers because it can be used to improve the firm's governance systems as well as a guide for future research on sustainable corporate governance.*

Keywords *Corporate governance, Sustainable development, Society*

Paper type *Research paper*

Introduction

In recent years, there has been a virtual explosion of interest in corporate governance. Corporate scandals and the need to protect minority shareholders' interests, for example, are some of the reasons behind the development of corporate governance codes in numerous countries and corporations. Most corporate governance codes offer recommendations to foster good corporate governance and increase transparency and disclosure (Mallin, 2002). At the same time, the concepts of ''sustainable development'', ''corporate responsibility'', and ''corporate citizenship'' have taken root in the business world. Although an extensive body of research treats the fields of corporate governance and sustainable development separately, less attention has been paid to the interaction between both fields. This paper attempts to bridge this gap by examining how corporate governance systems are evolving in order to integrate sustainable development thinking into them. We do so by analyzing the governance systems of the 18 corporations that are leading the market sectors considered by the Dow Jones Sustainability World Index (DJSI World). The

objectives of this paper are twofold: to analyze in depth how and to what extent DJSI World leaders are integrating sustainability into their corporate governance systems; and to develop a model for sustainable corporate governance based upon corporate governance and sustainable development theories, and built upon empirical research of the DJSI leading companies' corporate governance systems.

We start the paper by reviewing the literature on corporate governance systems. Our goal was to identify the elements of governance systems that are key determinants of their performance. In order to integrate the sustainability dimension in our research framework, we also consider the most important insights related to corporate governance systems from stakeholder and sustainable development theories (Freeman, 1984; Gladwin *et al.*, 1995; Bansal and Roth, 2000). Drawing from the aforementioned literatures streams, we identified those issues we should consider in our in depth research on the governance systems of DJSI World leaders. Next, we describe the research design and methods for the study. This is then followed by a discussion of the results of our analysis of corporate governance systems of DJSI World leading companies. In this discussion, we present the model of sustainable corporate governance that emerges from our benchmark study. We conclude by pointing out the limitations of our research and discussing the implications for researchers and practitioners.

Theory

Corporate governance systems

The literature on corporate governance systems follows four main approaches – agency theory (Jensen and Meckling, 1976; Fama and Jensen, 1983), the legalistic perspective (Williamson, 1964; Berle and Means, 1968; Mace, 1971; Budnitz, 1990; Bainbridge, 1993; Miller, 1993; Cieri *et al.*, 1994), resource dependence (Pfeffer, 1972, 1973), and class hegemony (Mills, 1956; Domhoff, 1969); their theoretical origins are, respectively, economics and finance, corporate law, organizational theory and sociology, and Marxist sociology. The agency theory views the modern corporation as a nexus of contracts between principals and agents (e.g. Jensen and Meckling, 1976) and has made valuable insights into many aspects of the manager-shareholder conflict (Daily *et al.*, 2003) and, as so, into the role of boards (Aguilera and Jackson, 2003). The legalistic perspective considers that boards contribute to the performance of their firms by carrying out their legally mandated responsibilities, that is to say, corporate leadership without actual interference in day-to-day operations (e.g. Williamson, 1964). The resource dependence perspective views boards as important boundary spanners that provide information to executives and are able to achieve resources for company operations (e.g. Pfeffer, 1973). Finally, the class hegemony perspective views boards as a means to perpetuating the powers of the ruling capitalist elite and its control of social and economic institutions (e.g. Mills, 1956).

Two of the issues that the aforementioned perspectives have tackled with have been the roles that boards of directors have to fulfill and the attributes these boards have to encompass in order to contribute to the performance of the firm. In Table I we summarize the attributes and roles considered by the four perspectives (Zahra and Pearce, 1989; Johnson *et al.*, 1996; Daily *et al.*, 2003).

Board composition denotes the size (number of directors), director types (inside and outside directors) and minority representation (ethnic minorities and females) (Hillman *et al.*, 2000). Board characteristics have two basic components – directors' background (age, educational background, values and experience) and board personality (Zahra and Pearce, 1989). Board structure refers to the dimensions of the board's organization, covering the number and types of committees, committee membership, and the flow of information among these committees and board leadership (Zahra and Pearce, 1989). Board process signifies the approach the board takes in making its decisions, embodying the frequency and length of meetings, the CEO-board interface, the formality of board proceedings, and the extent to which the board is involved in evaluating itself (Mueller, 1979; Vance, 1983). The strategy role refers to the board's essential contribution in formulating strategy and

Table I Attributes and roles of boards of directors

	Perspectives
Attributes	
Composition	Legalistic, resource dependence, class hegemony, agency theory
Characteristics	Legalistic, resource dependence, class hegemony, agency theory
Structure	Legalistic, agency theory
Process	Legalistic, class hegemony, agency theory
Roles	
Control	Legalistic, resource dependence, class hegemony, agency theory
Service	Legalistic, resource dependence, class hegemony, agency theory
Resource	Resource dependence
Strategy	Resource dependence, agency theory

monitoring its effective implementation (Baysinger and Butler, 1985; Kosnik, 1987). The service role involves enhancing company reputation, establishing contacts with external environment, and giving counsel and advice to executives (Carpenter, 1988; Louden, 1982; Pfeffer, 1972). The control role refers to the assessment of firm performance, evaluation of the CEO, and the definition of executive compensation policies (Brindisi, 1989; Brossy, 1986). The resource role implies the view of the board as a means for facilitating the acquisition of resources critical for the firm's success (Pfeffer, 1972; Pfeffer and Salancik, 1978).

Sustainable development and stakeholder theories

Although as we have just seen corporate governance is studied in the literature from different perspectives, agency theory plays a pivotal role. While producing valuable insights into many aspects of the manager-shareholder conflict, agency theory has overlooked important interdependencies among other stakeholders of the firm (Aguilera and Jackson, 2003). Thus, this dominant approach has impeded a profound analysis of new idiosyncratic relationships of today's firms.

Stakeholder theory posits that the capacity of a firm to generate sustainable wealth over time, and hence its long-term value, is determined by its relationships with critical stakeholders (e.g. Carroll, 1989; Donaldson and Preston, 1995; Freeman, 1984; Jones, 1995; Jones and Wicks, 1999; Mitchell *et al.*, 1997; Post *et al.*, 2002). In this theory, the corporation is defined as a socio-economic organization built to create wealth for its multiple constituencies. The stakeholders[1] of any firm are usually quite diverse, but relationships between the firm and each of its stakeholders have many common features; in addition, the stakeholders have common interests (as well as potential conflicts) among themselves (Mitchell *et al.*, 1997). According to this view, the critical challenge for contemporary management is recognizing the mutual interests among the firm and its stakeholders.

In the management field, sustainable development theory has attempted to broadly redefine the global societal role of the business corporation (Gladwin *et al.*, 1995; Sharma *et al.*, 1994; Shrivastava, 1995; Starik and Rands, 1995; Westley and Vredenburg, 1996). Researchers have proposed that our future lies in building sustainable enterprises and an economic reality that connects industry, society, and the environment (Hart, 1997; Senge and Carstedt, 2001). According to Elkington (1997), the firm's ultimate objective is not singular (create value for its shareholders) but rather three-fold (create economic, ecological, and social value). Therefore, the central value of the sustainable firm is not economic growth but rather sustainable development. Another stream of literature has made the attempt to demonstrate how firms might gain competitive advantage from sustainability strategies through efficiency cost savings and product stewardship (Hart and Ahuja, 1996; Porter and van der Linde,

1995; Shrivastava, 1995), acquisition of strategic resources and capabilities (Hart, 1995; Rodríguez *et al.*, 2002), and development of learning and dynamic capabilities (Hart and Sharma, 2004).

Following these theories and thoughts, we base our research on the DJSI World leading companies' corporate governance practices on two basic assumptions regarding the path towards sustainable development. First, firms must change their values, strategies and businesses models in order to embed sustainable development dimensions. Second, firms must open their boundaries through the establishment of a fluid, honest, and transparent dialogue with their stakeholders.

Methodology

Given the relatively new and unexplored nature of the phenomenon – how and to what extent leading companies are embedding sustainability in their governance systems – this study adopted an inductive research strategy (Eisenhardt, 1989) based on qualitative research techniques (Miles and Huberman, 1984). The objective was to conduct an analysis of firms leading the sustainability process in order to see how sustainable development was really affecting and changing corporate governance systems. In doing so, rather than conducting a statistical study to find out the ''average'', we wanted to see if a trend towards sustainable corporate governance exists as well as to develop constructs that facilitate future hypotheses testing (Eisenhardt, 1989). Thus, companies were not selected randomly. Rather they were chosen because they were recognized as sustainability leaders by the most renowned sustainability index, the Dow Jones Sustainability World Indexes (DJSI World). The DJSI World consists of more than 300 companies that represent the top 10 percent of the leading sustainability companies in 59 industry groups in the 34 countries covered by the largest 2,500 companies in the Dow Jones Global Indexes. This sample covers different geographical areas (Australia, Europe, Japan, and North America) and a wide array of industries, offering a rich diversity of corporate cultures. A selected sample of 18 companies constitutes the well-known group of sector market leaders[2]. These 18 companies represent the sample for our exploratory study[3].

We focused our research on the embedding of sustainability and stakeholder openness values in the attributes – composition, characteristics, structure and process – and roles – control, service, resource and strategy – in the DJSI leading companies' corporate governance systems. The research was conducted over a period of one year and involved triangulation among a variety of different sources of data (Yin, 1984) including analysis of companies' web pages and public reports, the answers to customized questionnaires sent to companies and the additional information gathered through the collaboration of Sustainability Asset Management (SAM) Research division.

Data collection involved several overlapping steps (Yin, 1984). Beginning in 2002, two MBA students and two research assistants conducted an exhaustive search of information on corporate governance using publicly available sources, namely internet web sites and company reports. Next, a questionnaire was prepared and sent to all corporations from the sample. The rate of response was 62.5 percent. We also relied on the valuable collaboration of SAM for completing this process and obtaining the remaining information. Besides, SAM's information allowed us to compare some results with a wider sample of almost 800 companies. This comparative analysis was especially useful to identify emerging practices. The information gathered from public sources was then compared and contrasted with the results from the questionnaires and SAM information in an exploratory fashion to enhance ''generalizability'' (Miles and Huberman, 1984).

Results

The analysis of the corporate governance systems of DJSI leading companies pointed to important results that we discuss below and led to the proposal of the sustainable corporate governance model[4].

Values

Values reflect beliefs about what is truly important. For this reason, the acceptance of values tightly coupled with the principles of sustainable development is essential for achieving real progress towards a sustainable organization. Although the companies in our sample tend to denominate these values with different names, we have used what we consider the most standard ones as a way to obtain meaningful results in our research. In Table II, we present the results.

As we can see, ''responsibility'' and ''sustainability'' are the most accepted core values with 12 companies embracing them, followed by ''integrity'' with 11. The values ''dialogue with stakeholders'' and ''diversity'' also have a wide acceptance with eight of the companies adopting them. Interestingly, we can see that ten of DJSI leading companies consider innovation as a core value. This can be interpreted as the importance of innovation for remaining competitive, but we can also infer that innovation can be considered as a sustainability driver.

Board composition and characteristics

Board members should have the skills, experience and capabilities required for developing as effectively as possible their specific responsibilities. In this sense, we might expect that leading sustainability companies have in their board-rooms members and executives who are capable of providing essential new viewpoints and expertise on sustainable development topics. At the same time, due to the novelty of the CR/SD[5] field, we wanted to find out if board directors receive some kind of induction training to improve their understanding of the implications of sustainable development for the firm.

Our results show that 13 boards are adequately conversant with and aware of the questions related to sustainable development. However, just four companies have formal training programs on CR for their directors. Table III shows the results of the composition and characteristics of the board.

Structure of the board

Considering the implications of sustainable development for the firm, it might seem reasonable that top corporate governance bodies have a board committee which, under the responsibility of one of its members, will be in charge of promoting, supervising and assessing the incorporation of these aspects in the firm's strategy and operation, and in the activities of its top corporate governance body.

We reviewed the board structures of the DJSI sector market leading companies looking for board committees with formal responsibilities in CR or similar (CR committees henceforth).

Table II Corporate values (18 DJSI sector leaders)

Values	*DJSI leading companies*
Sustainability	12
Responsibility	12
Integrity	11
Dialogue with stakeholders	8
Diversity	8
Innovation	10

Table III Composition and characteristics of the board

	Yes	*No*	*Not known*
One or more directors knowledgeable about SD	13	1	4
Induction training in SD	4	6	8

Our results show that ten companies have already appointed a CR committee to integrate sustainable development topics into their firm's strategy and operations. There are a higher number of board committees with only non-executives members than with executive and non-executive members, although the difference is not significant. We also observed that the firm's CEO is always present in the CR committees made up of executive and non-executive members. Mainly, CR committees are responsible of advising the board on SD/CR policies as well as evaluating and reviewing these policies.

Among companies without a CR committee we identified two systems that allow the board of directors to track the progress of the company towards sustainability: the integration of sustainability issues and CR policies in existing board or top management committees; and the appointment one director of the board with specific responsibilities in this field.

Considering all the different types of corporate governance structures and systems mentioned above, we can say that all companies except one have some type of governance structure that allows the board of directors to review, supervise and assess the firm's ''triple bottom line''. Table IV shows these results.

Comparing the different committees appointed by DJSI leading companies with all the companies analyzed by SAM (approximately 800 companies), we can observe that the biggest difference resides precisely in the appointment of CR committees (see Figure 1). Thus, the adaptation of the structure of the board to sustainability aspects turns into a fundamental factor for ensuring a better quality and depth of overall formulation and implementation of sustainability strategy. Furthermore, Figure 1 shows that DJSI leading companies always have better governance structures to deal with typical board responsibilities than ordinary companies[6].

Process of the board

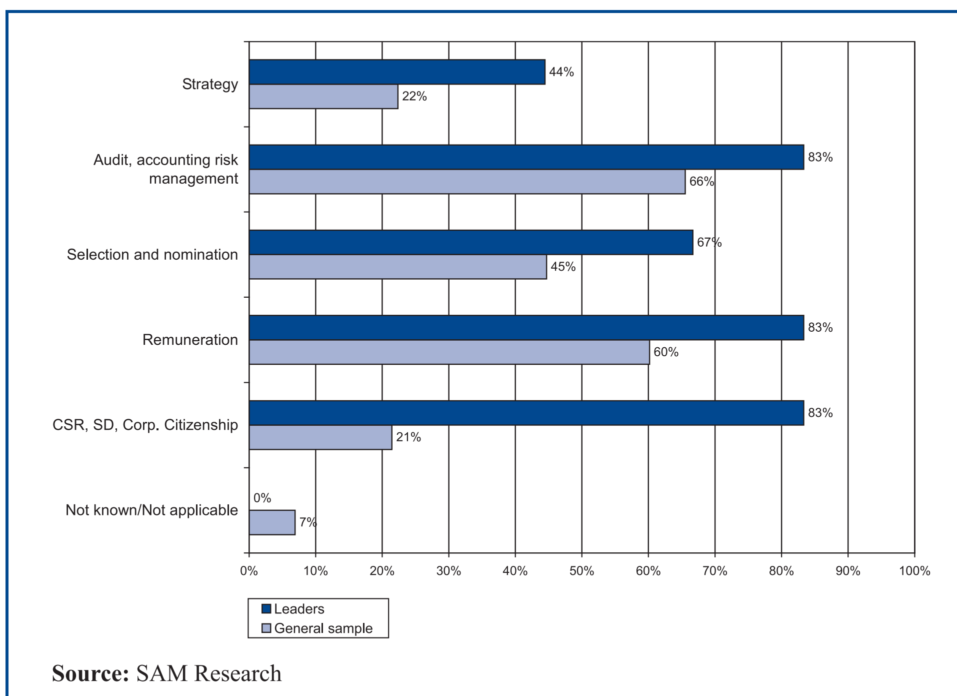
The board operations are working procedures that determine how the processes of information generation and sharing, decision-making and accountability, and distribution of resources and wealth are carried out. Because most of the aspects of sustainable development are quite new for most companies, it seems advisable for their top corporate governance bodies to regularly consider and prioritize these issues and good practices in their boardrooms. Thus, discussion of sustainable development and its implications for the firm should become routine among the board of directors of companies that have adopted sustainability as a core value and business driver.

Our results show that the frequency of meetings where sustainability policies are formally discussed varies from one to four times a year (see Table V). We should also mention that most companies state that sustainability is informally discussed often or at every board meeting because sustainable development is integrated into the way they do business and lies at the core of the firm's strategy. The agenda for each meeting is normally formalized one month before the meeting and information, whether or not related to sustainability, and is distributed one or two weeks in advance of the meeting.

Table IV Structure of the board for integrating sustainability into strategy

Governance structures			*Number of companies*
Formal CR board committee	Made up of only non-executive members	6	10
	Made up of executive and non-executive members	4	
Other governance structures	Integration of CR, SD in existing board/top mgmt committees	5	7
	Appointment of a board director with specific responsibilities in CR, SD	2	
Without any kind of structure			1

Figure 1 Appointment of board committees



Source: SAM Research

Table V Sustainable development in board meetings

Number of board meetings where sustainability strategy and policies are formally discussed	*Number of companies*
Once a year	4
Twice a year	4
Three times a year	3
Four times a year	5
Not known	2

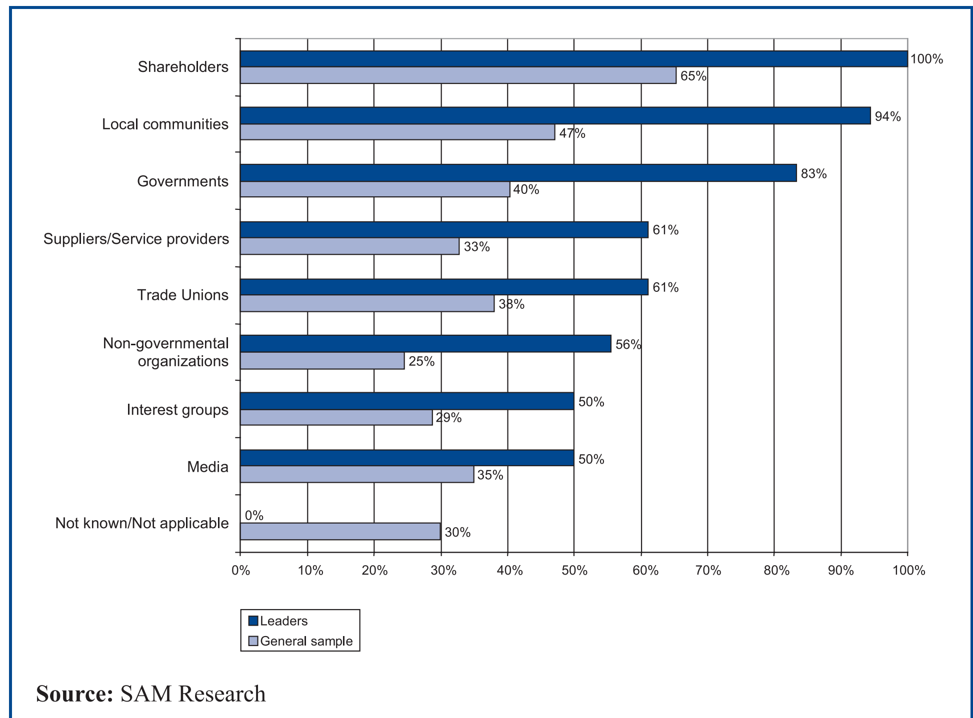
Regarding board CR committees, we observed that the frequency of meetings varies from two to four times a year. After each meeting the committee reports to the board on its activities and decisions. Furthermore, as some or all of CR committee's members are also board members, communication is secured through membership to both bodies. Other common communication mechanisms to inform the board of sustainability issues are: periodic updates to directors on all matters, including sustainability, and regular reports to directors on CR from internal executives committees.

Finally, in none of the companies analyzed is the invitation of external experts on sustainable development to board meetings considered a formal policy. However, based on the responses from the companies we contacted, we found that most of them are inviting external experts when they consider it appropriate.

Resource role of the board

As we explained above, the resource dependence perspective on corporate governance underlines the importance of the board and, as a result, of the characteristics of its membership, in assuring that the firm obtains the necessary resources through their linkages to the external environment. In Figure 2 we can see the answers provided by DJSI

Figure 2 Importance of stakeholder groups



Source: SAM Research

leaders and ordinary companies to the question ''to what extent are these stakeholders influencing the firm's decisions''[7].

The first interpretation that we can make from Figure 2 is that DJSI sector leaders are clearly more ''stakeholder-oriented'' than ordinary companies. In all cases, at least 50 percent of DJSI sector leaders consider the different stakeholder groups important for their businesses. For ordinary companies, on the other hand, only shareholders go beyond this percentage. These results confirm that the traditional company stills sees shareholders as the main stakeholder and other groups as less relevant.

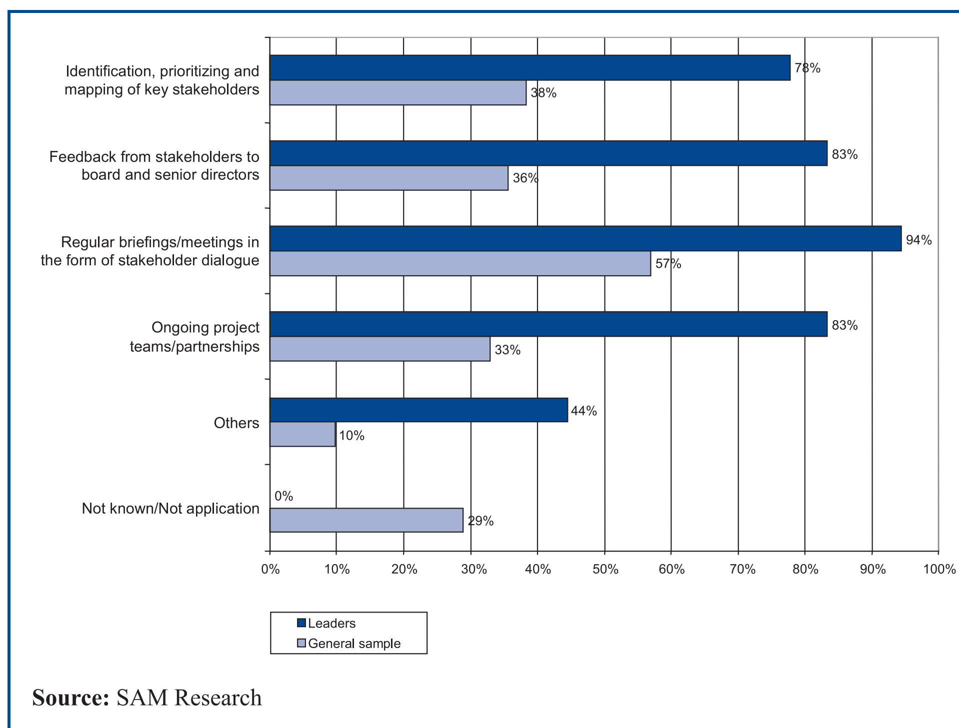
Dialogue mechanisms are those activities that allow the firm to interact with its stakeholders. Our research found that stakeholder dialogue is a common practice among DJSI sector leaders. Mechanisms such as stakeholder panels, meetings with local communities, forums with employees or suppliers, internet and intranet communication tools are just a small sample of different systems used to establish relationships with stakeholders.

Figure 3 groups these mechanisms into four categories and it shows that all of them are, unlike among ordinary companies, quite widespread among DJSI sector leaders. As we can see in Figure 3 and more specifically in Table VI, the direct involvement of board's members in this dialogue with stakeholders is a usual practice among leading companies. Nevertheless, only informal processes can be considered a widespread procedure. Since we can assume that the outcomes of formal processes of board's interactions with stakeholders have a greater impact in board's decisions and firm's strategy, it seems that this is an area that even leading companies are still starting to cultivate.

Strategy role of the board

As we stated in the literature review, firms must change their strategies in order to embed sustainable development dimensions; likewise, formulating strategy is one of the key roles of boards. As a result, one crucial role of top corporate governance bodies is to make sure that SD/CR is a key variable embedded in the strategy formulation process. Figure 4 depicts

Figure 3 Engagement processes with stakeholders



Source: SAM Research

Table VI Board interactions with stakeholder

	Yes	*No*	*Not known*
External advisory councils on sustainable development	7	11	0
External experts invited to board meetings	7	3	8
Formal responsibility of CR Comm./Chairman and/or CEO	8	10	0
Informal processes	15	1	2

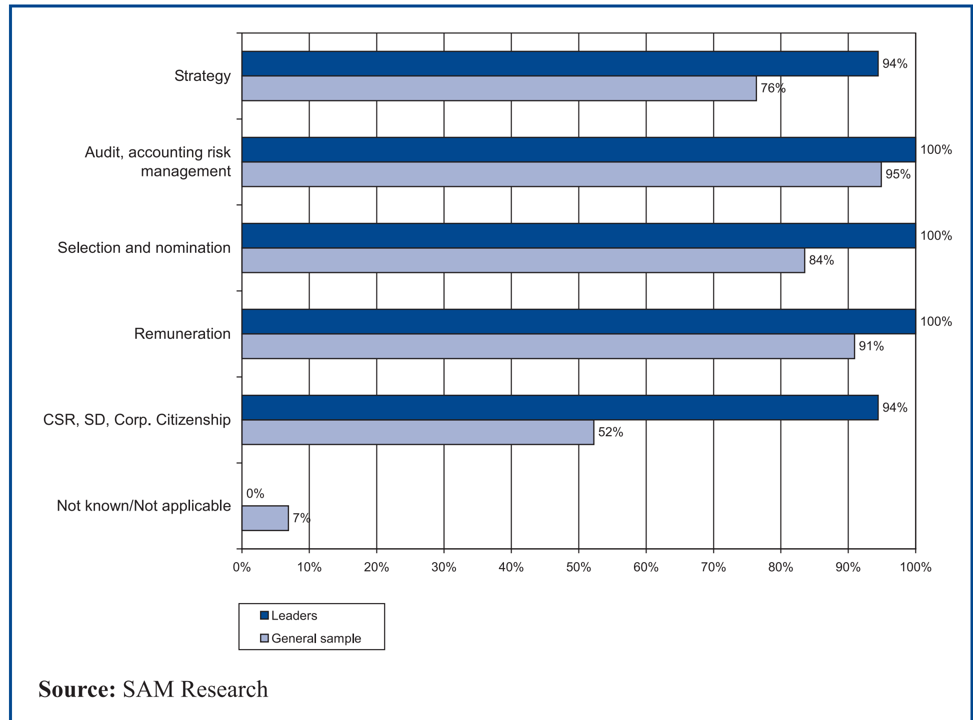
different roles that are formally taken on by the board of directors. Once again we can see how the biggest difference between DJSI leading companies and ordinary companies resides in the field of CR.

Only 52 percent of the ordinary companies consider sustainable development a responsibility of the board of directors, whereas a remarkable 94 percent (all but one) of DJSI leading companies consider this function a key responsibility of the board. We can obtain an interesting insight by comparing the results from this graph with the table of the structure of the board. In Table IV we found that only one company did not have any kind of structure to integrate sustainability into strategy. This is the same result that was found regarding the issue of ''formal responsibilities of the board of directors''. Therefore, we can infer that the structure of the board is a decisive factor for embedding sustainability into the firm's strategy.

Service role of the board

Most perspectives on corporate governance underline the importance of the service role of the board. Within the context of sustainable corporate governance, we expect that a key

Figure 4 Formal responsibilities of board of directors



Source: SAM Research

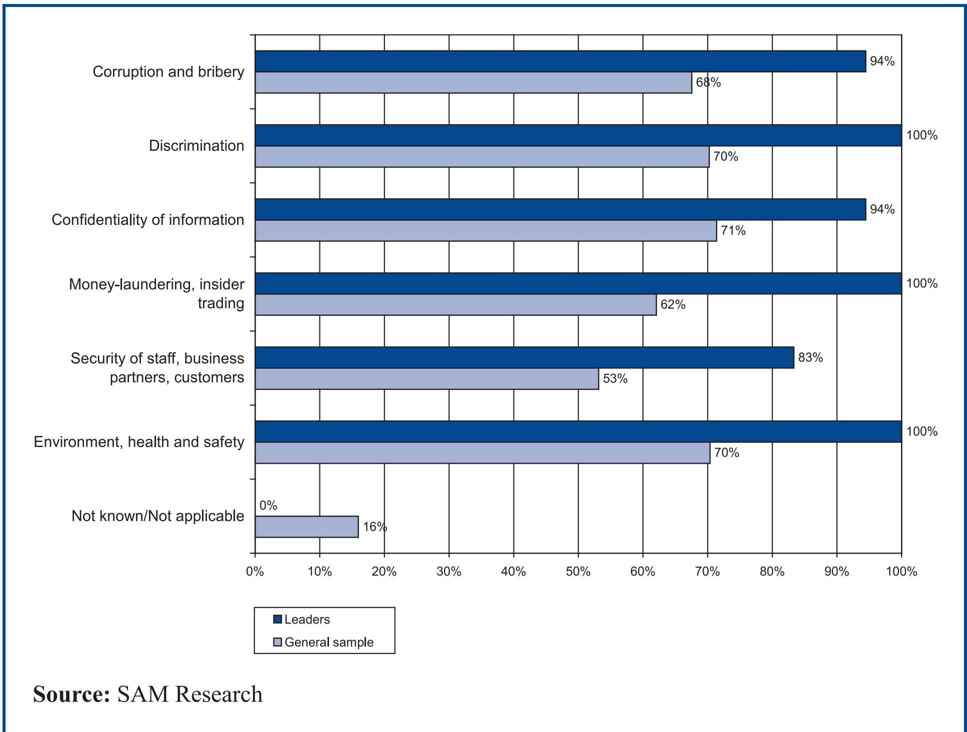
board's activity related to this role is to promote core values. In this section we discuss how the boards or any other department on behalf of the board of DJSI leading companies are internalizing corporate values, checking the level of awareness of these values, and promoting them externally.

Internalizing values. In order to achieve the acknowledgement of corporate values inherent in sustainable corporate governance, the formal declaration of values and principles in the form of a code of conduct is the most common mechanism used for this purpose. In Figure 5 we can observe how DJSI leading companies' codes clearly address ethical, social and environmental values and principles. The percentages are considerably smaller when taking into account the general sample. Some other tools exist to reinforce the understanding of the code of conduct or corporate values related to sustainability. Among these, we can find communication programs, training programs for managers and employees, and dedicated help desks and procedures for solving code of conduct concerns and doubts.

As we can see in Figure 6, the code of conduct is the most important tool for internalizing values. However, the use of systems to internalize the code of conduct across the organization is much more developed in DJSI leading companies than in ordinary companies. These are important results because unless there are clear systems to implement the code of conduct, this document has no impact on management and employees' behavior.

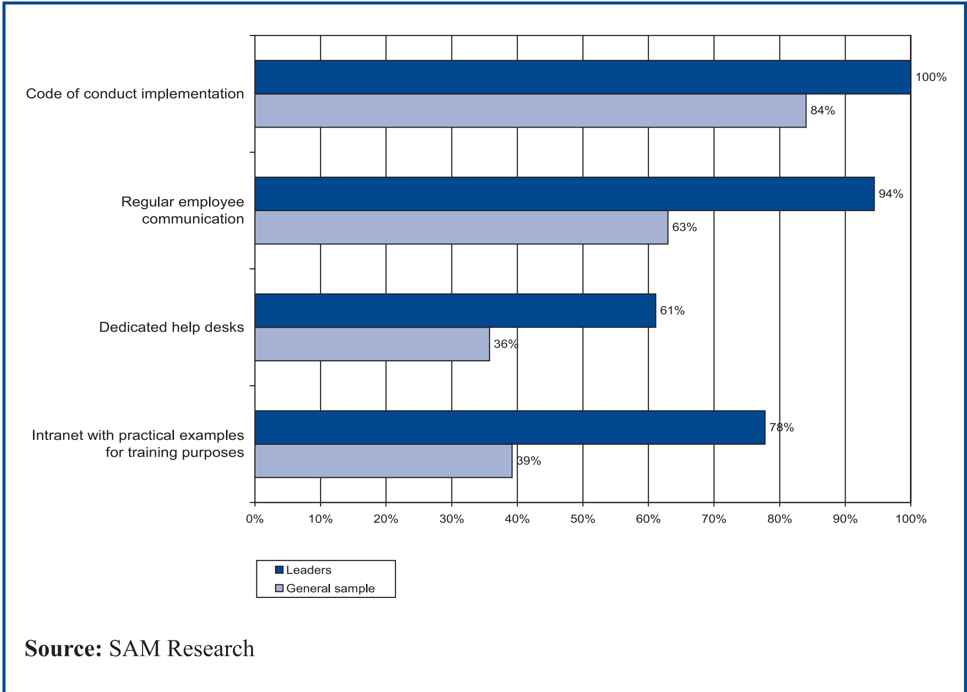
Checking the level of awareness of values. Whereas the code of conduct is a reserved power of, and is endorsed by, the board of directors in DJSI leading companies, the implementation programs are the responsibility of the business units or divisions. Figure 7 makes a comparison between DJSI leading companies and the universe of companies analyzed by SAM of the most common code of conduct's implementation procedures that we have observed.

Figure 5 Focus of codes of conduct



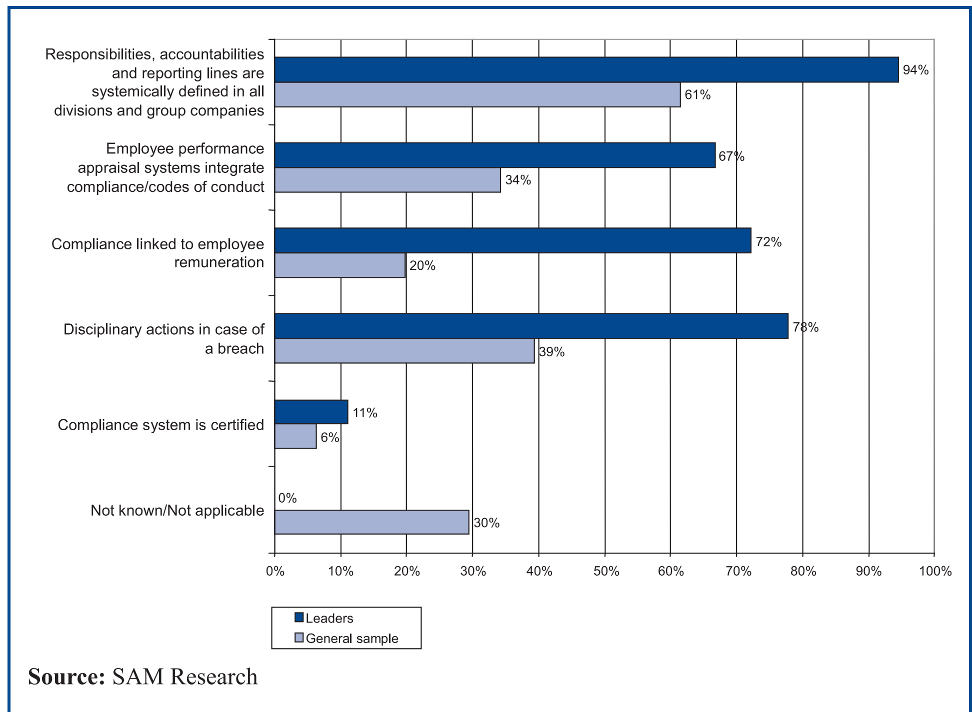
Source: SAM Research

Figure 6 Procedures for internalizing values and codes of conduct



Source: SAM Research

Figure 7 Implementation procedures of codes of conduct



Source: SAM Research

Comparing the results between these two groups of companies we can observe that DJSI leading companies are by far more advanced than ordinary companies. These results reaffirm the main idea that leading companies not only have declarations or statements on the importance of embracing new values in accordance with sustainability, but also has systems and procedures that ensure that all members from the company live up to these values.

Promoting values externally. The most extended and proactive way among DJSI leading companies to foster corporate values externally is the assessment of suppliers' accordance with social and environmental aspects. The development of a ''sustainable chain policy'' or ''sustainable supplier guidelines'' is discussed and endorsed by the board of directors or the board CR committees. Figure 8 depicts the results of social and environmental areas considered in the evaluation and selection of key suppliers. When comparing the results of DJSI leading companies with ordinary companies, we can observe impressive differences

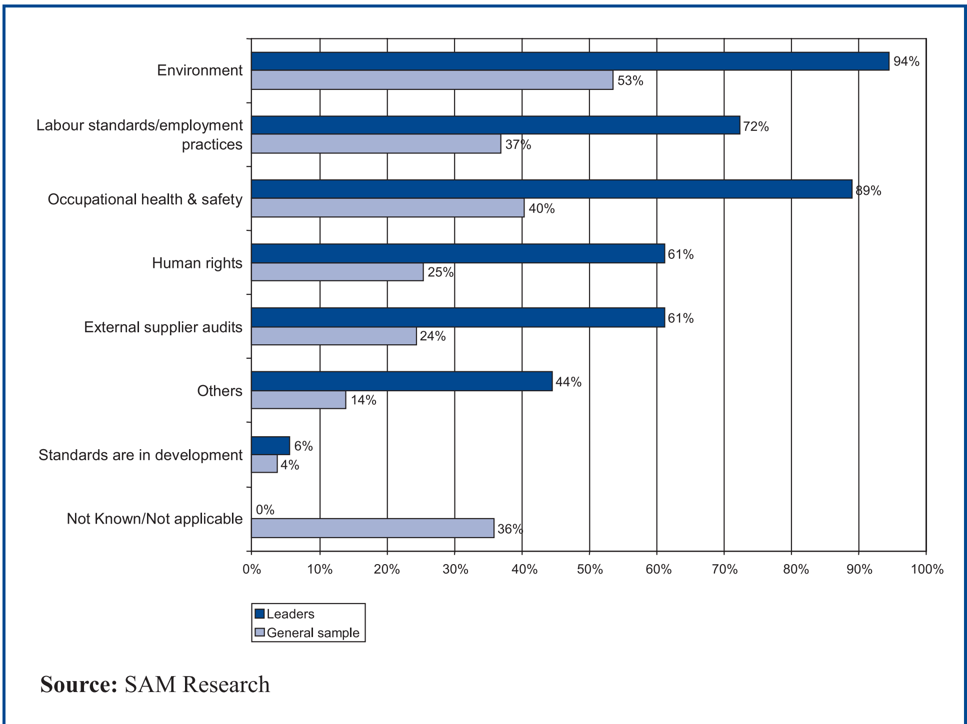
The sustainable chain policy can be complemented with some other activities or policies, such as the extension of some parts of the code of conduct to suppliers, the establishment of dialogue channels and training programs to improve the suppliers' sustainable performance, and the endorsements and support of international standards, such as the United Nations Universal Declaration of Human Rights[8].

Control role of the board

All the different perspectives on corporate governance agree on considering assessing firm performance a key role of the board. In our analysis of DJSI leading companies we focused on how their boards evaluated the performance of their firms from a triple bottom line perspective. Since the balanced scorecard (BSC) has become a standard tool, we analyzed to what extent leading companies are integrating sustainability objectives in their corporate BSC; that is to say, whether their BSC are rather Sustainable BSC.

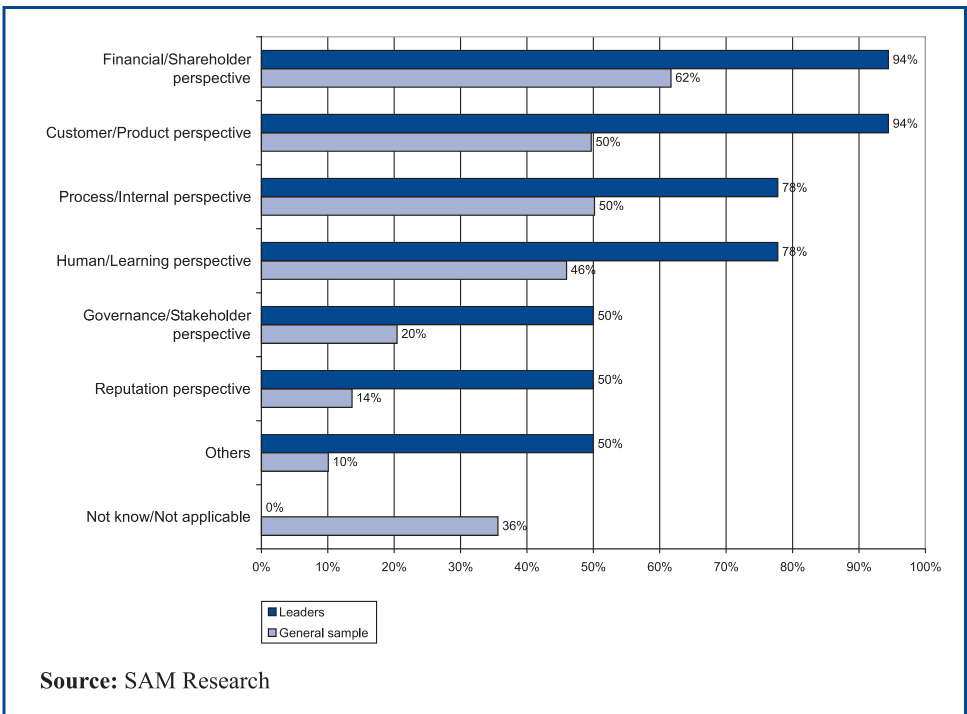
Figure 9 offers the results regarding the different perspectives of the BSC considered by companies. As we can see, the ''traditional'' perspectives (customer, financial, process and

Figure 8 Areas considered in the evaluation and selection of key suppliers



Source: SAM Research

Figure 9 Perspectives of BSC



Source: SAM Research

learning) have the biggest percentages both in DJSI sector leaders and ordinary companies. The inclusion of new perspectives is not yet a common practice. Only 50 percent of DJSI sector leaders have included new perspectives, such as governance/stakeholder and reputation. From the questionnaires we sent to DJSI leading companies, we conclude that the adaptation of the BSC to sustainable development dimensions is still in an embryonic stage.

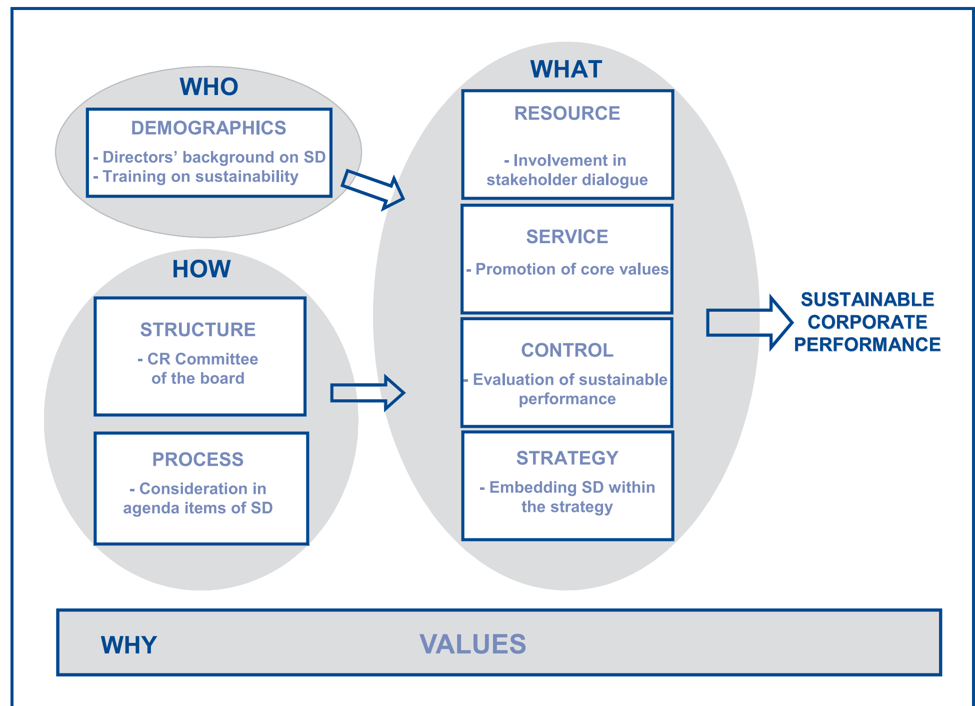
Sustainable corporate governance model

From our analysis of corporate governance systems of DJSI leading companies emerges the sustainable corporate governance model. As we can see in Figure 10, a governance system should give an appropriate answer to four key questions to contribute to the firm's sustainable corporate performance: who the board's members should be, what their most important roles should be, how the board should function to play those roles in an effective and efficient way, and why the board should do it.

Why? Values. In accordance with the sustainability requirements, the proposals of sustainability literature and the insights drawn from our analysis of DJSI leading companies, the ultimate and single goal of business should not be to create shareholder value but to endure contributing to the endurance of the larger system. This is only possible if the firm's value foundations are coherent with this view of the firm. Therefore, sustainability must be part of the nitty-gritty of corporate governance and infuse governance systems.

Who? Demographics. Since composition and characteristics are attributes so closely related, we have merged them under the label ''demographics''. One of the basic agreements of corporate governance scholars is that boards' members must have the appropriate knowledge, experience, skills, network, etc. to carry out their duties. As we have seen in our research on the governance systems of DJSI leading companies, their boards' membership hold a fine understanding of SD/CR requirements and challenges. They achieve this by including experts on these topics in their boards and, to a lesser extent, by providing training to their directors.

Figure 10 The sustainable corporate governance model



How? Structure and process. Most corporate governance codes propose the establishment of board's committees – such as audit, nomination, etc. – and underline the importance of board working procedures. As we have seen in our research, DJSI leading companies have adapted their boards' structure to tackle with SD/CR issues and consider them in their meetings in the same way as other more traditional ones.

What? Resource, service, control and strategy roles. Resource dependence, legalistic, agency theory and class hegemony perspectives on corporate governance propose, to a greater or lesser extent, control, service, strategy and resource as the key roles of governance systems. From our research on DJSI leading companies we have seen how these roles become definite when SD/CR is embraced by their top corporate governance bodies. As we can see in the sustainable corporate governance model, involvement in stakeholder dialogue (resource role), promotion of core values (service role), embedding SD/CR within strategy (strategy role) and evaluation of sustainable performance (control role) are the specific tasks that governance systems should undertake to promote sustainable corporate performance in firms.

Limitations and implications

Drawing from corporate governance, sustainable development, and stakeholder theory literatures, and based on our own research on the corporate governance systems of the 18 market sector leaders of the Dow Jones Sustainability World Index, in this paper we have presented the sustainable corporate governance model that emerges. In addition to this contribution, it is necessary to point out certain limitations of this study.

First of all, this is a benchmark study that focuses on leading companies' practices and aims to explore the future of corporate governance systems in relation to sustainability issues. As a result, we would like to emphasize that neither our study nor the emerging model attempts to represent the way in which the average firm is embracing sustainability in its governance systems. Rather, the objective of this work has been to shed some light on how sustainable governance systems could take shape in the near future.

Also, although it is legitimate to state that our sample of companies represents sustainable leading companies, this should not mask its limitations. The 18 companies we have analyzed in depth are the market sector leaders of the DJSI World. It is obvious that different market sectors represent different circumstances and, as a result, different experiences and sensitivities towards SD/CR. Because of that, we have found diverse approaches and degrees of commitment to SD/CR, a fact that also adds to the richness of the study.

Finally, the proposal for a model of sustainable corporate governance does not attempt to question or replace the previous recommendation and frameworks suggested in the literature on corporate governance and codes of governance. As we have explained throughout the paper, we have focused our analysis on governance practices related to SD/CR, not on good governance in its broadest interpretation. In this sense, the proposals for a committee on SD/CR or for directors' training on these issues do not imply that companies should not set up compensation and appointment committees, nor train their directors in accounting. On the contrary, the model should be viewed as a way of integrating SD/CR into the fabric of already existing governance models suggested elsewhere.

Reputation seems to be the main reason for most companies to consider SD/CR issues (World Economic Forum, 2003). Of course, reputation is a strategic asset and, as such, should be carefully managed. Nevertheless, to advance towards sustainability, society needs firms to adopt an approach towards SD/CR issues based more on innovation. Innovation is a way to build more sustainable, in the double sense, competitive advantages. Our analysis of DJSI leading companies and the sustainable corporate governance framework might be useful for those companies that, aware of the importance of sustainability and of their role in achieving it, are trying to incorporate SD/CR issues in their governance systems.

Notes

1. Post *et al.* (2002, p. 8) propose the following definition of stakeholders: ''The stakeholders in a firm are individuals and constituencies that contribute, either voluntarily or involuntarily, to its wealth-creating capacity and activities, and who are therefore its potential beneficiaries and/or risk bearers.''

2. The sample is composed by the following companies: 3M, British Telecom, CRH, Dofasco, DuPont, Lend Lease, Intel, Marks & Spencer, Novozymes, Pearson, Procter & Gamble, Severn Trent, Shell, Swiss Re, Teijin, Unilever, Volkswagen, and Westpac Banking.

3. The identification of sustainability leaders for the Dow Jones Sustainability Indexes is based on the corporate sustainability assessment of sustainability asset management (SAM) research. SAM research identifies those companies with the highest sustainability performance score for each sector market within the Dow Jones classification.

4. Due to space constraints, it is not possible to provide best practices from the 18 DJSI World leading companies. A collection of best practices and more detailed results can be found in the following book: Ricart, J.E., Rodríguez, M.A., Sánchez, P. and Ventoso, L. (in press). *The Sustainable Enterprise: Learning from DJSI Leaders*, Fundación BBVA: Bilbao.

5. Throughout the article we use indistinctly ''corporate responsibility'', sustainable development and their abbreviations CR and SD.

6. We tested the equality of the proportions between the results of DJSI leading companies and ordinary companies through a chi-square test. The test was done for all the variables in the nine graphs of this paper. According to our results, the difference between the variables are significant at $p = 0.05$ in all cases except in the following: ''selection and nomination'' (significant at $p = 0.1$), ''remuneration'' and ''audit, accounting and risk management'' in Figure 4; ''code of conduct implementation'' (significant at $p = 0.1$) in Figure 6; ''compliance systems certified'' in Figure 7; and ''standards are in development'' in Figure 8.

7. The customer group is missing from these results. However, our analysis of DJSI sector leaders shows that 100 percent of these companies recognize customers as a relevant group. We can assume that this percentage would also be close to 100 percent for ordinary companies.

8. The most common standards supported by DJSI leaders are: United Nations Universal Declaration of Human Rights, United Nations Global Compact, ILO Declaration of Fundamental Principles and Rights at Work, the ILO Tripartite Declaration concerning Multinational Corporations and Social Policy, and some other more specific standards depending on the firm's main business activity and location.

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Responding to global business critical issues

A source of innovation and transformation for FTSE 350 companies?

Jane Fiona Cumming, Neela Bettridge and Paul Toyne

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Abstract

Purpose – *The main aim of this research was to review which FTSE 350 companies were responding to social, ethical and environmental business-critical global issues such as climate change, governance and technology. If they were, did this response result in innovation and transformation? The 14 issues were identified by a range of business practitioners and experts through a visioning exercise.*

Design/methodology/approach – *Independent data analysis of the companies, excluding around 50 investment trusts, by SERM Rating Agency provided a sector review of how companies were innovating or transforming their business as a response to the 14 issues. This review identified 40 companies as being most active in demonstrating their response. Of these 40, further analysis identified ten companies that showed signs of innovation or transformation.*

Findings – *The identified ten companies demonstrated evidence of pilot business transformation (or incremental innovation towards transformation) as a direct result of responding to the issues. For example, a mining company's HIV treatment program for its workers in South Africa. Most approaches were characterized by a wide-ranging series of incremental changes, with no convincing examples yet existing of transformation implemented across the entirety of the company's operations. Hints of this radical direction, however, are evident from the vision statements of several organizations.*

Research limitations/implications – *The research methodology is dependent on publicly available evidence. However, the implication of the research findings is that the 14 issues identified can be viewed as opportunities rather than obligations. Realizing the opportunity relies on integrating the issues in the core strategy of the organization.*

Practical implications – *This paper provides insight for business strategists and practitioners into potential new ways of working by companies. It illuminates an emerging source of innovation and ultimately business transformation driven by the growing significance of world issues to implementing corporate strategy and delivering sustainable profit.*

Originality/value – *The value of this paper is in the insight it provides on how companies are finding a source of innovation through responding to global issues.*

Keywords *Organizational restructuring, Innovation, Social responsibility*

Paper type *Research paper*

Introduction

> Can you think beyond new products and new services to entirely new business concepts – ones that meet deep customer needs in unconventional ways? Can you think of unconventional ways of recharging an existing business concept? (Gary Hamel, 2000).

Changing environments

Companies face a complex and changing market and operating environment – from the impacts of global conflict to the technological leaps of the information age; from the

demographic challenges to world-wide health and education provision to the environmental impacts of climate change and water scarcity.

Multinational corporations and domestic business giants are increasingly expected by government and other elements of society to contribute to resolving these critical, yet apparently intractable, issues – a requirement recognized by parts of the business community in the 60 multi-sector partnerships announced during the Johannesburg Summit on Sustainable Development in 2002.

This business response is more than the responsive protection of corporate reputation. Leading companies recognize the importance of sophisticated (formal and informal) networks in the planning and delivery of appealing business solutions; and indeed, many multi-stakeholder partnerships may have unexpected and remarkable consequences, possessing the potential to transform the vision and strategy of the organization.

In this climate of complexity, innovative practice in relation to global issues – political, social, technological, environmental and governance-related – appears likely to become a central driver of competitive advantage in the coming decade.

Innovation

Peter Drucker's (1985) early contributions to the literature on business innovation assert that entrepreneurship lies in the careful analysis and exploitation of changes to a business and its external environment. Forget the ''popular picture of innovators – half pop-psychology, half-Hollywood'' that ''makes them look like a cross between Superman and the Knights of the Round Table''. Instead, Drucker suggests:

> Successful innovators are conservative. They have to be. They are not ''risk-focused''; they are ''opportunity-focused''.

In his book *Leading The Revolution* (Hamel, 2000) Gary Hamel confirmed that the basis of business innovation lies in a sensitivity to the radical changes of the business environment: that business concept innovation is ''a capacity to create new wealth-generating strategies – strategies that are as revolutionary as the time we live in''.

Article 13's research hypothesis was that a new model of innovation was emerging – that the concept was being ''recharged'' by the key challenges found within the social, environmental and ethical issues that form part of the CSR and sustainable development debates (see Table I). Enlightened business leaders are recognizing that commercial success requires them to address the current business-critical global issues, and in particular to understand and respond to the aspirations and expectations of a wide range of stakeholders – often groups that had traditionally been regarded as peripheral to the business.

Methodology

To test its hypothesis, Article 13 conducted a wide-ranging review into the history and prospects for the practice of sustainability-focused approaches to innovation. The first work phase reviewed the academic and business literature and press coverage for the major themes in innovation and social entrepreneurship.

This survey provided the basis for a round table visioning session with a number of business practitioners and specialists from the environmental, ethics, community-engagement and innovation fields to identify the key challenges facing the world – issues that provide a source of risk (and opportunity) for business in the next 20 years. The 14 issues business-critical global issues identified at the round-table are outlined in Table I.

Independent data from SERM Rating Agency was analyzed for the FTSE-350 companies (excluding the investment trusts) for evidence of management systems and business programs that sought to address a sample of eight of the 14 business-critical global issues that were identified at the round table: climate change; community; governance; health; sustainable production; technology; waste; and water.

Table I Business-critical world issues identified by Article 13

Global issues	Role (and expectations) of business?
Political	
Political agenda	Delivery of millennium development goals Public/private partnership
Conflict – and post-conflict	Responsible procurement and governance
Social	
Poverty – inequality	Generate secure employment Provision of food, shelter, health care, education and training Loans, micro credit
Education	Access to mentoring, capacity building and training
Health	Access, infrastructure for provision of health services Development and distribution of drugs Disease prevention Provide adequate health and safety program
Demographics	Family planning and education
Technological	
Technology – internet	Access to technology (computers) Use of technology/training/engagement
Ethics	
Governance – corruption, crime	Promote transparent governance Abide by the laws (but unfair and unjust laws) Reform of laws
Individual versus community versus global	Act local, think global, promote access of local services/products Staff involvement in the local community Partnership development Individuals working remotely Restructuring of board
Environment	
Climate change	Carbon neutral Energy efficiency and reduction, or switching to renewable energy
Water scarcity	Water recycling and reuse
Waste/reuse/recycle	Reduce waste, increase reuse and promote recycling – leadership Develop products with fewer materials, less energy
GMOs	Collect and communicate more information Implementation of precautionary principle
Cross-over	
Sustainable production and consumption (responsible consumerism)	Communicate benefits of sustainable production Improve labeling and communication of information of products Maximize efficiency of products and consider by-products Use components that have been produced in a socially and environmentally responsible manner

From the c. 300 companies (FTSE 350 less investment trusts), 40 leading organizations were then identified for an intensive case study review – a set of companies shown by the SERM Rating Agency research to be amongst the ''most active'' in demonstrating their response to the eight business-critical global issues.

Of the 40 companies, ten were featured in the final report, each of which demonstrated evidence of business transformation (or incremental innovation towards transformation) as a direct result of the companies' response to these global issues. The companies featured were: Anglo American; BP; BT; Centrica; GlaxoSmithKline; Kingfisher; Scottish Power; Tesco; Unilever; and Waste Recycling Group.

Results

Literature review and roundtable visioning

Through an extensive literature review and visioning exercise, Article 13 outlined the context for its research into business innovation. Key elements of this background – rooted in the challenges of (and changes to) business's operating environment – include:

- Organizations face a complex and changing market and operating environment – there is rapid and open movement of information and knowledge between societies; social and environmental catastrophes and inequalities persist; corporate boundaries are continually changing and companies are expected to contribute to resolving the critical issues facing society.
- In the 1990s, new tools and techniques in the measurement and reporting of social impact were led by overtly values-based businesses such as The Body Shop and Traidcraft. At the same time many mainstream companies also began to experiment, driven, for example, by public and campaigning organization pressure and in some cases subsequent regulation. A large proportion of these companies took a cautious approach to their activities and communication and sought to capture ad hoc benefits – reducing energy and raw material costs as well as environmental impact; reducing recruitment costs and improving productivity through higher levels of employee loyalty and commitment.
- Pressure for effective social responsibility management is slowly but surely becoming translated into standard commercial practice in the FTSE-350. Many of the quick wins – for example reducing costs from inefficient use of resources and improving employee loyalty – have been delivered and the on-going management processes have been mastered.

Data survey

Article 13's survey based on research from SERM Rating Agency (see Table II) demonstrates that corporate activity addressing the business-critical world issues is relatively consistent across all issues:

- Across ten industry sectors (FTSE Actuaries Industry Sectors), the average score per issue (on a scale of 1 to 10) ranges from 3.2 to 4.4.
- Health (4.4) and community issues (4.1) have the highest ratings.
- Companies performed more poorly on some long-standing environmental challenges (water – 3.2) as well as those issues that characterize the new environmental challenge (climate change and sustainable production – both 3.5). Scores on technology issues were also relatively poor (3.5).

The survey identified more significant differentials in performance on a cross-sectoral comparison, with performance strongest amongst utilities and non-cyclical consumer goods – industries facing regulatory and consumer pressure.

The utilities industry averaged a score of 8, performing strongly all issues including the environmental issues of waste and climate change.

Non-cyclical consumer goods businesses – including food, drink and healthcare companies – averaged 7 with strong scores on community (9) and health (8), The sector's scores were lower (6) for most environmental issues.

Table II Analysis of SERM Rating Agency research

Issues	*Resources*	*Basic industries*	*General industries*	*Cyclical consumer goods*	*Non-cyclical consumer goods*	*Cyclical services*	*Non-cyclical services*	*Utilities*	*Information technology*	*Financials*
	Mining Oil and gas	Chemicals Construction and building materials Forestry and paper	Aerospace and defense Electronic and electrical equipment Engineering and machinery	Automobiles and parts Household goods and textiles	Beverages Food producers and processors Health Personal care and household products Pharmaceuticals and biotech Tobacco	General retailers Leisure and hotels Media and entertainment Support services Transport	Food and drug retailers Telecomm-unication services	Electricity Other utilities	Hardware Software	Banks Insurance Life assurance Real estate Speciality and other finance
Climate change	4	4	2	3	6	2	3	8	1	2
Water	4	2	2	2	6	2	2	7	1	2
Governance	5	3	2	3	7	3	3	6	2	4
Technology	4	4	2	3	6	2	3	7	1	3
Waste	4	5	2	3	6	2	3	9	1	2
Community	5	3	2	3	8	3	4	8	2	3
Health	6	4	2	3	9	3	4	9	1	3
Sustainable production	4	4	2	3	6	2	3	8	1	2
Average	5	4	2	3	7	2	4	8	1	3

Note: Average FTSE 350 companies performance in demonstrating their commitment to addressing the Article 13 identified business critical world issues on a score of 10 (strong) to 1 (weak), categorized by FTSE Actuaries Industry sectors

The worst performing sector (averaging 1) was information technology. Other weak performers were cyclical services (2) and financial services (3).

Case studies

Article 13's subsequent case review of 40 companies took the analysis from the sector level to the practice of individual organizations.

Ten of the 40 businesses demonstrated evidence of significant innovation and potential transformation regarding the business-critical world issues (see Table III). As with the data analysis, community and health issues provided the most fertile area for business involvement. However, a number of programs addressing climate change and sustainable production were also identified.

Common aspects – relating to the companies' strategic positioning and operating environment – appear amongst the vanguard innovators. The ''early adopter'' companies of this new route to transformation frequently operate in consumer environments with supply chains and customer bases in volatile countries, with product and process issues that contain significant social, environmental and ethical risks, and where resolution of the issues requires high levels of collaborative problem-solving and high levels of current uncertainty (see Table IV).

Many approaches are currently cautious; pilot studies exploring the potential of new operating methods and alternative approaches to market. British Telecom, for example, decided in the autumn of 2003 to examine the potential of developing a wind-farm on its own land due to the absence of alternative ''green'' suppliers (see Table V).

This proposal was designed to break BT's historic methods of energy use and reduce costs – transforming the resourcing of the organization – as well as building its reputation by demonstrating the company's environmental awareness and responsibility.

Such apparently small-scale and piece-meal initiatives can represent part of a sustained and wide-ranging approach to the role of innovation in the delivery of competitive advantage – an incremental path to transformation. In the UK retail sector, Tesco, operating in a saturated market with limited opportunities to build new stores and a need for new and skilled staff, has piloted an approach to business development based on re-generation and social inclusion.

By developing what they term ''regeneration partnership stores'', the company has been able to contribute to the regeneration of deprived areas, quantifying the new jobs provided and improvements in diet. The regeneration stores are the latest in a series of Tesco's apparently phased initiatives ranging from procurement and supply chain management to customer information and staff incentive programs – collectively working towards sector leadership and transformation of its business processes.

The Tesco example also illustrates the critical role of partnership in enabling the implementation of complex projects and demonstrating sensitivity to the expectations of a wide range of stakeholders. The key to the effective delivery of the regeneration stores was

Table III The ten innovators: areas of innovation

Company	*Sector*	*Area of innovation*
Anglo American	Mining	Health and community
BP	Oil	Climate change
BT	Telecommunications	Climate change
Centrica	Energy sales and other consumer services	Community
GlaxoSmithKline	Pharmaceuticals	Health
Kingfisher	Retailer – department	General (process)
Scottish Power	Electricity	Community
Tesco	Retailer – food	Community
Unilever	Food processor	Sustainable production
Waste Recycling Group	Environmental control	Waste

Table IV Analyzing the innovators: the characteristics of the vanguard

Market and operating environment factors	*Companies indicating innovation*
High income/information-rich consumers	BP BT Kingfisher Tesco Unilever
Supply chain in developing countries	Anglo American BP Kingfisher Tesco
Products/services with direct and significant impact on critical social issues	Centrica GlaxoSmithKline Scottish Power
Market access and growth in developing/volatile countries	BP GlaxoSmithKline
Strong tradition of NGO pressure	BP GlaxoSmithKline
Branded products/services	Centrica Kingfisher Scottish Power Tesco Unilever
Business to consumer	BP Centrica Kingfisher Scottish Power Tesco Unilever
New technology industries	BP Waste Recycling Group

Table V Approaches to innovation

	Process innovations	*Product/service and channels to market innovations*
Incremental change	Anglo American's HIV treatment programs BT's wind-farm energy self-supply BP's shift to renewables Centrica's customer education Scottish Power's community learning Unilever's sustainable production procurement guidelines	GlaxoSmithKline's alliance with generic drug manufacturer Tesco's regeneration partnership stores Waste Recycling Group's new products from recycled waste
Transformation	Kingfisher's sustainability management process	Evidence only in vision statements currently

the use of a phased pilot approach that generated learning through partnerships with local government and community groups.

A series of local partnerships are equally central to the delivery of Scottish Power Learning, the energy company's educational program for work-place and life-skills. The program was

launched in partnership with the trade unions, extending its remit beyond Scottish Power employees to their families, retirees and also selected groups in the wider community – so contributing to the company's networks with key employment groups as well as building human capital in its operating regions. The program now draws on the skills and networks of the unions, governmental bodies such as the Learning and Skills Council, NGOs such as The Prince's Trust, and small enterprises such as the Cumbernauld Theatre.

Operating in politically sensitive and economically deprived communities, the mining company Anglo American is another company paying careful attention to groups outside its primary stakeholders. Anglo American's subsidiaries have worked in partnership with local medical groups and NGOs to implement a series of initiatives to address serious community issues. For example, Anglo Coal's HIV initiative has increased condom usage and treated sex workers and their clients. Anglo American's managed operations have extended anti-retroviral therapy at company expense to HIV positive employees progressing to AIDS; and the company has now recognized publicly that the extension of interventions beyond the workplace into communities associated with its operations is vital for its sustainability.

Centrica's UK energy business, British Gas, received unfavorable media coverage in late 2003 following the death of an elderly couple whose power supply had been disconnected. This public pressure will be a key test of its long-standing relationship with Help the Aged, a partnership designed to make the lives of the elderly warmer and less isolated. Interestingly, BBC coverage of the case included comments from a Help the Aged spokesperson, who said: ''I think the key issue here is that there is no system in place to flag up vulnerable people and though they [British Gas] knew there was vulnerability here they weren't able to tell social services,'' – her comments referring to the apparent implications of the Data Protection Act.

An innovative example of British Gas's partnership approach, looking beyond immediate delivery issues to the long-term health of its customer base, was its Benefits Advice scheme launched in December 2003. This pilot program is designed to address the confusion experienced by pensioners trying to understand the system of claiming benefits.

The formation of more unexpected relationships are also illustrated by the Article 13 review; the partnership may even be the critical innovation that creates a new market or transforms the costs and opportunity to access a new market, for examples the clinical trials alliance with a generic supplier announced by GlaxoSmithKline, the pharmaceuticals company.

Other case studies illustrate the creation of customer value through new products and services. An environmental services company, the Waste Recycling Group, has generated a series of environmentally beneficial production processes that create new green products. These include a green waste-composting alternative to peat-based products, and the recycling and recovery of organic content of household waste for use as soil conditioner.

The food processor, Unilever, has boldly embraced the sustainability agenda. As its corporate communications state:

> We are committed to contribute to sustainable development. We see this as a hard-edged commercial imperative because we will only be able to maximise shareholder value and prosper in the long-term if we operate in a much more sustainable way.

The multinational Unilever faces extraordinary challenges in translating its vision into reality. Its first step was to structure its initiatives across three areas where it has direct control and believes it can make a substantial difference: agriculture, fish and water. The agricultural program seeks to ensure continued access ''to the key agricultural raw materials, and ultimately to develop market mechanisms that allow consumers and customers to influence the sourcing of raw materials through their buying habits.'' Unilever's procurement innovation rests in the development of sustainability guidelines for its five key crops – palm oil, tea, peas, spinach and tomatoes – through a process of stakeholder engagement including a multi-stakeholder advisory board.

The global energy player, BP, has a similarly ambitious vision: ''to do no damage to the environment'' – a challenge that stimulates BP ''to find innovative ways to manage our

environmental impact at local, regional and global levels.'' BP's approach is multi-pronged, addressing climate change (through combinations of energy efficiency, flaring reductions and lower carbon products), biodiversity, water usage, waste and air emissions.

BP believes that gas will be the transitional fuel for several decades; yet a critical activity for the business, leading the gradual transformation to a position ''beyond petroleum'', is driven by BP's challenge ''to build a material and profitable renewables business'' based on solar and wind. BP emphasizes the use of solar power to reach the ''as much as one third of the world's population'' which is currently without access to electricity. It also advocates the role of partnership in delivery, working with global funding agencies, NGOs and private sector organizations as well as managing the training of local people to install and maintain the solar products.

Underlying the majority of the ten cases of innovation are leadership commitments to the creation of social, environmental and economic value supported by effective measurement and management processes – the tools and measures that help organizations to implement and deliver business transformation. An outstanding example of business process innovation is demonstrated by the retailer Kingfisher, which has introduced a ''ladder'' management model structured around a set of business-critical issues – a global agenda translated into the specific strategic challenges in the European home retail market.

Kingfisher's approach, published in detail in its plan for corporate social responsibility, is explicitly designed to enable different businesses within the group to innovate independently (reflecting their own market conditions) around a commonly accepted vision of the future challenges facing the organization.

Kingfisher's shared vision and ''ladder'' approach is already delivering incremental changes to the group's activity. The results to date have enabled the organization to share and report on best practice, so encouraging employees' individual creativity to think (and realize) the unthinkable. The test for the organization is whether these immediate successes can generate a step change from a price-focused retail tradition to a responsible and sustainable competitive edge.

The ten examples illustrate the range of approaches to socially-focused innovation: from a series of incremental changes to the fundamental alteration of a business's historic direction; from the creation of new products and services, to the formation of new partnership networks to develop and deliver the products and services, and to the introduction of new management processes that underpin the partnerships and product offer.

Several of the cases are small scale, the innovations still at pilot stage; yet a more important note of caution comes from the notable absence of evidence regarding the skills base and competencies of their organizations in terms of delivering the stated strategic objectives. It is these capacities that will be central to the companies' ability to identify and exploit the sources for transformation in response to business-critical world issues.

The emerging model – summarizing the Article 13 review

The Article 13 review illuminates an emerging model of innovation – a source of business transformation driven by the growing significance of world issues to implementing corporate strategy and delivering sustainable profit.

Current corporate responses to these business-critical issues are frequently limited to complying with legal obligations and other immediate stakeholder pressures. But a vanguard of companies is demonstrating significant evidence of innovating towards business transformation.

These strategic breakthroughs encompass innovations in product and service, the creation of new routes to market through partnerships and informal networks, and innovations in technology and business process – all backed-up by new strategic tools and measures to support forward-planning and measure progress.

Most approaches are currently characterized by a wide-ranging series of incremental changes, with no convincing examples yet existing of transformation implemented across the entirety of the company's operations. Hints of this radical direction, however, are evident from the vision statements of several organizations.

Partnerships are significant in building the credibility of many innovations, and can also be essential in providing the skills and networks required to deliver the innovation effectively. Other success factors for implementation include new strategic tools and measures to support planning and calibrate progress in previously unmeasured issues and themes. A collective approach to the measurement of these intangibles can have the knock-on effect of fostering a shared vision of transformation and delivering a demonstrable approach to risk identification and management.

It is Article 13's belief that the 14 business-critical world issues identified in its visioning exercise tie in with a growing recognition across society that commercial operations have an effect upon the natural and social world that impacts us all – as customers, investors, employees and members of local and global communities.

These social and environmental impacts have economic implications – from rising insurance premiums due to the effects of climate change to the shortage and increasing price of key resources such as fossil fuels, fish and timber, and to the shortage of landfill sites in the UK leading to tax and waste disposal costs.

And the economic effects are sharpening the awareness and investigation of how companies can use innovation to rethink their business and transform it for future success.

The early agents of change identified in the Article 13 research are straining beyond the immediate concerns of their business operations, carefully and imaginatively assessing the possible routes to creating value over the next ten to 20 years.

They face serious limitations – distrust and skepticism extending from the boardroom to the shop floor, from the stock market to town halls and parliaments. Yet these companies are seeking to overcome skepticism with practical results – they are daring to think the unthinkable, work with the unexpected and create the unknown.

These pioneering companies (and the entrepreneurial individuals within them) have grasped the notion that the risk of staying the same is greater than the risk of changing – signs of innovation at work.

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Strategy

A CSR framework due to multiculturalism: the Swiss Re case

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Abstract

Purpose – *Owing to the fact that the concept of ''CSR orientation in different cultural settings'' is still quite unexplored, both in CSR theory and in empirical research the paper aims to contribute to the question of how corporations can deal with different CSR orientations when they perform their activities in different cultural settings*

Design/methodology/approach – *Theoretically, the analysis is based on two well-known corporate social responsibility (CSR) approaches: first, reference is made to Carroll who reflects the economic paradigm as the basic layer of a pyramid in all cultural settings as economic responsibility and, on the opposite side, to Kang and Wood who give priority to moral and social responsibilities aligned to the difference of cultural settings. Based on the comparison of these theories in addition to a qualitative case study in the reinsurance industry some practical insights will be provided into and managerial implications developed regarding how to respond to the challenges of corporate responsibility due to multiculturalism.*

Findings – *It is claimed that corporations which follow a CSR understanding corresponding to the pyramid of Kang and Wood are better prepared to deal with differences regarding CSR orientation in different cultures compared with corporations that are based on the thinking of Carroll's pyramid.*

Originality/value – *Changing societal concerns and different local expectations across various countries, in the context of instantaneous world-wide communication, have strongly increased the exposure of corporations to external criticism and challenge. These effects are intensified for large multinational firms, where complex interactions among distant and diverse constituencies have become commonplace. Broad societal concerns challenge the core strategies of corporations and require strategic responses. But this important strategic challenge response process cannot be analyzed within the traditional views of the firm. Therefore, a paradigm shift is asked in corporate responsibility.*

Keywords *Social responsibility, Culture (sociology), Case studies, Reinsurance*

Paper type *Case study*

Frame of thinking

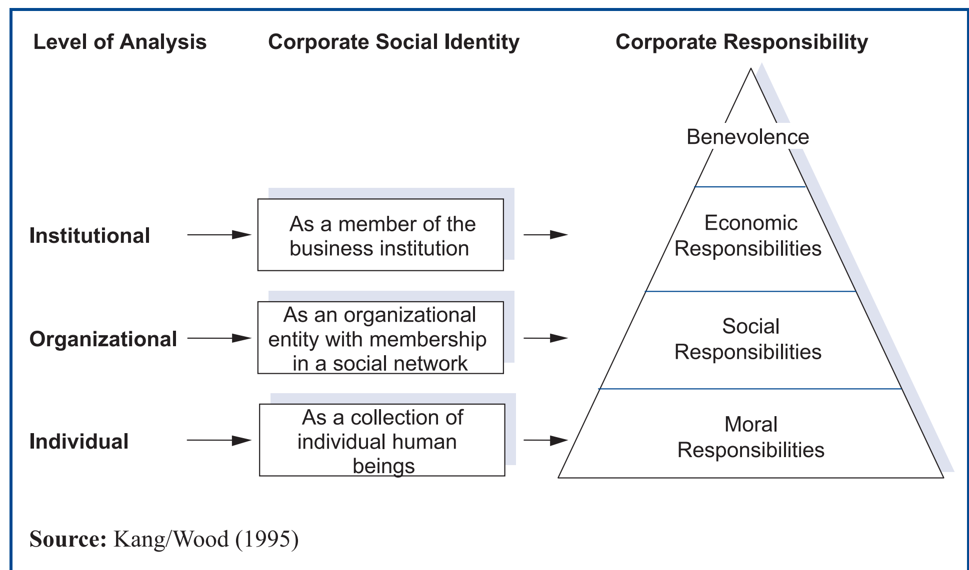
Corporations and their role are challenged by societal expectations due to multiculturalism[1]. In order to contribute to this challenge of how corporations can deal with different CSR orientations when they perform their activities in different cultural settings our analysis is theoretically based on the comparison of two well known corporate social responsibility (CSR) approaches by Carroll (1979, 1996) (see Figure 1) and Kang and Wood (1995) (see Figure 2).

Probably the best known concept of ''corporate social responsibility'' is the one by Archie B. Carroll (first published in 1979, afterwards especially 1996) who reflects on the economic paradigm as the basic layer of a pyramid in all cultural settings as economic responsibility. Carroll depicts the complexity and the categories of a broadly interpreted corporate responsibility in a pyramid that also shows the development of increasing firm responsibilities over time.

Figure 1 The pyramid of corporate social responsibility

Source: Carroll (1996)

Figure 2 Level of analysis, corporate identity, and corporate responsibilites



Source: Kang/Wood (1995)

On the first level of Carroll's responsibility pyramid – which is in accordance with the classical economic idea of Smith – the pure economic responsibility of the firm dominates as the market's famous ''invisible hand'' automatically turns individual into common interests. Milton Friedman is often mentioned as an economist who still represents this theory. In his book *Capitalism and Freedom* he wrote (Friedman, 1962, p. 133):

> 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 is it stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud.

Friedman concludes (Friedman, 1962, p. 134):

> Few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible.

Friedman especially dislikes the term ''social'', which to him is politically associated to socialism. When taking a closer look, one can see that his opinion is not merely economically-technically oriented but presupposes moral responsibility in the shape of fairness as the first part of the quotation proves (cf. for example Carroll, 1991; Clarkson, 1995).

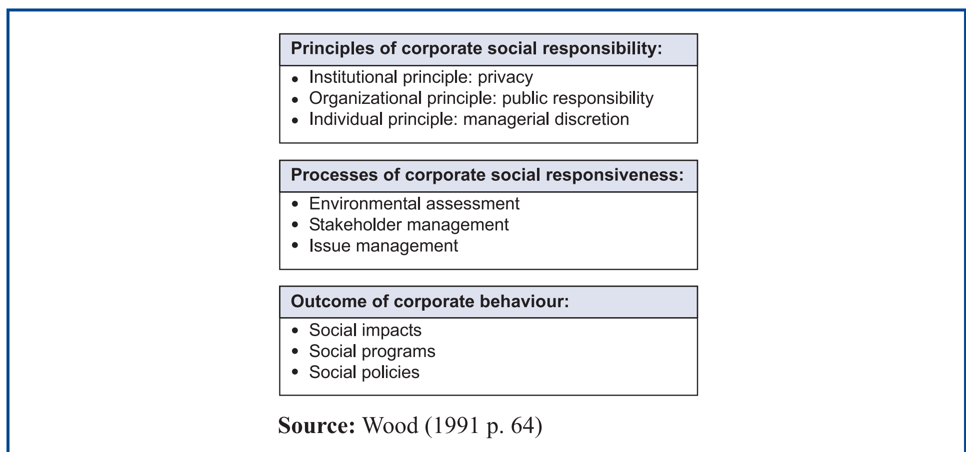
The following period and consequently the following level in the responsibility pyramid by Carroll is characterized by legislation. In this period a strong increase in the regulation of corporate activities can be observed, caused by the enormous growth of firms and the increasing complexity of the market. The legally regulated responsibility includes a partial ethical responsibility as legislation reflects the norms that are founded in society. Ethical responsibility as a whole also includes all those norms that are not legally founded but are still sanctioned by society responsible societal groups. The philanthropic responsibility as the final level of the responsibility pyramid and the following development phase in the discussion on corporate responsibility exceed the legal and ethical responsibility as they also include corporate commitment which increases societal wealth and is based on voluntary behavior on the part of the firm.

Wood (1991) criticizes Carroll's approach of steps and phases of responsibility as she regards the responsibilities defined by Carroll as delimited and therefore also as isolated domains. According to Wood, Carroll succeeds in differentiating the interactions between firm and society but he also neglects their interconnectedness that would be required in reality. For this reason, Wood superimposes the responsibility categories of ''corporate social responsibility'' with three levels of analysis and allocates principles to them in her interpretation of ''corporate social responsibility''.

The principle of legitimacy becomes effective on the ''institutional level'' which advises the corporation to justify itself *vis-à-vis* society, i.e. it must not use its power without justified reason. On the ''organizational level'' the principle of ''public responsibility'' means that the firms are responsible for the consequences of their actions which affect society directly or indirectly. Finally, on the ''individual level'' it is important that managers are constantly aware that they ought to act according to moral points-of-view.

Wood even turns Carroll's responsibility pyramid upside-down to achieve the interconnectedness of corporation and society. Simultaneously, she allocates the pyramid three levels (Figure 3):

Figure 3 Corporate social performance



Source: Wood (1991 p. 64)

> This figure proposes that the moral responsibilities of individual managers to make ethical choices are the most basic of CSR components, followed by the organization's obligation to obey social and legal norms. If these CSR conditions are met, the firm is then free to make a profit (Kang and Wood, 1995, p. 414).

By defining a common basis for corporation and society based on the individuals' moral responsibility, Wood wants to prevent the firm from being severed from society. Wood, on the contrary, wants to express the inescapable interconnectedness of corporations with society. She therefore follows a similar argumentation as Evan and Freeman (1987) or Bowie (1998), who refer to the following statement by Kant made in *Kritik der Praktischen Vernunft:*

> That in the order of ends, man (and with him every rational being) is an end in himself, that is, that he can never be used merely as a means by any (not even by God) without being at the same time an end also himself, that therefore humanity in our person must be holy to ourselves, this follows now of itself because he is the subject of the moral law, in other words, of that which is holy in itself, and on account of which and in agreement with which alone can anything be termed holy. For this moral law is founded on the autonomy of his will, as a free will which by its universal laws must necessarily be able to agree with that to which it is to submit itself (Kant, 1995, p. 209).

In this perspective, economic laws cannot be given priority if they infringe the free will of human beings and are therefore regarded as a means and not as a purpose. Bowie (1998) accentuates this correlation in the following quotation:

> The standard economic text treated human capital (employees, a major stakeholder group of the firm) not differently from any other kind of capital. It did not recognize that humans possessed characteristics that the other forms of capital did not and as a result the standard economic text did not instruct managers to treat human capital differently. The standard economic text gave instructions to managers that violated the respect for persons formulation (Bowie, 1994, pp. 7-8, cf. also Bowie, 1998).

Comparing Carroll's and Wood's approaches, we claim that corporations which follow a CSR understanding corresponding to the pyramid of Kang and Wood (1995) are better prepared to deal with differences regarding CSR orientation in different cultures compared to corporations that are based on the thinking of Carroll's (1991) pyramid. In the following paragraphs we will evaluate our proposition based on a case study of Swiss Re.

Empirical investigations

The lack of theoretical understanding and empirical results in cross-cultural CSR research might be caused by the fact that cultural settings are a very complex social phenomenon with no clearly evident boundaries to their context. Taking the high degree of complexity of real life situations into account, a qualitative approach seems to be appropriate to answer the proposed research questions. Particularly case studies are such a qualitative approach considered to incorporate a comprehensive perspective[2]. Therefore we adopted the method of single case studies and focused on the reinsurance corporation Swiss Re in order to investigate the possible CSR orientations in different cultural settings. In our investigation, we first analyzed external and internal material on the CSR orientation of Swiss Re setting the basis to conduct semi-structured interviews (Yin, 1994) with Swiss Re's representatives who are involved with CSR related tasks[3].

Case study

Today the Swiss Re Group is one of the world's leading and financially strongest reinsurers with roughly 9,000 employees. Swiss Re is a salient example of a knowledge-based company through its strong endeavor of being market leader in capital and risk management. Against this background sustainable stakeholder relations represent a key strategic factor in a value creation perspective (as risk bearers/providers and resource bearers/providers) and stakeholder interactions are justified by their value creation potential. From our analysis we identified shareholders, employees and clients as traditional stakeholders of Swiss Re and regulators as an upcoming strategic stakeholder in the near future. Several events[4] have heavily influenced Swiss Re's development and its relationship to stakeholders since its foundation in 1863. In its history Swiss Re has repeatedly shown a strong openness and ability to change through its proactive attention to new economic, social and environmental trends

based on its knowledge orientation. During the last decades, the most important event to Swiss Re was globalization, which had strong impacts on the strategy, structure, and culture of Swiss Re and more specifically on its interactions with stakeholders. Swiss Re started a massive globalization effort in 1990, which implied new challenges (and risks) linked to the fast-growing movement of products, services, people and capital across the globe. The most important consequence of the globalization over the past decade has thus been Swiss Re's transition from a diversified Swiss company to a global player with three different cultures (US, Europe, Asia), a divisionalization structure, broken down into three business groups (life and health, property and casualty, financial services), and a switch from diversification to a focused M&A strategy.

Whereas the solid financial structure allowed Swiss Re in the past to follow a before-profit CSR strategy (Kang/Wood), Swiss Re presently considers cost savings as crucial, given the expectations of the investors and the strong market competition and therefore moves towards stronger after-profit and economic based CSR strategy (Carroll). This change in CSR strategy was released by the strong influence of the Anglo-American culture coming up through the globalization activities and challenging Swiss Re in three dimensions: the identity preservation and adaptation, the resource perspective and Swiss Re's positioning in the industry and in its stakeholder network. Swiss Re has to take care of the pressure of this economic globalization and the impacts on its CSR strategy. On the other side globalization also means the confrontation with locally different values and expectations of its strategic stakeholders (shareholders, employees, customers, regulators). CSR in this situation means that Swiss Re, in addition to its basic values, has to take into account these local differences and in addition to this, Swiss Re, as a knowledge-based company, has to consider the local particularities to fully exploit its strategic potential. As a multicultural focus is crucial in this knowledge-based business, Swiss Re has to consider ''multiculturalism'' as being a core value with which to guide interaction with strategic stakeholders in the different cultural settings. This impacts the understanding of corporate responsibility as managerial implications.

In the following paragraphs we will try to highlight the impacts of this movement on these three dimensions referring to statements of the interviewed persons and show up the advantages of a social sciences-based CSR orientation on Swiss Re's ability to change.

Identity preservation and adaptation

The changes in culture and stakeholder orientation we are referring to in the following paragraphs have been supported to a great extent by Swiss Re's acquisition strategy with its strong focus on an expansion into the North-American market.

The fact that most of the M&A activities were based in the US the American culture had a strong influence on the former culture of Swiss Re which was Swiss dominated. The Zurich culture has weakened as a result of the general trend of European companies towards short-term financial success, while key positions have been assumed by Anglo-Americans (CEO John Coomber, from the UK, and CFO Ann Godbehere, from Canada) setting up a new dimension of moral responsibility and giving the established core values (efficiency, excellence, sustainability and integrity) a new weighting or integrating new core values (e.g. multiculturality). This ''Americanization process'' is reinforcing economic aspects, like ''efficiency'', not only in business but also in the relationship with stakeholders as the following citations will proof:

> There was also an Americanization process: the emphasis was placed much more firmly on the development of business and on business results. All of a sudden, everything became far more transparent – what our financial goals were, and also where we stood in relation to those goals.
>
> Efficiency is an important factor in the relationship with stakeholders. It seems to me that the benefit for both sides has become much more pronounced than it was in the past. I myself know nothing about that past, because I joined the company just as these mergers and acquisitions were happening. So I simply noticed that there had been a minor earthquake as regards the way we deal with our stakeholders.

The transformation of the ''efficiency'' orientation to the stakeholder relationships implies the potential risk, that if stakeholder relationships are not ''efficient'' enough they are only relevant in a specific region (market). Swiss Re has adopted a multicultural approach: remarkable cultural differences exist between the European (Zurich), Anglo-American and Asian cultures, challenging the new core value of ''multiculturalism''. Swiss Re has developed a three-layer culture covering the corporate, the divisional and the regional levels whereas the Swiss Re culture at corporate level used to predominate as we were able to see in the underlying study. The interview partners often mentioned that the Anglo-American culture gained great influence in this process, especially within the business unit Life and Health that has grown in the last ten years mostly due to the Anglo-American acquisitions:

> I think the efficiency and performance mean different things to different business groups. We are very much more Americanized in the Life and Health business group. We have a lot of very positive commercial trades of American position in Life and Health. On the P&C side, we are very much more a Swiss company.

There are some uncertainties about the growing Anglo-American influence, mainly the shift from an employee- and client-oriented culture to a cost- and performance-oriented one that favors shareholder and investor relations.

At divisional level, cultural differences arise from the different nature of business carried out by the three business groups, which in turn influences client, employee and regulator relations. In addition, there is a need for core values to be interpreted at a regional level. This makes for a stimulating sense of diversity but is not always without tensions.

On its way to a global company Swiss Re is also searching for a balance between identity preservation on the one hand and adaptation to the new cultural influences caused by the implementation of new cultures through M&A on the other hand. As we were able to see in the analysis of its history Swiss Re's openness to change allows it to react to the latest events. This shows that on the one hand the company has a strong sense of adaptation. On the other hand, internal pressures often stabilize and strengthen the persistence of past selection criteria, thus enhancing identity preservation. Swiss Re's identity preservation is primarily based on upholding and interpreting its core values. The consistency of core values over time among different business units and in different geographic regions is considered as very important. Although Swiss Re's transition process is still under way and we can observe a struggle in the search for a balance between adaptation and the identity preservation of the old ''Schweizer Rückversicherung'' and the future ''Swiss Re''. Thereby, key persons play an important role. They have an important influence on culture and cultural changes.

This leads to the following insight:

> A social science based CSR orientation (Kang and Wood, 1995) impacts also managers' selection processes and development. In a firm acting in a multicultural setting the management team can no longer be recruited from the home country representing one dominant culture. It has to be purposefully selected from different cultural regions. Top-level managers should also have experiences in different cultural settings to balance the challenges of identity preservation and adaptation.

Following this insight, Swiss Re recruits not only top management with multicultural setting experiences but also enforces this experience by international exchange. Furthermore, in Swiss Re's top management there are representatives of the Zurich and Anglo-American culture.

CSR in a resource perspective

Swiss Re is a salient example of a resource-based company. Explaining Swiss Re's strategy, the interview partners overwhelmingly pointed out the importance of financial and knowledge resources. Swiss Re considers the importance of the knowledge of their employees and their customers as well as the integration and the building of knowledge networks as knowledge resources:

> As a knowledge-based company, Swiss Re is intimately dependent on its ability to generate value from the collective knowledge held by its people, its systems and its relationships (Swiss Re, 2001).
>
> So, of course, we say that we are a knowledge company. [. . .] As a general rule, we create networks, extending across all cultures and throughout all the legal entities.
>
> Swiss Re's employees are the company's most valuable asset. It is their commitment, know-how and integrity that sustain the Group's performance (Swiss Re, 2002).

As all the experts of the reinsurance business are well educated and trained over many years at Swiss Re, employee relations are fundamental to gaining, maintaining and sustaining knowledge within the company. The challenge in CSR is therefore to keep the employee as a knowledge provider even in a multicultural strategy. This seems to be easier in a social science based CSR framework than in an economic based CSR framework.

The customers are also seen in a resource-based perspective:

> We consult with our clients as partners for the long term. We develop the most effective tailor-made solutions for our clients, leveraging our experience and profound know-how to help them attain their individual goals (Swiss Re, 2004).

This challenges CSR in a multicultural understanding to meet the different core values of regions. From this, we can derive the following insight:

> In a resource based perspective, corporations need a knowledge base to understand cultural differences. A social science based CSR framework (Kang and Wood, 1995) enables corporations to understand the different cultural social expectations better than an economic based CSR framework (Carroll, 1979). Based on this understanding, corporations can develop core competencies to deal successfully with different cultural settings.

In an ever more complex and knowledge-oriented society, investments in knowledge development in the context of a stakeholder network are crucial for developing future competitive advantages. But the influence of the American culture and economic orientation led also to a new prioritizing of stakeholder relationships:

> The clear values were formerly these: employees are stakeholder number 1, security and treating the clients well are number 2, and liquidity is number 3; he (i.e. CEO) completely reversed the order. Employees have moved right up. He introduced decentralized structures and in this way, he attempted to create firms of our own within the company.

This new weighting might have potential impacts on the core competency ''knowledge'' of Swiss Re because customers as external and employees as internal knowledge providers are losing importance due to the strong economic orientation.

Supported mainly by the nature of the reinsurance business, which demands stable outstanding services over the long term, Swiss Re has a long tradition of building positive relations with its strategic stakeholders. To a certain extent, a humanistic commitment may reinforce this focus. However, from our analysis it becomes clear that Swiss Re views interactions with its strategic stakeholders in terms of value creation. Stakeholder relations are justified mainly in terms of their value creation potential as risk bearers/providers and benefit bearers/providers. Outstanding relationships with clients and employees, for example, are seen by most interview partners as being the precondition for sustainable economic success. Sometimes even luxurious investments in relationships were made to maintain and develop these resources. With the stronger emphasis on economic aspects these investments can get lost, if the stakeholder relationships will be neglected.

In addition to this, globalization also means the confrontation with locally different values and expectations of strategic stakeholders (shareholders, employees, customers, regulators). CSR in this situation means that Swiss Re has to take into account these local differences and in addition to this Swiss Re, as a knowledge-based company, has to consider the local particularities to fully exploit its strategic potential:

> In order to do business, you first have to understand how you do business in such an area. This is not comparable to developed markets such as Europe or the USA. It goes without saying that we cannot behave like missionaries and tell them how to do business. It must be clear, that if we state

our opinion, what we say must fit the context. This includes understanding and learning how business is done in Latin America. This has worked well so far. We managed to build a good reputation during the last 70 or 80 years in which we have been doing business in Latin America.

As a multicultural focus is crucial in this knowledge-based business, Swiss Re has to consider ''multiculturalism'' as being a core value with which to guide interaction with strategic stakeholders in the different cultural settings. This impacts the understanding of corporate responsibility as managerial implications.

Summing up we can conclude that the insights of the Swiss Re case support a social science based CSR framework which seems to better fit in a multicultural setting than an economic based and seems to understand the different social expectations better. To fully exploit the stakeholder interactions in a strategic management perspective, further investigations based on a comparative case study design are in progress.

Notes

1. The pattern for these challenges was set by worldwide concerns about the racial policies of the former government of South Africa during 1950-1990. Other well-known examples include the challenge to Nestlé's marketing practices for infant formula, criticism of the chemical industry after the Bhopal tragedy or the disposal of Brent Spar in the north sea by Shell, etc.
2. According to Yin (1994), case studies are especially suitable when the intention is to understand contemporary complex social phenomena.
3. Swiss Re was analyzed in a stakeholder perspective between June and December 2003. The results and findings are based on the analysis of 20 key documents and 21 interviews with the former and current CEOs, with other members of top management, with divisional heads and with staff members in the different SBUs in Europe, the US and Asia.
4. In our research we were able to identify nine events that had a deep impact on the strategy, structure and culture of Swiss Re and therefore also influenced its interactions with stakeholders over the time. The nine events are: (1) the great fires (e.g. Hamburg 1862) leading to the foundation of Swiss Re in 1863; (2) the second industrial revolution, creating new fields of activities for reinsurers and influencing the firm's basic configuration; (3) catastrophes of unprecedented magnitude after 1900 (e.g. Titanic 1912) led to great losses and setbacks but also to a remarkable internationalization based on participations and subsidiaries; (4) stock market crash in 1929 led again to significant losses but Swiss Re was able not only to survive but to expand at the international level through its key factors knowledge and financial strength; (5) the period after the second world war was characterized by unprecedented growth and technological progress allowing Swiss Re a development in both scale and scope; (6) the period after 1987 signified by changes in regulations for insurance and financial service industries in addition to big natural catastrophes; (7) Globalization movement; (8) stock market crash and corporate scandals after 2000; (9) triggered by the 11 September 2001, new dimensions of risks in terrorism became predominant.

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Marketing and market development

Dealing with a global issue: contributing to poverty alleviation

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Abstract

Purpose – *To present one approach to integrating societal expectations in business as adopted by Electricité de France through their Access to Energy Program.*

Design/methodology/approach – *The objective is achieved through three main actions, one of which is explored here: rural electrification through the setting-up of rural energy services companies in developing countries which bring energy (electricity or gas) services to isolated populations, thereby encouraging the development of local economic activities and contributing to poverty reduction.*

Findings – *Findings range from the importance of an existing and suitable institutional framework, through the reduction of start-up costs and the cash-flow problems of these small companies, to the definition of a sustainable model (fee for service) and the provision of accompanying services (gas, water, telephone, etc.) and capacity building.*

Research limitations/implications – *Further research will be determined following monitoring and evaluation feedback from these local companies.*

Practical implications – *Working in countries with suitable institutional frameworks and with grant financing to cover most of initial equipment investment to keep tariffs low. Establishing local business zones with higher power levels to encourage local economic development. Ensuring maximum equipment efficiency (particularly batteries).*

Originality/value – *Identification of a sustainable model in rural electrification that is now being replicated on a major scale in Morocco and South Africa.*

Keywords *Social responsibility, Energy, Poverty, Partnership*

Paper type *General review*

1. Introduction

The sustainable development agenda is in a process of change. Up to the World Summit on Sustainable Development (WSSD) in Johannesburg in 2002, sustainable development was a ''campaign topic''. Today, however, we are in a new phase of the sustainable development journey focused on implementation. For business, this means more emphasis on actions and measurable results.

EDF's business is the generation, transmission, supply and distribution of energy (mainly electricity) and energy services. Energy is one of the basic needs of today's society. The link between energy and development was strongly underlined by the Johannesburg WSSD where access to modern energy was recognized as indispensable in poverty reduction. This link is now increasingly subject to analysis and evaluation in order to understand the inherent levers and causalities. As a global player, the group is directly involved but also strongly committed to sustainable development and all the issues it raises. EDF cannot ignore that one-third of the world population has no access to modern energy and especially to electricity. Being active in developing countries, we have to tackle both the issue of sustainable electricity supply in peri-urban areas and off-grid solutions in remote rural areas. This is part of our sustainable development agenda and of our corporate social responsibility objectives.

EDF Group has initiated some leading projects related to poverty reduction. The aim is to optimize the group's own actions but also to serve as reference to encourage other players, whether local or global, to participate in setting up viable, sustainable programs with lasting, long-term benefits for poor populations leading to wealth creation. Leadership in this domain is necessary in order to stimulate change and promote sustainable development.

Improving the livelihoods of people living in remote rural areas through the provision of an energy service brings a range of benefits, some of which will be re-channeled into the rural services company and ensure its long term viability, at the same time slowing down the inevitable demographic movement of people towards the cities. Improving the quality of service and access to electricity of populations living in the slum areas of the world's major cities will have direct benefits for the local electricity company in terms of increased productivity, reduced theft of electricity, increased social stability and an improved relationship between the supplier and its customers for the future.

Today, most people living without access to electricity are in rural areas. In the future this will change with the migration of populations to peri-urban areas where the problems of access will also concern quality of supply and service. EDF is active in both fields, working on peri-urban electrification solutions in Africa (Cape Town and Casablanca) and South America (Buenos Aires and Rio de Janeiro) and rural solutions in Africa (Mali, South Africa, Morocco, Senegal, Madagascar) and Asia (China, India, Laos).

To tackle these rural and peri-urban issues, EDF has set up a specific action program called Access.

In this paper we have chosen to share our experience in terms of contribution of poverty alleviation by presenting our rural electrification projects that include:

- to test through pilot projects sustainable solutions which are adapted to the real situations in different parts of the world and identify the key conditions for replication; and
- to scale up access to electricity by running long term (15 to 20 years) large-scale rural electrification programs on the rural energy services company (RESCO) model.

2. Rural electrification: the Access program

The questions involved in poverty reduction are interconnected and complex compared to earlier one-dimensional environmental issues and the corresponding solutions are neither easy nor obvious. For this reason, EDF has set up a range of actions to look at these questions:

- an R&D program to find new technical solutions;
- an operational program intended to test models in the field (the Access program) in partnership with institutions and other industries, as well as NGOs; and
- an international working group looking at the monitoring and evaluation of the impact of electricity on development in order to be able to assess the real effects of the programs, the causal links and the inherent levers, to be able to continuously improve our actions in the field, and to form a key element of local stakeholder dialogue.

The EDF Access Program has set up and operates four RESCOs, two in Mali (at present 2,000 families – average family size of 20 people – in the future to be extended to a total of 7,000 families), one in Morocco (at present 7,000 families – average family size of seven people – in the future to be extended to a total of 53,000 families) and one in South Africa (at present 3,100 families – average family size of six people – in the future to be extended to 12,000 families). Three of these four projects are based on energy provided through solar panels, the fourth, in Mali, being based mainly on village diesel mini-grids and a few solar panels for outlying houses.

The program also assists and supports the group's affiliates in their rural electrification projects. One such example is EDF Energy, our UK affiliate, which inaugurated a solar pumping project in central KwaZulu Natal in South Africa in July 2004. This project will provide drinking water for the local community and also water for irrigating a community

garden where the produce will be sold on local markets but which will also be used to feed the local school children. The project has been set up in the concession area where the Access Program is already very active and EDF Energy was able to benefit from the existing infrastructure and skills of the local RESCO for the installation of the system and to ensure long-term maintenance and therefore sustainability. EDF Energy is the first UK electricity company to set up a project in a developing country in this manner and this first action will serve to nourish their reflection around the possibility of implementing a social tariff for electricity at some future date.

The Access Program also sets up innovative pilot projects throughout the world working in partnership with the ADEME (the French Agency for the Environment and Energy Efficiency) and the FONDEM (a French NGO – the Foundation for Energies in the World). These projects, which can also be used as test-beds for the EDF R&D department, have been set up in China, Laos and Madagascar, and in the last quarter of 2004 two pilot projects will be set in India in order to test a biomass gasification model run on a local cooperative basis with the support of local NGOs.

Since the beginning of the Access Program in 2001, 400,000 people in developing countries have been provided with access to energy. EDF has deliberately chosen to target the most needy and poorest populations. This decision in turn has shaped the model developed and has led to the identification and implementation of a number of basic guidelines which reflect the requirements of setting up viable and sustainable projects. These guidelines, established through experience in the field, have come to form the model that is now generally followed whenever setting up a new project. These guidelines are described below along with the reasons for their evolution during project implementation and the lessons learnt in each case.

3. Guidelines for integrating social expectations: the lessons learned

3.1 A suitable institutional framework

This must be in place in the country concerned, without this it is impossible for us to work. One of the major global actors working on institutional reform in developing countries is the World Bank which helps to put in place the legal, technical and financial frameworks necessary. EDF has regular contacts with the bank in order to be able to contribute to the setting up of new institutional and regulatory frameworks within which the company will be able to work. Without these long-term tools, it would be impossible to set up objectives and plan dedicated financing. EDF works with these international institutions and national governments to set up general electrification master plans and our R&D department develops specialized tools and methodologies to facilitate this task. For example, countries that often previously had electricity monopolies need to change the law to enable the opening of the market to competition. EDF worked with the World Bank in Madagascar to set up just such institutional conditions, drafting a new section of the energy policy to enable the entry of other players in the rural electrification market.

Governments are often responsible, either entirely or in part, for the general electrification planning within a country, as well as the technology decisions to be made, and it is essential to the long-term development of the populations involved that viable solutions are proposed with the provision of professional backup and support. Distance and low population density makes rural electrification costly. Planning is needed to determine the relevance of the options chosen (grid extension, off-grid solutions, etc.). These decisions may often be cost-related (renewable or conventional equipment) and may depend also on the desires of the international backers or donors (renewable).

The long-term nature of the commitments to be made by the operating companies and the need for grants means that a public-private-partnership has to be set up from the very beginning.

In Morocco, when setting up the RESCO, discussions had to be carried out both at national and local government level. This created an unnecessary complexity in the negotiations with

an inevitable doubling of effort. At the same time, the method chosen for the payment of subsidies by passing through the local electricity company has led to delays in payment which for small local companies are difficult to absorb. The local RESCO is obliged to advance the money for the equipment before reclaiming this from the electricity company. Obviously, notable delays in payment for the installation of this equipment lead to major cash-flow problems that cannot be tolerated by a small local company of this nature. Only companies with major backers such as EDF or Total can survive these cash-flow crises. This makes these projects difficult to replicate for local actors.

Lessons learned. The institutional problems encountered while implementing these projects have led us to conclude that it is impossible for us to work in countries where this framework is not already in place. Where previously we would have been open to study interesting projects from other countries, today the number of countries where these conditions are in place are obviously limited as is our scope of action.

In order for projects to be successful, upstream work with the World Bank (where relevant) or the national government is indispensable if the project is to be sustainable. The support of the institutional authorities is essential since these small local companies are highly sensitive to institutional change.

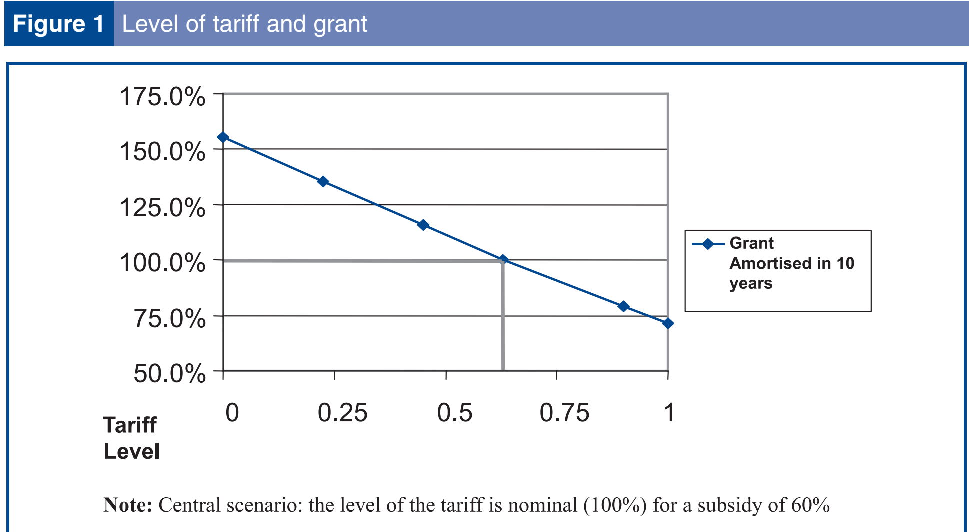
3.2 An efficient financing mechanism

Along with the institutional situation comes the financing mechanism necessary. All developed countries have, in the past, and still today, provided subsidies for rural electrification, either on-grid or off-grid. France subsidizes rural electrification at a rate of 70 to 85 percent of the initial investment cost, and operational costs are subsidized through an indirect cross-subsidy based on the sales prices which are the same for urban and rural areas. In developing countries, grants are provided by the major international institutions such as the World Bank, development banks (KfW) or national development agencies (AFD, Dutch Cooperation, DFID, DANIDA, SIDA, etc.), and very occasionally by the national governments themselves.

The financial model for setting up a small local company is based on the ratio of receiving 60-80 percent grants from international aid agencies to cover initial investment in equipment, 20 percent equity from EDF and its partners and up to 20 percent of commercial loans. The initial investment in equipment is a one-shot investment after which the RESCO will run for 15 to 20 years without further need for subsidies or grants.

The level of grant obtained has a direct impact on the tariff that can be set as seen in Figure 1.

Figure 1 Level of tariff and grant



Note: Central scenario: the level of the tariff is nominal (100%) for a subsidy of 60%

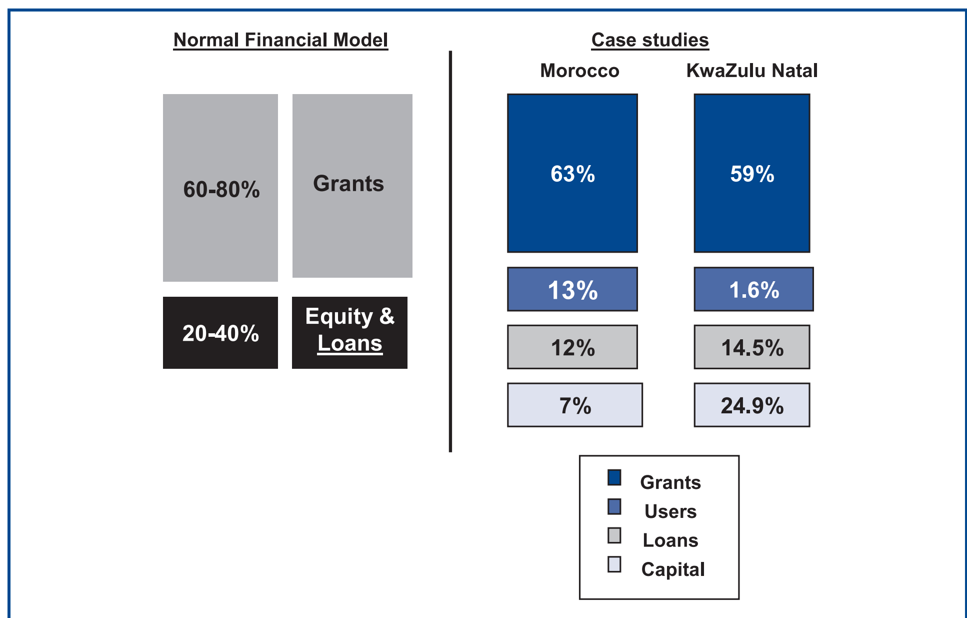
If the ratio of the grant is lower than 60 percent, the tariffs will be too high and the poorer customers will not be able to afford the service that means we will not be reaching our target customers. It is nowadays generally agreed that an initial grant of 80 percent is essential to cover investment in equipment. However, it is also a general consensus that grants for operational costs are not sustainable and that these costs should be covered by the fees charged to the customers for the service.

The breakdown of the financial model for the South African and Moroccan RESCOS are displayed in Figure 2.

Lessons learned. Experience in the field has revealed that start-up costs are higher than expected and the learning curve for EDF in this matter has been quite steep. For instance, it has proved difficult in these remote areas to find the skilled personnel required, ranging from the project manager through to the installation and maintenance teams and the marketing personnel. This means that considerable time needs to be spent prior to the project in training the personnel, who are all recruited from the villages and who are all previously disadvantaged, with the exception of the project manager, for whose position it is normally necessary to use an expatriate on site for at least the first year in order to ensure a good skills transfer, the implementation of good business practice and a rapid launch. The first years of the RESCO are often the most stressful on the company structure as these are the years of equipment installation. The pattern of installation and replacement of worn equipment (for example, batteries, which only last around three years) also means that the RESCO is late, around year 7 or 8 in most cases.

Technical questions can have a direct impact on the financial model. For example, the normal estimated lifetime of a battery is between three to four years. This calculation has been built into the business model with replacement of batteries every three to four years over a 15 or 20 year period. After the solar panels, the batteries are the biggest investment item. In Mali, it was revealed that the batteries began failing after 2.5 years. As you can imagine, the impact of this on the original business plan was considerable. Studies are now being carried out into the reasons for these failures and methods of extending this lifetime. This is one of the subjects in which EDF R&D is particularly closely associated.

Figure 2 Breakdown of the financial model for the South African and Moroccan RESCOS



3.3 Setting up economically viable models

The financial model described in the previous section is extremely dependent on payment by the customers with the operational costs being paid by customer fees. From the beginning, EDF has promoted a rural electrification model that relies on a payment culture as this is, in our opinion, the only economically viable model. The viability of the projects depends on obtaining a sufficient level of initial grant, keeping operational costs (and particularly start-up costs) as low as possible, and working extremely closely with the community to ensure high payment rates and low equipment theft rates.

EDF has now tested in the field and promotes the ''fee for service'' model where a ''service'' is sold rather than a piece of equipment. This organizational model results in the local company having a stronger presence on the ground than a traditional ''retail'' company which purely specializes in the sale of equipment, and in the long term this model presents many advantages.

Lessons learned. Working on concrete projects in the field has permitted EDF to build experience in the setting up of an economically viable model that at the same time is sustainable in the long term. It could be argued that a retail model, where the business focuses on the sale of equipment with a short-term guarantee, is a better business option and this is true if the company is purely in this market for financial reasons. However, the weakness of the retail model is that it is a short-term (three to five years) solution that does not lead to lasting poverty reduction on the ground. After three years, the batteries for solar panels need to be replaced and in most cases the owners do not have sufficient resources so the solar panel falls into disuse. No long-term maintenance solution is provided for poor populations and the result of this type of model is that only the richer levels of the population are reached. The fee for service model permits the poorer layers of the population to be targeted, allows for long-term development goals to be met by being flexible enough to cater for future needs and is wide enough in scope to be able to extend the range of services provided.

3.4 Working in partnership

Working on projects of this scale requires the building of partnerships on all levels:

Local partnerships. Arguably the most important – without good local partnerships the business will not be viable. Our business models are based on local needs and habits related to energy, and we create medium-sized local companies which hire and train local people.

We also introduce a payment culture into areas that have never received any services of this type in the past. Our long-term presence on the ground leads us to work with local authorities, local communities, local groups and associations and to be in touch with grassroots level development issues. In poverty alleviation, this attention to the requirements and wishes of the poor is obviously an essential part of integrating their expectations into our work.

We have to be deeply involved in the communities. One of the ways is to rely on local people to manage the company we have created. A major challenge is overcoming the lack of local skills through capacity building and skills transfers. Employees of the company are hired from the villages we serve and trained by our personnel. The communities can have fluctuating revenue levels (Mali cotton harvest for example) and this can lead to problems with the payment of the service fees. The impact of energy on revenues is constantly monitored to ensure that EDF's societal objective of poverty alleviation is being attained.

National partnerships. Good working relations are necessary with all sorts of government departments and national companies. The Energy Ministry will be responsible for electrification planning and the concession area awarded to the RESCO. They may also be responsible for the payment of grants for equipment installation and as we have already explained above, prompt payment of these amounts is crucial. The Finance Ministry will be involved in questions touching tariffs and taxes. The local electricity company will need to

agree the concession area awarded to the RESCO and may also, as in Morocco, be responsible for channeling grant money. Inherent territorial conflicts with what was often previously the traditional national electricity monopoly need to be avoided through the encouragement of frank and clear discussions. Finally, a good relationship with the Regulator's office is also indispensable in order to conform with the current legal and administrative conditions in force and to try and ensure a secure future for the RESCO.

International partnerships. International partnerships can range from exchanges with major donors or national development agencies, through to working with international or local NGOs to accelerate the development of the populations in the concession area (AIDS, economic development, etc.). International ''platforms'' are sought to pursue debates which are taking place on an international level, such as the debate at present occurring around the place of renewable energies in development, or the fee-for-service as against the retail model. Major lobbying from equipment retail companies supporting the retail model needs to be countered through demonstration on the ground of the effectiveness of a long-term, fee-for-service model.

Lessons learned. The lesson learned here is that partnerships on all levels are essential and need to be established on a frank, open basis where the objectives of each partner are clearly stated and mutually shared. Total transparency is an obvious necessity and mutual confidence must be built as these are partners for the long term.

3.5 Respecting technological neutrality

Access to improved energy is recognized as a fundamental part of tackling the levels of poverty in the world – a problem that is regarded as one of the great challenges of the twenty-first century. Without modern forms of energy reaching the world's poor, the millennium development goals of halving poverty by 2015 will not be met. But another issue is fast becoming a huge challenge for mankind: how to provide this energy without worsening climate change or putting added pressure on the earth's natural resources.

Renewables can provide access to improved forms of energy to the millions of people living without it at the moment without inflicting more damage on the environment or adding even more pressure on the earth's resources. The technologies that can offer communities a mix of energy sources and so provide energy security, deliver economic and social benefits and in turn offer a real win-win situation in the battle of tackling world poverty while protecting the earth.

But current thinking towards renewables will fail to deliver this double victory. In fact, current attitudes toward renewable technologies will leave millions without access to modern forms of energy that is so desperately needed to escape poverty. The problem is that the renewable agenda is being driven by ''northern'' market-led technologies that will bypass those in the rural areas of the developing world. In addition, northern technologies such as PV cells which can be used for decentralized small-scale schemes normally focus on the markets which can afford their products and are not interested in markets that have little buying power, such as poor communities in rural, off-grid areas. In areas where there is no wind, and where wind turbines are therefore not an option, and where there is no water, ruling out mini-hydro plants, solar panels remain the only renewable option apart from biomass, a technology that has not yet been sufficiently experimented outside India. However, the price of solar equipment needs to be drastically reduced if these communities are to be able to have access to renewable energy and particularly if they are to have access to this energy at a power level which can drive small machinery in order to encourage local economic development and enable these populations to create wealth and therefore escape the poverty trap.

Renewables are not yet a panacea for poverty reduction and, in the immediate future, there will still be a role for fossil fuels. The world's poorest countries must be allowed an increased level of fossil fuel consumption in order to tackle poverty while at the same time the rich world reduces its consumption. Diesel gensets must remain an available option for the present time, development must be made a priority in the short-term. Once wealth creation has been

initiated, cheaper renewable options, developed by northern markets, could be encouraged through properly designed incentives.

Lessons learned. Three of the EDF Access existing projects are based on solar home systems, while the fourth uses them for outlying areas of the village. Although in certain areas other forms of electrification are not possible due to the extremely scattered houses, in some cases conventional methods of electrification, such as diesel gensets, would be appropriate where households are clustered, and in this case sufficient power could be provided to initiate local economic development. However, international grant funding is rarely available for technologies other than renewable technologies and the development of these populations is subsequently penalized.

International tenders for these projects impose their own technological conditions, in these cases solar home systems. However, solar home systems only cover the basic needs of lighting and radio or television. In order to cover the need for a clean cooking fuel (respiratory diseases caused by the inhalation of wood smoke or paraffin fumes inside huts is one of the major killers even today in Africa) and space heating (South Africa), our projects are now beginning to associate the distribution of LPG bottles. And in order to cover the need to create economic activities, EDF is now setting up small business areas based on diesel mini-grids in all its rural electrification projects.

3.6 Ensuring training and technology transfer for the future

Training and technology transfer are essential if the future of these projects is to be assured and if the lives of employees and local populations are to be improved and poverty thus alleviated, or rather, as we like to think of it, wealth created.

Employing exclusively local personnel, recruited from the villages and often without any previous formal education beyond basic schooling, EDF provides full training not only in the skills required for the tasks of installation, maintenance or vending, but also business skills for the future, as well as in basic good practice and business procedures. Employment is often the most crying need and the most often expressed desire of these disadvantaged and remote populations. In addition, the lighting provided in local schools or other public buildings provides opportunities for the community to hold evening classes and therefore to provide new opportunities for further education.

A maximum of equipment is sourced within the same country in order to encourage local businesses and to create a stable market for these goods. Local subcontractors are also used and some tasks, such as accounting and legal questions, are outsourced.

Lessons learned. The absence of local skills in these rural areas was much greater than EDF anticipated which meant that more training has had to be provided than expected.

3.7 A monitoring and evaluation model shared with international partners

The World Bank decided after Johannesburg to underline the necessity of energy in development and EDF works closely with the Global Village Energy Partnership (World Bank – UNDP initiative) on the measurement of the impacts of electrification at global, regional and project level, leading a working group which includes the European Union and UNEP. GVEP members are international institutions, NGOs, private companies and governments. The work is based on concrete evaluation of projects by using common methodologies and criteria.

During 2004, the impacts of the electrification on the local populations will be measured in Morocco and South Africa and this will then be regularly monitored on an annual basis. An innovative model of monitoring is being developed for EDF by a South African expert in this field who will set up a mechanism whereby the employees of the company carry out some of the monitoring tasks themselves. The monitoring and evaluation will therefore come to form part of the structure of the company. Local staff will be more completely involved in questions relating to the development of the local economic and social welfare of their colleagues and customers and the system will in itself provide feedback for improvement of the RESCO's

operation. Indicators are in the process of being developed which will permit the measurement of progress towards the millennium development goals.

Monitoring and evaluation is an excellent stakeholder consultation tool, particularly when run by external, independent experts. It permits EDF to check that the service it is providing is truly tailored to local expectations and to integrate proposals and suggestions for change or additional services required by these local communities.

Lessons learned. Monitoring and evaluation provides a snapshot of the community that it is difficult for EDF to obtain on its own with its conventional vision as electricity provider. It is as yet too early to identify the lessons learnt since the results of these surveys will only be available towards the beginning of 2005 but it is without doubt that they will reveal areas for improvement of existing services and will identify future needs that the RESCO will strive to meet.

4. Conclusion

The Access program has enabled EDF to test a number of pilot projects that have provided rich information. Building from this experience we have revised and improved our approach to providing energy to developing countries.

Among the main lessons learnt, we must underline the following:

- RESCOs are very sensitive to cash flow problems (payment rates, etc.);
- lack of visibility of the institutional frameworks of the countries concerned can be a real handicap;
- because of cash flow problems, start-up costs need to be kept very low;
- the lack of local skills and training requires extensive training programs in the field;
- the lack of risk cover mechanisms (institutional risks for example) means that new solutions are required from the international institutions; and
- the fee-for-service business model is viable and sustainable if run on the long-term, which is in line with the needs for sustainable electricity supply.

The existing projects, after initial teething problems and a steep learning curve, are now demonstrating that they are successful as business projects but also in providing energy access to the poorest and thereby contributing to the overall goal of sustainable development. All four of the existing companies are seeing their customer-base enlarged, either through extensions within their current concession or through reply to call for tender on new concessions. Our RESCO in Morocco recently won a tender that will amount to a total customer-base of 58,000 families. This will make the company a world reference in this field. It also demonstrates that it is possible to scale-up such projects.

We are now looking to the future: at the beginning of 2004 we started two new R&D programs focused on these issues, the first one oriented on medium-term questions concerning energy access, whether technical, economic or social, the second one focusing on long-term questions which we will need to anticipate to be able to give relevant answers related to poverty, economic development and access to energy and electricity. Further work is required to find satisfactory answers to the power requirements of these populations, outside solar home systems, in order to encourage local economic activities and wealth creation. In 2004 we will be setting up four new pilot projects in India focusing on biomass gasification. This is a renewable option, involving the burning and gasification of agricultural or wood waste and could provide a solution for village electrification in many areas of the world. We are also developing, with the R&D division, pico-hydro solutions for use where water is present.

Our contribution is a drop in the ocean of needs for access to energy. But by showing others that it is possible to improve the situation, we hope to encourage them to join us in our work. Scaling up is now the first priority of the international institutions on their way towards the millennium development goals. Public private partnerships like the ones set up for access to electricity in remote areas seem to be one of the concrete answers. But this means a long-term commitment on the part of all the actors, which is perhaps the most difficult challenge.

Signaling corporate values: consumers' suspicious minds

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Abstract

Purpose – *While managers and researchers recognize that corporate social responsibility is positively related to some corporate performance measures, the instrumental reason for this linkage is still unclear. The present research proposes that this relationship can be better understood if the concept of trustworthiness is included.*

Design/methodology/approach – *Using an experimental design, the present research presents a study in which the presence or absence of environmental commitment information in a company profile is manipulated and presented to consumers, and reports the differences in the measures of consumers' perceptions of company trustworthiness and its sources originated by this manipulation. The analysis of these differences provided evidence of significant positive effects on perceived benevolence and negative effects on perceived ability measures.*

Findings – *The findings of the present research seem to indicate that, in some contexts, companies' cause commitment can have different (positive and negative) effects on consumers' perception of firms' trustworthiness.*

Research limitations/implications – *The small sample size is the principal limitation of the study. Also the exclusion of personal and cultural values as moderators of the effects is a limitation. Therefore, results should be analyzed carefully because they could vary if the study is replicated in a different culture. Future research should include these personal and cultural variables in a more comprehensive model.*

Practical implications – *Managers must manage carefully this type of company commitment and the communication of these corporate activities to stakeholders.*

Originality/value – *This paper tries to analyze from the individual behavior perspective the relationship between corporate social responsibility and corporate trustworthiness.*

Keywords *Corporate image, Trust, Social responsibility*

Paper type *Research paper*

Introduction

While different streams of management literature agree in the fact that corporate social responsibility is positive related with corporate performance, the reasons to expect this relationship are not clearly articulated. Stakeholder theory (Freeman, 1984), and specifically its instrumental aspects, has been focused in the proposition that corporations practicing stakeholder management will, all things being equal, be relatively successful in conventional performance terms (Donaldson and Preston, 1995). Jones (1995) makes a theoretical case for the general proposition that if firms contract (through their managers) with their stakeholders on the basis of mutual trust and cooperation, they will have a competitive advantage over firms that do not. Nevertheless, instrumental stakeholder theorists stop short of exploring specific links between cause (stakeholder management) and effect (corporate performance) in detail (Donaldson and Preston, 1995). This problem is most apparent in the research linking measures of corporate social performance (e.g. Fortune Reputational

Index, KLD ratings) with financial performance (e.g. ROI, ROA, and so forth) (Jawahar and McLaughlin, 2001).

Reputation literature is also concern about corporate social responsibility. Fombrun and Shanley (1990) found that one significant dimension that signals constituents about firms' prospects and generate reputations is social responsiveness. The instrumental argument is that social responsiveness generates goodwill from employees, consumers, and other publics that enhances the long-run profitability and viability of firms. This argument is related with the general assumption that the strategic importance of reputation resides in the fact that corporate audiences routinely rely on the reputations of firms in making investment decisions, career decisions, and product choices (Dowling, 1986).

These two positions have some common and important assumptions related with the way in which the firm responds to its non-economic agenda and the effect of these actions on the quality of the relationships with their stakeholders. While stakeholder theory argument is focused on the development of relations on the basis of mutual trust and cooperation, reputation literature is focused on the generation of goodwill from different stakeholders. One common, and underlying pattern, is the importance assigned to firm's non-economic behavior as a way to signals firm's moral properties, and the positive effect of these signals in their economic activities. This convergent point is related with the importance of firm trustworthiness as a source of competitive advantage. The argument is that trustworthy and cooperative firms will be sought after as partners in economic relationships that require trust and will be offered opportunities that firms lacking these traits will not (Barney and Hansen, 1994). Nevertheless, trustworthiness, and the organizational attributes that create trustworthiness (corporate culture and values, and associated control systems) are difficult to observe directly (Barney and Hansen, 1994). One possible way to identify trustworthy partners can be through the use of signals of trustworthiness (Spence, 1973). It is in this linkage where stakeholder theory and reputation literature have some convergent, but still unclear, assumptions about the role of non-economic behavior (social responsibility) as a signal of firm's ethical standards and values, the way in which stakeholders interpret this signals and construct firm's reputation, and the consequent effect on performance.

The present research is an attempt to answer a couple of questions related with these issues:

- Does corporate social responsibility affect consumers' perceptions of firm trustworthiness?
- How does corporate social responsibility affect the different attributes that create trustworthiness?

To answer these questions, concepts like corporate culture, corporate reputation, and trustworthiness, are included in the research design.

The study consists in four parts. In the first instance is presented an overview of corporate culture, corporate reputation, trustworthiness, and their links. Secondly, the hypotheses and the methods used to investigate the possible effects between these concepts will be described and explained. Thirdly, the results of the investigation are presented and analyzed. Finally, conclusions, limitations, and a discussion of managerial and academic implications will be provided.

Literature review

Corporate culture

The concept of corporate culture has been studied in management field since many years. Initially, within organizational theory, scholars used the culture concept to study organizations as forums in which meanings are constructed and expressed through social interaction (Wilson, 2001). Some of the earliest references to the concept of culture as an internal organizational variable are found in the literature of organization development (Jacques, 1951; Harrison, 1972). After the recognition of corporate culture as an important

organizational variable, some scholars began to link various types of cultures to certain outcome variables. For example, Wilkins and Ouchi (1983) explored the relationship between culture and organizational performance. Thus, culture became a mechanism with which to achieve managerial effectiveness and control (Barley *et al.*, 1988).

During this process of development, many definitions have been proposed for the concept of culture in the corporate setting. The more basic definitions simply provide a vague description to replace the term culture. The ''rules of the game'' (Van Maanen, 1979), and ''how things are done around here'' (Drennan, 1992) are part of these simple descriptions. These basic definitions contrast with the more developed and useful definitions produced by other scholars (e.g. Schein, 1991; Schneider, 1988; Kotter and Heskett, 1992). For example, according to Schneider (1988):

> Corporate culture refers to: (a) the values that lie beneath what the organization rewards, supports and expects; (b) the norms that surround and or underpin the policies; practices and procedures of organizations; and (c) the meaning incumbents share about what the norms and values of the organization are (p. 353).

It is in the belief of the majority of authors, with the exception of Schein (1991), that there are two levels of culture, the visible level and the deeper, less visible level. At the visible level are aspects like behavior patterns, the physical and social environment and the written and spoken language used by the group (Wilson, 2001). The deeper, less visible level of culture refers to values that are shared by the people in a group and that tend to persist over time even when group membership changes (Kotter and Heskett, 1992). These shared values consist of the goals and concerns that shape a group's sense of what ''ought'' to be (Wilson, 2001).

These considerations outline two important elements of organizational culture. First, the visible level aspects are the ''expression'' of the deeper, less visible level, and therefore, an analysis of these visible aspects can give a lot of information about the less visible level of corporate culture (Barley, 1983; Manning, 1979).

Second, corporate values are central and foundational elements of corporate culture. Different authors have been stressed this relationship, arguing that in the core of corporate culture are corporate values, which provide a system of guiding principles (Harris and de Chernatony, 2001), and that the organization's culture encompasses employees values and assumptions, which also guide their behavior, particularly in novel situations (Wilkins and Ouchi, 1983).

Corporate reputation

The concept of corporate reputation has been studied extensively in fields like economics (Shapiro, 1983; Wilson, 1985; Kreps and Wilson, 1982; Milgrom and Roberts, 1982, 1986) and corporate strategy (Weigelt and Camerer, 1988; Fombrun and Shanley, 1990; Shamsie, 2003). In general, corporate reputation has been defined as a set of attributes ascribed to a firm, inferred from the firms past actions (Weigelt and Camerer, 1988). Herbig and Milewicz (1995, p. 18) define reputation as ''an estimation of the consistency over time of an attribute of an entity'', and highlight the fact that a firm can have numerous reputations – one for each attribute such as price, product quality, innovativeness, management quality – or a global reputation.

The development of reputation research is based on the vision of a world of imperfect information in which actors rely on proxies or signals to make rational assumptions about the intentions and future behaviors of other actors (Fombrun and Shanley, 1990). Thus, reputation models presume a tight coupling between past actions and future expectations, and organizational attributes and the evaluation of organizations (Weigelt and Camerer, 1988).

The importance of corporate reputation in the management field resides in the fact that corporate audiences routinely rely on the reputations of firms in making investment decisions, career decisions, and product choices (Dowling, 1986). Therefore, a firm's reputation is an asset which can generate future rents (Wilson, 1985). Moreover, reputational

advantages that stem from informational asymmetries can provide firms with a valuable resource that they can use against their rivals for a relatively long period of time (Shamsie, 2003). The intangible nature of reputation, its rareness and social complexity, makes it difficult to trade and imitate, and therefore reputation can contribute significantly to performance differences among organizations (Barney, 1991; Peteraf, 1993).

Corporate trustworthiness

The relevance of the concept of trustworthiness is closely related with the development of trust and trusting behavior literature. Trusting behavior implies allowing oneself to be in a potentially vulnerable position relative to another, while possessing some knowledge of the other that inspires trust in his goodwill, i.e. in his good intentions (Blomqvist, 1997). Thus risk and some information about the potentially trusted person or situation are seen as necessary conditions for trust to exist (Lewis and Weiger, 1985; Oakes, 1990). This information about the potentially trusted person can be used to infer the future behavior of the person. Following the same line, Good (1988) suggested that trust is based on expectations of how another person will behave, based on that person's current and previous implicit and explicit claims. In a similar position, Mayer *et al.* (1995) suggested that the amount of trust that a given party will have for another party can be determinate by some attributes of the trustee. Therefore, trustworthiness is related with the attributes of the trustee, and the assumption of different scholars (Good, 1988; Johnson-George and Swap, 1982) is that characteristics and actions of the trustee will lead that person to be more or less trusted. According to this, trust is partially a product of one's capacity to assess the trustworthiness of one's potential partner (Sheppard and Sherman, 1998). Barney and Hansen (1994) explicitly differentiate between trust and trustworthiness pointing that ''while trust is an attribute of a relationship between exchange partners, trustworthiness is an attribute of individual exchange partners''.

Trustworthiness, and specifically corporate trustworthiness, is important in the management field because has been recognized as a possible source of competitive advantage (Barney and Hansen, 1994). Corporate trustworthiness may increase the set of exchange opportunities available to a firm, compared to firms that are less trustworthy (Zajac and Olsen, 1993; Ring and Van de Ven, 1994). Moreover, corporate trustworthiness is costly to imitate and immune from rapid diffusion, because the organizational attributes that make trustworthiness possible reflect an exchange partner's unique path through history (path dependence) and are socially complex (Barney and Hansen, 1994).

Mayer *et al.* (1995), in a very exhaustive work, identified more than ten different individual and organizational attributes that lead to trust, resuming these concepts into three constructs: ability, benevolence and integrity. In a similar context, Blomqvist (1997) identified two main dimensions for trustworthiness, named competence and goodwill. Competence includes technical capabilities, skills and know-how, and goodwill implies moral responsibility and positive intentions towards the others. Nevertheless, these organizational attributes are difficult to observe directly, making difficult the assessments of corporate trustworthiness (Barney and Hansen, 1994).

Relationship between corporate culture and corporate reputation, and their effect on corporate trustworthiness

Corporate reputation is a complex social phenomena, in which corporate audiences ascribe to a firm a set of attributes, inferred from the firms past actions (Weigelt and Camerer, 1988). Therefore, past and current actions of a firm determine its actual and future reputation. Firms' actions are, in most of the cases, determined by the decisions and actions of managers and employees, which are part of the firm. These decisions can be constrained by the values, norms, practices and procedures of the organization, and therefore are more or less determined by corporate culture. If organizational culture is defined as the visible and less visible norms, values and behavior that are shared by a group of employees which shape the group's sense of what is acceptable and valid (Wilson, 2001), it is possible to suppose that managers and employees' decisions and actions are influenced by corporate culture, and therefore corporate culture can be considered as a determinant of corporate reputation. For

example, several formal reputation-building models show that corporate culture can support an efficient, implicit contract system within firms (Cremer, 1986). In these models, the employee gives the employer a broad range of authority to resolve unforeseen contingencies, or to judge, *ex post*, an employee's reaction to the unforeseen. In this way, the employee trust that the process achieves equitable results, based on the firm's reputation for using clear, well-know, ''unwritten rules'' in responding unforeseen contingencies. The unwritten rules are the corporate culture. Therefore, it is possible to affirm that corporate reputation depends, to some extent, on corporate culture.

Corporate reputation has been recognized as a possible source of trustworthiness. For example, a reputation for being trustworthy is a signal of trustworthiness. Gaining a reputation as a trustworthy exchange partner occurs, over time, as an exchange partner confronts situations where opportunistic behavior is possible, but chooses not to engage in opportunistic activities (Barney and Hansen, 1994). At the corporate attribute level, a good reputation in specific attributes as competence, discretion, honesty, integrity, altruism, benevolence, consistency, transparency, and predictability can increase the trustworthiness of a partner, depending upon the nature of the risk assumed in the relationship (Sheppard and Sherman, 1998).

Several authors have hypothesized that corporate culture and values can also have an impact on corporate trustworthiness. Barney and Hansen (1994) argued that trust can emerge in the face of significant exchange vulnerabilities, independent of whether or not elaborate social and economic governance mechanism exist, because opportunistic behavior would violate values, principles, and standards of behavior that have been internalized by parties to an exchange. Therefore, trustworthy exchange partners are trustworthy because that is who, or what, they are. In this sense, trustworthiness is clearly exogenous to a particular exchange structure. Trust does not emerge from the structure of an exchange, but rather, reflects the values, principles, and standards that partners bring to an exchange. Those values, principles, and standards may reflect an exchange partner's unique history, its culture, or the personal beliefs and values of critical individuals associated with it (Arthur, 1989; Barney, 1986; Dierickx and Cool, 1989). If a firm possess a culture and associated control systems that reward trustworthy behavior, these characteristics can increase the trustworthiness of the firm (Barney and Hansen, 1994). For example, Cowles (1997) make a case for the importance of corporate culture in the consumer marketing field, arguing that the extent that a customer is aware of a firm's corporate culture, the customer will use that awareness to make assumptions about the knowledge-ability, competence and motives of a specific marketing entity representing that firm. In turn, these assumptions influence the perceptions of the firm's and the marketing entity's trustworthiness. Nevertheless, the impact of corporate culture on trustworthiness is only possible if this culture is communicated to partners, and therefore should be considered as part of firm's reputation sources.

Research design

Hypotheses

The research design was conceived to answer two important questions:

1. Does corporate social responsibility affects consumers' perceptions of firm trustworthiness?
2. How corporate social responsibility affects the different attributes that create trustworthiness?

To answer these questions, the research design considers the use of signals as a way to communicate the firm's social concern. This social concern is considered and expression of firm's corporate values and culture. The objective is to measure the effect of these signals in consumers' perceptions about the firm overall trustworthiness and the specific organizational attributes identified as trustworthiness sources (i.e. ability, benevolence and integrity). Managers can signal their firms social concern by contributing to charitable

causes, developing nonpolluting products, achieving equal opportunity employment, creating foundations, placing women and minority members on boards, or adhering to the Sullivan principles (Fombrun and Shanley, 1990). In the present research, the signal considered is the commitment of the company with a cause. The general hypothesis is that consumers will use this information to infer the motives and intentions of the company, and perceptions of overall trustworthiness will be improved. Therefore, the general hypothesis is:

H1.
Company commitment with a ''fair'' cause is positively related with the trustworthiness of the company.

With respect to the specific determinants of trustworthiness (i.e. ability, benevolence and integrity), the effect of company commitment with a cause in each of the may not be equal. In the case of benevolence, the company active commitment with a cause is hypothesized to be positive related, because the company concern about others, aside with and egocentric profit motive, is on the core of benevolence definition (Mayer *et al.*, 1995). Therefore:

H2. Company commitment with a ''fair'' cause is positively related with the perceived benevolence of the company.

In the case of integrity, the commitment with a cause is hypothesized to be positive related. The company active commitment with a cause can be a way to signal consistency with corporate values, sense of justice, and congruence with its words, all issues that affect the degree to which a party is judged to have integrity (Mayer *et al.*, 1995). Therefore:

H3. Company commitment with a ''fair'' cause is positively related with the perceived integrity of the company.

Finally, the effect of company active commitment with a cause is hypothesized to be not significant. Ability is related with the skills, competencies, and characteristics that enable a party to have influence within some specific domain (Mayer *et al.*, 1995). Therefore, it is possible to suppose that corporate commitment with a cause will not affect the perceptions about the technical skills of the firm:

H4. Company commitment with a ''fair'' cause is not related with the perceived ability of the company.

To test the first hypothesis, a comparison of the judgments of company trustworthiness, in presence and absence of cause commitment information, was performed. If trustworthiness is higher when cause commitment information is present, it is possible to conclude that commitment with a cause has a positive effect in the trustworthiness of the company.

The second, third, and fourth hypotheses concern the effect of cause commitment in each of the determinants of trustworthiness. To address this question, a comparison of the judgments in each characteristic (i.e. ability, benevolence and integrity) of the firm, in presence and absence of cause commitment information, was performed.

Cause and company selection

To guide cause selection, a pretest of ''common'' accepted causes was conducted using an open-ended question, asking to respondents to mention not controversial and common accepted causes This pretest ($n = 10$) identified the ''environmental commitment'' as the most common accepted cause.

The company name selection was made considering one restriction, related with the product category associated to the company. It was necessary a product category familiar to the respondents, with some level of performance ambiguity and significant consequentiality. Then, the product category selected was casual clothes, a familiar product with a high experience component and significant price.

Also, the company name selection balanced two considerations. On the one hand, a company for which subjects had strong beliefs and attitudes, which are difficult to change

(Crocker *et al.*, 1984), would be unlikely to show effects of company cause commitment on company trustworthiness. On the other hand, hypotheses assume subjects have some pre-existing company knowledge. The Wrangler company[1] name met these needs. Pretests revealed that, compared with other tested casual clothes brands, like Levi's and Benetton, subjects were moderately familiar with Wrangler, had neutral attitudes toward it, and did not know the corporate culture and values.

Information stimuli, manipulations and design

The company information was a document describing the company demographics, performance, investments and, for one half of the respondents, environmental commitment. The demographic description included ''age'' of the company, the main corporation behind the company, the position of the company in the specific sector, and the geographic scope of its activities. The performance description mentioned the amount of annual sales and its growth in the last year. The investment description was related with market research and research and development activities. Finally, the cause commitment information described the commitment of the company with environmental causes, the economical and managerial support to organizations related with this cause and the efforts of the company towards the development of environmental friendly products and processes. Thus, the study was applied to two groups of subjects. The absence of cause commitment information represented the baseline to test for effects in trustworthiness. Subjects were male participants in an information systems seminar. The average age was 30 years, and the overall sample size was 40.

Experimental procedure

Subjects were tested all together in a 20-minute session. Each subject received one of the two possible information stimuli and a questionnaire. The stimuli were randomly assigned and the questionnaire was the same for all the subjects. Then, they were instructed to ''. . . read carefully the information about the company. Take all the time that you need. Then, please answer the questionnaire following the instructions.'' In the questionnaire, subjects expressed their perceptions about company's trustworthiness and company's ability, benevolence and integrity. Finally, they completed questions on demographic information.

Measurement

Perceived ability of the company was measured by tapping the respondent's perception about the company's experience in the market and the ability to fulfill market's needs. One item was adapted from Delgado and Munuera (2001).

Perceived benevolence of the company was operationalized using one item developed by Lau and Lee (1999) and other adapted from Kumar's *et al.*'s (1995) measure of benevolence in a partner. The respondents were asked if they felt that the company cared for its partners' welfare or only about itself.

Perceived integrity was measured using one item developed by Lau and Lee (1999) to measure perceptions of the company's ethical values, and other was adapted from Anderson and Weitz's (1992) scale to measure reputation for fairness in business dealings.

Overall trustworthiness was operationalized using direct measures, adapted from the trust perceptions scale of Lau and Lee's (1999) study.

All of the aforementioned constructs were measured with the use of a seven-point Likert-type agreement scale with anchors of strongly disagree (1) and strongly agree (7). The items used for corporate trustworthiness, ability, benevolence and integrity are presented in Table I.

Data analysis and results

The correlation matrix of the above mentioned items obtained from the pooled data is presented in Table II. The purpose of the correlation analysis is to assess the convergent validity of four indices representing corporate ability, benevolence, integrity, and corporate

Table I Measures of corporate ability, corporate benevolence, corporate integrity and corporate trustworthiness

Corporate ability	
ABI1	This company has experience in the market
ABI2	I believe that this company has the ability to produce products according to market requirements
Corporate benevolence	
BEN1	I believe that this company is concerned about the well-being of its partners
BEN2	This company only cares about making profits (reversed)
Corporate integrity	
INT1	This company has a fair behavior
INT2	This company is ethical
Corporate trustworthiness	
TRU1	I do not trust this company (reversed)
TRU2	I feel that I can trust this company completely

Table II Correlation matrix of items used in the measurement

Items	*ABI1*	*ABI2*	*BEN1*	*BEN2*	*INT1*	*INT2*	*TRU1*
ABI2	0.320*						
BEN1	0.076	−0.188					
BEN2	−0.183	−0.031	0.430**				
INT1	−0.066	−0.093	0.129	0.050			
INT2	0.076	0.006	0.465**	0.037	0.549**		
TRU1	0.172	0.114	0.329*	0.233	0.141	0.315*	
TRU2	0.238	−0.033	0.205	0.164	0.436**	0.413**	0.562*

Notes: *Correlation is significant at the 0.05 level; **Correlation is significant at the 0.01 level

trustworthiness, as well as the discriminant validity between the first three constructs. As can be observed in Table II, the coefficients of correlation within indices (varying from 0.320 to 0.562) are generally greater than those between the first six indices (varying from 0.006 to −0.188) with the exception of the correlation between BEN1 and INT2 (0.465). The indices used to measure trustworthiness are not comparable in these terms with the first six indices, because a relationship is expected. These coefficients of correlation show that the validity of these measures is relatively acceptable, considering the sample size.

To test the hypotheses proposed, it is necessary to compare the judgments in each characteristic (i.e. ability, benevolence and integrity) and in the overall trustworthiness of the company in presence and absence of cause commitment information.

In order to select the appropriate procedure to test these hypotheses, normality tests were conducted to determine if the values were normally distributed. The results of the tests (Kolmogorov-Smirnov, and Shapiro-Wilk) revealed that just one of the eight variables was normally distributed ($p > 0.10$). Then, a non-parametric test was selected as the most appropriate way to compare the means. Considering the sample size, the Mann-Whitney U test for means comparison is considered the best way to compare the two populations.

The descriptive statistics and the results of the Mann-Whitney U test for means comparison are presented in Table III. As can be observed in Table III, the groups had significant differences ($p < 0.05$) only in two of the eight indices used. One of these variables was related with benevolence (''I believe that this company is concern about the wellness of its partners'') for which the group with company environmental commitment information shown

Table III Descriptive statistics, differences between groups, and significance of differences

Group		*ABI1*	*ABI2*	*BEN1*	*BEN2*	*INT1*	*INT2*	*TRU1*	*TRU2*
Group 1 (with cause commitment information)	Mean	5.80	5.40	4.95	3.50	4.65	4.75	2.80	4.45
$n = 20$	Std. deviation	0.95	0.60	0.94	1.19	0.67	0.72	1.15	0.83
Group 2 (without cause commitment information)	Mean	5.95	5.95	4.40	2.95	4.35	4.50	2.85	4.50
$n = 20$	Std. deviation	1.00	0.69	0.60	1.36	0.49	0.76	0.99	1.05
Difference		−0.15	−0.55	0.55	0.55	0.30	0.25	−0.05	−0.05
P-value for Mann-Whitney U test		0.66	0.03	0.04	0.17	0.21	0.25	0.97	0.80

a better perception of the company than the group without this information. For the other variable, related with ability (''I believe that this company has the ability to produce products according to market requirements''), the group with the company environmental commitment information shown a lower perception of the company than the group without the information. For the other indices, the differences were not statistically significant. Therefore, *H1*, *H3* and *H4* were rejected, and *H2* was partially confirmed.

Conclusions, limitations and discussion

The experiment demonstrates that consumer's knowledge about company's environmental commitment can affect the consumer's perception of company trustworthiness, but this effect is not strong and not present in all the variables that are considered as sources of company trustworthiness.

Perceived benevolence seems to be the more sensitive variable. The positive and significant effect of company cause commitment in one measure, and the also positive (same difference between groups) but not significant effect ($p < 0.20$) on the other seems to indicate that this type of signal is relevant in respondents' assessment of company benevolence.

The fact that one of the measures of company's perceived ability was affected, but in a negative way, by the knowledge of this type of commitment opens an interesting discussion. First, why the effect is negative? A possible answer can be that respondents perceive these activities as ''deviation of resources'', and if the company assigns too much resources to this activities, then some other activities, more important for consumers, would be performed in a deficient way. Therefore, a possible answer is that respondents perceive a ''trade-off'' of resources. The second question is related with the previous one; if the effect on perceived ability is negative, what is the optimal trade-off between an increase in perceived benevolence and a decrease in perceived ability? The more reasonable answer is that this trade-off depends on the type of risks associated to specific relationships. As Sheppard and Sherman (1998) suggested, it is possible that trustworthiness means different things, depending upon the nature of the risk being assumed in the relationship. On one hand, when the risk of unreliability is present (i.e. when exists the risk that the trustee will not be able to fulfill the trustor requirements), competence has been emphasized as a feature of trustworthy partners (Butler, 1991; Cook and Wall, 1980; Good, 1988; Mishra, 1996; Sitkin and Roth, 1993). On the other hand, when the potential for abuse or neglect exists, benevolence is a desirable quality in trustworthy partners (Larzelere and Huston, 1980).

The absence of effect in perceived integrity is an unexpected result. Further investigation must be recommendable to check for the possible causes, if the effect is really not significant.

Finally, the almost inexistence effect of company's cause commitment on company's perceived trustworthiness is also an unexpected result. Possible explanations for this result can be associated with the sample characteristics, the product category used in the research, and the relationship among the three variables that are considered as sources of company trustworthiness.

An important limitation of the present research is related with the sample size. The number of respondents considered was small, and therefore the statistical analysis, specially the validity analysis of measures, must be taken with caution.

The fact that respondents were all males is another point to take into consideration. While this sample characteristic makes possible test the hypothesis without controlling for gender effects, also limits the conclusions. In this direction, future research can be oriented to identify differences, in size and orientation, produced by this type of company's signals in different genders. Following the same line of thinking, the effect of this type of signals in consumers' perception can be an interesting topic for cross-cultural research.

The evaluation of positive or negative effects caused by the company commitment with more controversial causes may be another interesting issue to be tested. In this line of study, the incorporation of personal values and the level of agreement or disagreement with the cause can be considered as moderators of the effects, and a formal model can be proposed and tested.

An important managerial implication is related with the environmental commitment of firms. Increasingly, companies are considering environmental differentiation as a basis for their competitive strategy (Roy and Vézina, 2001). The central discussion related to the implementation of this type of strategy has been centered on the appropriate signal device for different groups of stakeholders, assuming that the environmental commitment content of the signal is always perceived as positive feature of the company. The results of the present research seem to indicate that this content, in some contexts, can have a negative impact on stakeholders' perception of the firm.

Note

1. For simplicity, the brand Wrangler was used as a company name. The reason for this is that consumers are familiar with the specific brand, but does not know the company that produces it. Therefore, and as a way to avoid confusion from the part of respondents, the company name used was ''Wrangler Inc.'', and was presented as part of a bigger corporation. Nevertheless, all the information presented to respondents was related to ''Wrangler Inc.''.

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Leadership, learning and human resource management

Exploring leadership in times of paradox and complexity

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Abstract

Purpose – *Increasingly, organizations are faced with complex challenges stemming from integrating societal change into business. These challenges create new demands for leadership. The paper aims at more clearly identifying these leadership demands and possible courses of development.*

Design/methodology/approach – *Based on an exploratory, multi-method program of research at the Center for Creative Leadership, this paper reports on cross-national data from 157 practicing managers to uncover the patterns that exist between the societal context, organizations, and the changing nature of leadership. Specifically, the paper addresses the following questions: What skills do individual leaders need to be successful in the future? How is leadership at the organizational level different today, and what will it look like in the future? Are there differences between the US and non-US populations in their view of organizational leadership? What is the current capacity of organizations to accomplish leadership?*

Findings – *Results demonstrate a shift in the practice of leadership from more traditional, individual approaches to more innovative, collaborative approaches. Further, the comparison of non-US with US data shows that non-US populations expect more innovative leadership approaches/philosophies in the future.*

Research limitations/implications – *The implications for research are discussed in terms of expanding the definition of leadership, while implications for practice are framed within the context of emerging approaches to leadership development.*

Originality/value – *This paper will be of value to those practicing leaders, researchers, and development specialists who are interested in exploring the frontiers of leadership in times of paradox and complexity.*

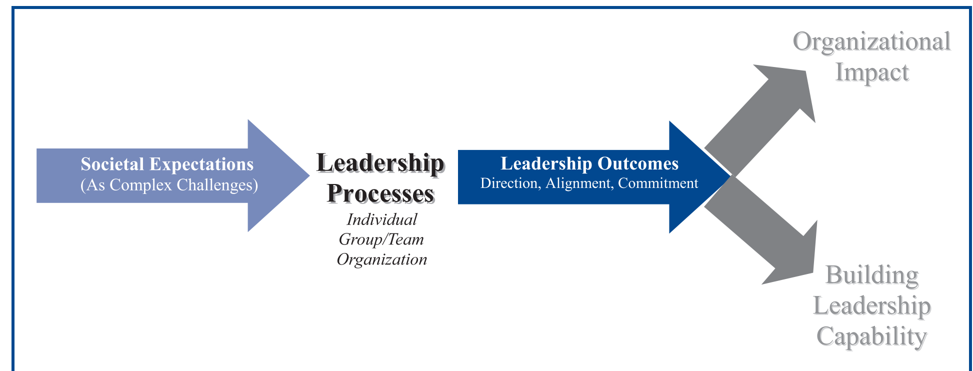
Keywords *Leadership, Development, Complexity theory, Organizational change*

Paper type *Research paper*

Reports in the academic and popular press make it clear that organizations are increasingly being required to face complex challenges stemming from integrating societal change into business. By their nature, complex challenges require new knowledge, resources, and perspectives found outside current organizational capacity. As such, these challenges create new demands for leadership.

In this paper, we explore how leadership is changing in light of increasing paradox and complexity in society. The literature review is organized according to the components of the framework identified in Figure 1. Specifically, in the first section we consider the relationship between societal expectations and the complex challenges organizations must increasingly face. And in the second section, we consider the definition of leadership and how it is changing in light of these challenges.

Figure 1 A framework of leadership in a time of paradox and complexity



Societal change and complex challenges

Society is not afforded any certainty about the future. Generations before us had decades to prepare for shifts in thought, technological advances, or cultural transformations. Today we are lucky to be given 24 hours (Enriquez, 2000). Recent research has predicted that the exponential pattern of current change is so steep that by the year 2025 we would be witnessing the equivalent of all the major milestones of the twentieth century (i.e. electricity, automobile, DNA structure described, nuclear energy, WWII, space travel, internet, human genome sequencing) in less than a week (Modis, 2003).

With these advances, come changing mandates concerning the role of business in our global society. Due to increasing transparency, opposing tensions are created between business and civil society on a number of fronts including globalization, demographic shifts and migration, degradation of natural resources, and diminishing social and community structures (Connor and Mackenzie-Smith, 2003). It is within these tensions where complexity can reach a ''boiling point'' and make mutually beneficial solutions impossible to see, let alone realistic to achieve.

Organizations are experiencing the effects of changing societal mandates in the form of complex challenges. Complex challenges are bundles of both technical challenges – those possibly within our current problem solving expertise, plus adaptive challenges – those requiring new understandings, processes and perspectives found outside current knowledge and resources (Heifetz, 1994; Palus and Horth, 2002). The Center for Creative Leadership is currently examining a third type of complex challenge called critical challenges, or those challenges that result from an unexpected event that require immediate and often drastic organizational response.

Complex challenges defy existing solutions, resources, and approaches; they question fundamental assumptions and mental models; and they demand new learning and creativity. Paradoxically, complex challenges require quick and decisive action, yet because the individual or organization does not know how to act, there is a need to slow down and reflect. Examples of complex challenges facing organizations include the call for traditional manufacturing firms to adopt sustainable production processes, the tension felt by organizations in integrating cultural diversity, the need of a postal delivery company to respond to a mail contamination crisis, and the role of global business within the broader society (Dalton *et al.*, 2002).

Challenges such as these, brought on by the need to integrate societal change into business, bear down on organizations at an ever-increasing rate. Specifically, these challenges are asking organizations to practice higher levels of collaboration, especially as they are forced to work across boundaries and interact in a more meaningful way with society at large. It is assumed that as organizations go, so must their leaders. Thus,

leadership will experience a fundamental transformation in order to react, to learn, and to approach work in innovative ways to combat complex challenges. Or, will it?

The changing nature of leadership

Leadership has been the source of more extensive investigation than almost any other aspect of human behavior (Kets de Vries, 1993). In 1999 alone, an estimated 2,000 + books were published on the topic of leadership (Goffee and Jones, 2000). Unfortunately, the construct of leadership lacks a common and established definition by which we can evaluate variation over time (Barker, 1997; Higgs, 2003).

A recent investigation (Steed and McCauley, n.d.) evaluated the articles published between 1994 and 2003 in the *Leadership Quarterly*, a widely recognized journal of leadership with an international circulation. Initially, the researchers looked for evidence of fundamental changes in the way leadership is being discussed in the literature. They found wide diversity of leadership definitions but no explicit patterns or evolutions of a single definition over time. More interesting, when we look beyond a given journal, leadership-based articles often do not offer a definition of leadership at all. For example, Rost (1991) analyzed a total of 587 articles that referred to leadership and found that 366 of the papers lacked any definition of leadership.

For purposes of this paper, we define leadership as the collective activities of organizational members to accomplish the tasks of setting direction, building commitment, and creating alignment (McCauley and Van Velsor, 2004):

- *Setting direction*: the articulation of mission, vision, values, and purposes that address questions such as: Where are we going? What are we going to do? Why are we doing it?
- *Building commitment*: the creation of mutual trust and accountability that addresses questions such as: How can we stay together? How can we work better as a group? What can improve cooperation?
- *Creating alignment*: the finding of common ground and areas of interrelated responsibility that address questions such as: How do we develop a shared understanding of our situation? How can our actions be better coordinated?

The process of completing these tasks can be understood from a variety of perspectives such as viewing leadership as an individual activity carried out by people in positions of authority to viewing leadership as a collective activity carried out by groups of individuals, communities, and organizations who share work (Drath, 2001). In either of these points of view, leadership is seen as the outcome of interactions between groups of people. If these interactions lead to the tasks of direction, commitment, and alignment being accomplished, then leadership capacity is present and optimal levels of organizational performance are more likely to exist. However, as work becomes increasingly interdependent and complex, the tasks of direction, commitment, and alignment are becoming less attainable (McCauley and Van Velsor, 2004).

Given this line of inquiry, in this paper we investigate the following research questions:

- What skills do individual leaders need to be successful in the future?
- How is leadership at the organizational level different today, and what will it look like in the future?
- Are there differences between the US and non-US populations in their view of organizational leadership?
- What is the current capacity of organizations to accomplish leadership?

Methods

The present study reports on exploratory, multi-method, cross-national data to uncover the patterns that exist between the societal context, organizations, and the changing nature of leadership. A description of the participants and procedure employed is provided below.

Participants

The participants were 157 practicing leaders attending either the Leadership Development Program (LDP) or Leadership Development for HR Professionals (LDHRP) conducted at one of the Center for Creative Leadership's (CCL) four active campuses. CCL is an internationally recognized resource for understanding and expanding the leadership capabilities of individuals and organizations from across the public, private, nonprofit, government and education sectors.

Both programs are five-day executive development programs. A total of 113 participants provided biographical data and had the following demographics: they were predominantly Caucasian (80 percent), male (64.3 percent), from the business sector (80.5 percent), with an average age of 42 (range from 29 to 61). A total of 27.8 percent identified themselves as executives and 56.4 percent identified themselves as upper middle managers. A total of 72 percent of the participants were currently living in the US while 67 percent listed the US as their country of origin. The non-US participants represented 28 percent of the data when broken out by country of residence. Within the non-US sample, the UK represented 36 percent of the data while Canada, Brazil, Ireland, Germany, and Switzerland represented 7 percent of the sample.

Procedure

Participants contributed to three different data collection opportunities. The first consisted of a leadership continuum wall chart that was located directly outside the classroom. At the start of the program, participants were asked to designate their responses to 11 characteristics of organizational leadership over three time periods (five years ago, now, and five years in the future). The characteristics ranged from more individual leadership approaches to more collaborative leadership approaches (for example, leadership is a position versus leadership is a process). The ordering of the characteristics was varied to control for response bias, and responses were tracked back to previously collected general demographic data (age, executive level, organizational type, etc.).

The second data collection opportunity asked participants to complete a worksheet as part of their program experience. During a module associated with the process of professional development in organizations, participants were asked to reflect upon their organization's development culture. The worksheet focused on three main areas:

1. The leadership skills needed in the future.
2. The organizational constraints or obstacles to development.
3. The organizational supports to development.

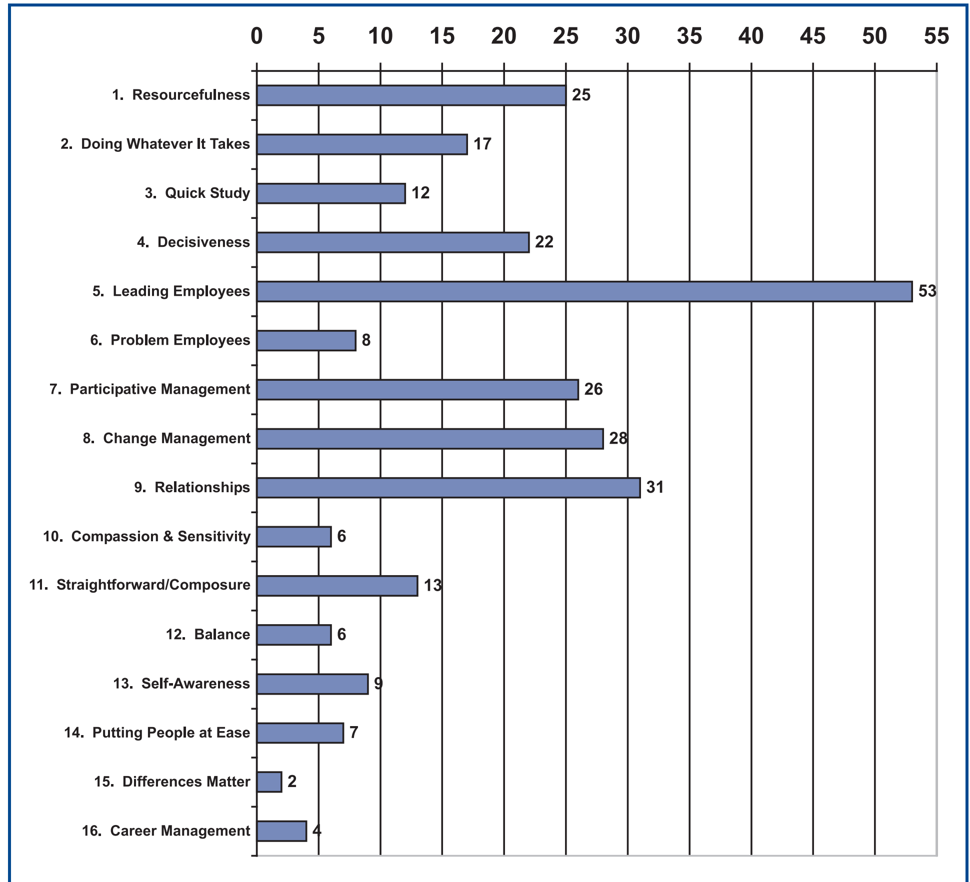
The third collection opportunity involved the participants providing permission for the research team to send a follow-up internet survey to them two weeks after the conclusion of the program. The completed participation cards were given directly to the research team and the volunteers were sent a survey two weeks after the program close. The survey examined leadership in response to complex organizational challenges.

Results

Research question I: what skills do individual leaders need to be successful in the future?

Based on the framework provided in Benchmarks®, a CCL research-based assessment instrument, we asked 85 leaders in our open enrollment program what leadership skills they thought would be more important to successful leadership in the next two to three years. Out of the 16 scales within Benchmarks®, five scales represented 60.9 percent of the data. Those scales and their frequency percentages (see Figure 2) were leading employees (20 percent), building and mending relationships (11.5 percent), change management (10.4 percent), participative management (9.7 percent), and resourcefulness (9.3 percent). A complete description of the scales and their associated items are provided in Table I.

Figure 2 The frequency counts of future leadership skills via The Benchmarks® 360 instrument



To assess if there are any differences in the individual leadership skills needed in the past versus the near future, we compared our data to that collected via our Benchmarks® database. Within the Benchmarks® instrument, participants are asked to select no more than eight of the 16 scales they believe are most important for leadership success in their organization. As shown in Table II, the scales evaluated as being most important include:

- leading employees;
- resourcefulness;
- straightforwardness and composure;
- decisiveness; and
- building and mending relationships.

Each of these categories was listed as important over 64 percent of the time. By comparing the importance ratings, it is clear that future leadership skills will place increased emphasis on building relationships, collaboration, and change management.

Research question II: how is leadership at the organizational level different today and what will it look like in the future?

To address this question, we employed the aforementioned wall chart methodology with 113 participants. The data shows that leadership is moving from more traditional, individual

Table I A description of the scales most important to future success as a leader

Benchmarks scale	*A sample of the associated items*
Leading employees	Is willing to delegate important tasks, not just things he/she does not want to do Provides prompt feedback, both positive and negative Coaches employees in how to meet expectations Interacts with staff in a way that results in the staff feeling motivated Develops employees by providing challenge and opportunity Surrounds him/herself with the best people
Building and mending relationships	Gets things done without creating unnecessary adversarial relationships When working with a group over whom he/she has no control, gets things done by finding common ground Tries to understand what other people think before making judgments about them Quickly gains trust and respect from his/her customers Can settle problems with external groups without alienating them
Change management	Leads change by example Accepts change as positive Takes into account people's concerns during change Adjusts management style to changing situations Adapts to the changing external pressures facing the organization
Participative management	Uses effective listening skills to gain clarification from others Encourages direct reports to share Gains commitment of others before implementing changes Listens to employees both when things are going well and when they are not Recognizes that every decision has conflicting interests and constituencies
Resourcefulness	Does his/her homework before making a proposal to top management Links his/her responsibilities with the mission of the whole organization Understands higher management's values, how higher management operates, and how they see things Learns from the mistakes of higher management (i.e. does not repeat them him/herself)

leadership approaches to more innovative, collaborative approaches. In an examination of the means and standard deviations (see Table III and Figure 3), on all 11 scales, the ''five years ago'' mean was in the negative range (meaning it leaned towards a more ''traditional'' approach to leadership). On seven of the 11 scales, the ''now'' mean was in the negative range, but closer to the 0 point (which represents the balance point between the two poles of the dyad). On ten of the dyads, the ''five years from now'' mean was in the positive range (meaning towards a more innovative approach to leadership) with the ''logical and rational/feeling and emotional'' scale being the only exception.

Table II Percentage of times Benchmarks® takers deemed a category important

Benchmarks® scale	*n*	*Percentage**
Resourcefulness	170,139	78
Doing whatever it takes	170,139	59
Being a quick study	170,139	47
Decisiveness	170,139	66
Leading employees	170,139	83
Confronting problem employees	170,139	29
Participative management	170,139	62
Change management	170,139	59
Building and mending relationships	170,139	64
Compassion and sensitivity	170,139	29
Straightforwardness and composure	170,139	68
Balance between personal life and work	170,139	37
Self-awareness	170,139	33
Putting people at ease	170,139	25
Differences matter	170,139	19
Career management	170,139	18

Note: *Percentage of raters who selected it as one of the eight scales that are most important for success at their organization (these are the all-observer selections)

Table III The means and standard deviations for the wall chart continua

	Five years ago		*Now*		*Five years in future*	
Leadership is . . .	*Mean*	*SD*	*Mean*	*SD*	*Mean*	*SD*
A position/a process	−2.42	2.62	−0.06	2.66	2.41	2.38
Functional/boundaryless orientation	−1.39	3.05	−0.24	2.51	0.71	2.91
Happens at the top/happens throughout organization	−1.44	3.18	0.72	2.85	2.54	2.34
Rewarded for being a star/rewarded for success of others	−1.10	3.51	−0.02	2.54	1.49	2.84
Independent decision making/interdependent decision making	−2.11	2.64	0.25	2.28	2.35	2.10
Individual leadership competencies/groups and networks	−0.91	2.93	−0.38	2.22	0.87	2.96
Power lies in the position/power lies in knowledge	−2.25	2.87	−0.80	2.31	1.52	2.47
Competitive/collaborative	−0.89	3.21	0.16	2.45	0.82	2.99
Logical and rational/feeling and emotional	−1.82	2.91	−1.46	2.34	−0.92	2.38
Stay the course strategy/emergent strategy	−0.41	3.26	0.99	2.27	1.46	2.08
Sells their opinion/inquires for buy-in	−2.04	2.50	−0.29	2.22	1.57	2.13

Research question III: are there differences between US and non-US populations with regard to their view of organizational leadership?

By comparing the leadership continua means across the three time periods by country of residence, we were able to see some key differences in the way organizational leadership is being viewed from a US versus non-US perspective (see Table IV and Figure 4). First, a general trend among the data showed that across all continua the non-US population has seen or expects to see the greatest change in leadership with a mean difference of 3.86 from ‘‘five years in the past’’ to ‘‘five years in the future’’ while the mean difference for the US population was 2.53. These results show that the non-US population is expecting greater differences in leadership to occur over time.

A second finding examined the means of the two groups to assess the greatest differences in leadership between the US and non-US populations in the present and future. In the

Figure 3 The means of wall chart continua by time period

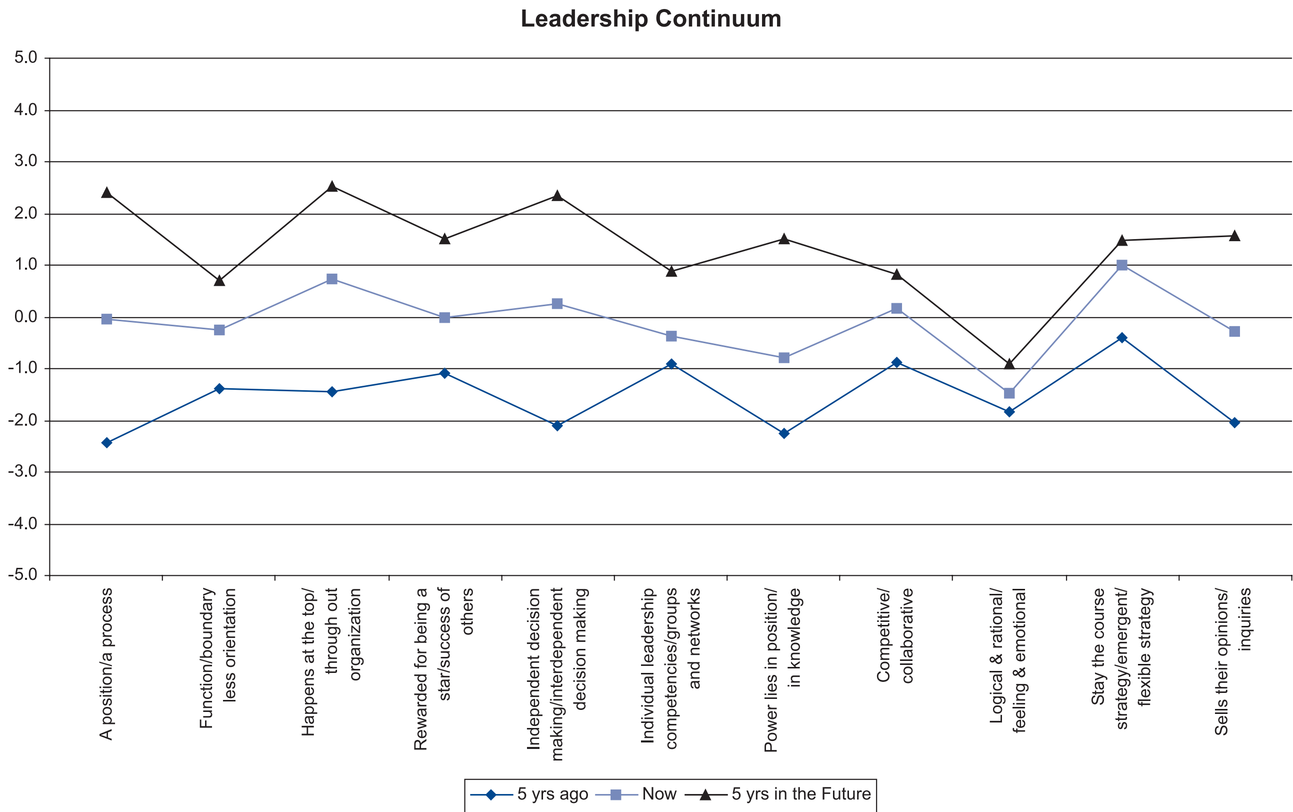
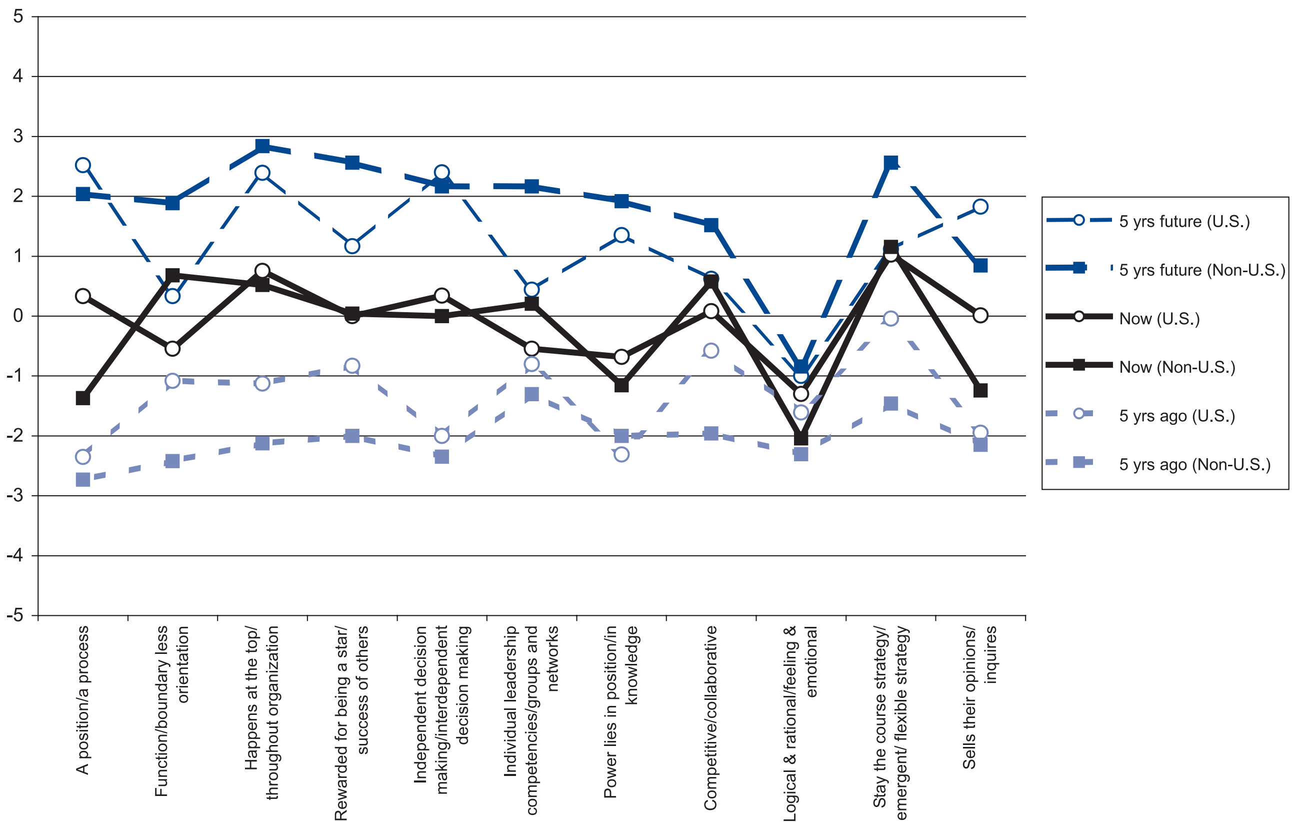


Table IV The means and standard deviations for the continuum wall charts by country of residence (US versus non-US) and time period

Leadership is . . .		*Five years ago* Non-US	*Five years ago* US	*Now* Non-US	*Now* US	*Five years in future* Non-US	*Five years in future* US
A position/a process	Mean	−2.73	−2.35	−1.37	0.33	2.04	2.52
	SD	2.74	2.58	2.73	2.49	2.68	2.29
Functional/boundaryless orientation	Mean	−2.42	−1.08	0.68	−0.54	1.88	0.33
	SD	2.49	3.45	2.50	2.56	2.61	2.89
Happens at the top/happens throughout organization	Mean	−2.13	−1.13	0.52	0.76	2.84	2.39
	SD	3.44	3.07	2.77	2.90	2.36	2.34
Rewarded for being a star/rewarded for success of others	Mean	−2.00	−0.83	0.04	0.00	2.56	1.17
	SD	3.5	2.51	2.85	2.47	2.49	2.80
Independent decision making/interdependent decision making	Mean	−2.35	−2.00	0.00	0.34	2.17	2.40
	SD	2.62	2.70	2.45	2.23	2.28	2.04
Individual leadership competencies/groups and networks	Mean	−1.30	−0.80	0.21	−0.54	2.17	0.44
	SD	3.14	2.89	2.40	2.15	2.67	2.91
Power lies in the position/power lies in knowledge	Mean	−2.00	−2.31	−1.15	−0.68	1.92	1.35
	SD	3.08	2.80	2.36	2.31	2.80	2.38
Competitive/collaborative	Mean	−1.96	−0.58	0.58	0.08	1.52	0.62
	SD	3.00	3.20	2.25	2.51	2.86	3.01
Logical and rational/feeling and emotional	Mean	−2.31	−1.61	−2.04	−1.30	−0.84	−1.00
	SD	2.54	3.03	2.26	2.37	2.64	2.31
Stay the course strategy/emergent strategy	Mean	−1.46	−0.04	1.15	1.03	2.56	1.12
	SD	3.27	3.19	1.87	2.35	2.42	3.15
Sells their opinion/inquires for buy-in	Mean	−2.15	−1.95	−1.24	0.01	0.85	1.83
	SD	2.82	2.40	2.03	2.18	2.43	2.24

Figure 4 Means for leadership continuum wall chart data by country of residence (US vs non-US)



present, the non-US population saw leadership more as a process by which leaders gain buy-in via inquiry, whereas the US population viewed leadership more as a position where opinions are ''sold'' via advocacy.

As we examined the future itself, the non-US population expected a shift towards the ''non-traditional'' aspects of leadership including allowing leadership to be enacted in a boundary-less orientation (mean difference = 1.55) through groups and networks (mean difference = 1.73) and a flexible strategy (mean difference = 1.44). In comparison, the US population gravitated more towards leadership as a process (mean difference = 0.48) that happens through inquiry (mean difference = 0.98).

Research question IV: what is the current capacity of organizations to set direction, build commitment, and create alignment?

As part of our internet survey (see Table V for specific items), participants were asked to consider their organizations and determine the extent to which they agreed with a series of statements, with higher responses indicating greater levels of agreement. The highest level

Table V The means and standard deviations for the theory and construct items

	n	*Minimum*	*Maximum*	*Mean*	*Std. deviation*
The definition of ''effective leadership'' has changed in the last five years	47	1.00	5.00	3.9574	1.06235
Leadership sets direction effectively	47	1.00	5.00	3.3404	0.98415
Leadership gains commitment effectively	47	1.00	5.00	3.2979	1.17797
Leadership creates alignment effectively	47	1.00	5.00	3.3404	0.98415
Valid *n* (listwise)	47				

of agreement was found in response to the question, ''has the definition of leadership changed in your organization in the last five years?'' The mean ($x = 3.96$) suggests that leadership, as defined in this sample of organizations, is rapidly changing. The lowest level of agreement was found in relation to three questions assessing the ''tasks of leadership.''

Participants were asked to reflect on their organization and its leadership ''as a whole'' and determine how well that leadership is currently ''setting direction,'' ''building commitment,'' and ''creating alignment.'' Respondents in the survey believed their organizations had room to improve at gaining commitment ($x = 3.29$), setting direction ($x = 3.34$), or creating alignment ($x = 3.34$). This trend is especially apparent when we looked at the percent favorable (scores ranging at or above four on a five-point scale) where direction (45.8 percent), commitment (47.9 percent), and alignment (41.7 percent) all scored below 50 percent.

Discussion

Are there meaningful patterns that exist between societal context, organizational challenges, and leadership? If so, how is leadership changing as a result? The present paper sought to address these questions with a sample of practicing leaders. While more research is needed to understand the complex nature of these interactions, the present findings will be of benefit to leadership practitioners and researchers interested in exploring the changing nature of leadership. To guide this discussion, the paper findings are framed under two main statements:

1. The nature of leadership is changing.
2. Leadership capacity is limiting current organizational effectiveness.

The nature of leadership is changing

In response to complex challenges, leadership is being forced to react, to learn, and to approach work in innovative ways. To fully understand this phenomenon, we must examine leadership from three perspectives: the individual, the organization, and leadership across cultures. At the individual level, the skills that practicing leaders believe will be most important to effective leadership in the future fall generally in the category of relationships and collaboration.

When the skills around collaboration and relationships are combined with the other skills deemed most important (change management and resourcefulness), it seems leaders are expecting little or no relief from the turbulence and slashing of resources that have begun to characterize our time. When we examine the entire picture of leadership skills, essentially leaders and their organizations must build a proficiency to move faster with greater collaboration and shared commitment as opposed to the past, which simply focused on proficiency.

Though development of individual leaders will continue to be important for sustained organizational success, we must also address leadership at the broader organizational level. As evidenced by the research findings, organizations have made some significant shifts in their practice of leadership by attempting to reach a greater balance between traditional leadership approaches and more innovative interactions. For instance, at present, organizational leadership is being considered more of a process that occurs throughout the organization rather than a position someone holds. Further, leadership is rooted in knowledge power over position power and inquiry over advocacy.

Our data also allows us to look at variations in perspectives on leadership by comparing the US and non-US (primarily European) data. Both the US and non-US data demonstrate a general movement from more individual, leader-centric approaches to more collective, collaborative approaches when comparing leadership at three points in time (past, present, and future). Yet, the extent of this movement is far more striking in the non-US data. Specifically, the leaders outside the US expect to see organizations and their leadership creating boundary-less organizations where emergent strategies are enacted through

groups and networks and leadership is understood as existing throughout the organization rather than solely at the top.

While we can only speculate at this time, there are a number of possible explanations for this finding. First, it is possible that the non-US population view leadership as a more malleable and flexible construct than the US population. Whereas the social construction of ''heroic leadership'' and leadership as ''the person at the top'' have become firmly embedded in the American psyche, the understanding of leadership outside the US, in contrast, is perhaps more nuanced and variable than this limited approach.

A second possible explanation is the difference between a strong psychological orientation toward viewing organizations in the US compared to a more sociological orientation in Europe, and other parts of the world. These orientations play out repeatedly in the literature with US-based leadership research tending to focus on the unique attributes, skills, and abilities within individual leaders, whereas European leadership research is more often grounded in systems thinking and group dynamics.

A final explanation, most relevant to the focus of the present paper, is the heightened level of expectation regarding the role of the business in society in Europe and other countries in comparison to the US higher expectations and greater organizational transparency, call for more boundary-less, collaborative, and emergent strategic forms of leadership than more closed systems in which the organization is viewed as being independent from the broader society. Further research is needed to more fully understand differences in perceptions of leadership across these cultural contexts.

Leadership capacity as a limit to organizational effectiveness

It is clear that leadership has changed in the last five years and that the outcomes that leadership are expected to achieve on behalf of the organization are not currently being met. If we look at our definition of leadership, leadership capability and eventual organizational performance is being achieved when optimal levels of setting direction, creating alignment, and building commitment are reached. Practicing leaders are telling us that their organizations have considerable work to do in these areas.

We make the assumption that organizations cannot obtain the optimal effectiveness without adequately achieving these leadership outcomes. Given this assumption, it would also be plausible to theorize that society ultimately suffers when organizations are performing at a sub-optimal level due to the inability to mobilize resources towards some mutual good, whether that would be infrastructure investment, education, additional jobs, or corporate governance. The question remains, how can we help organizations build greater leadership capability now and in the future to do our part in meeting societal expectations?

Building leadership capacity for the future

This final section of the paper will discuss how leadership can be used as a mechanism to drive more effective response to societal demands by addressing the implications on research and practice. The research implications will focus on broadening the definition of leadership, while the practice implications will introduce CCL's next evolution of leadership development.

In terms of research, more work is needed to operationally define the very construct of leadership. On one hand, we continue to see a number of leadership studies that fail to define the central construct of interest. On the other hand, we see that among those studies that do define leadership, leadership is most often described as something that an individual or group possesses – whether it be a skill, a role, a strategy, or a practice. Consequently, we end up with a wide variety of leadership definitions.

Alternatively, in our research and practice at the Center for Creative Leadership, we define leadership as the collective activities of organizational members to accomplish the tasks of setting direction, building commitment, and creating alignment (McCauley and Van Velsor, 2004). By viewing leadership as an outcome to be achieved by the organization or collective rather than a skill or role that a person or group possesses, it becomes possible to view

leadership from a broader, more inclusive lens. According to this definition, leadership would be exercised when a CEO articulates a compelling and inspirational mission that sets organizational direction; when a cross-functional group reaches across organizational boundaries to align IT systems; and when organizational members come together to confront a critical challenge and develop greater trust and respect through their interactions.

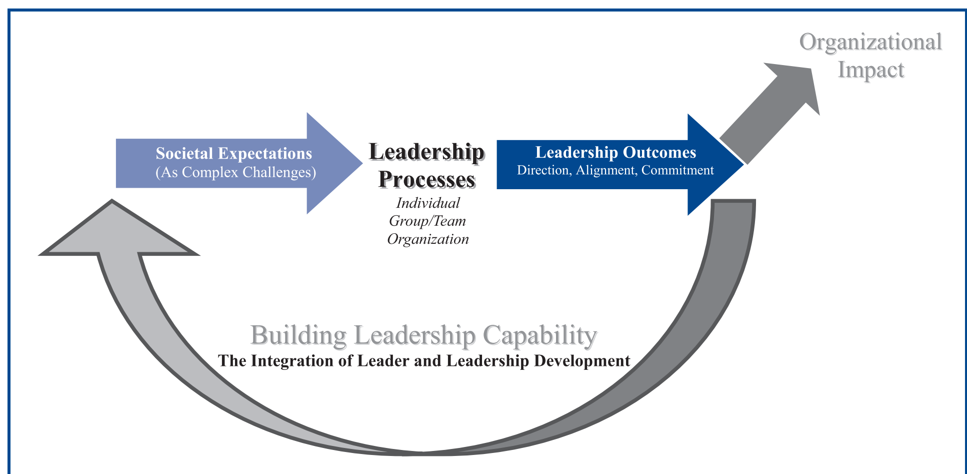
Given the findings of this research, we also see the need for broadening our understanding of how to develop leadership. Traditional approaches to developing leadership focus on the unique attributes and qualities of the individual leader. At CCL, we refer to such approaches as leader development in which the focus is on building individual capacity to participate in accomplishing the leadership tasks. In contrast, leadership development focuses on building organizational capacity for accomplishing leadership tasks in the face of complex challenges. To effectively overcome the complex challenges identified in this paper, organizations must begin developing leadership both at the individual and organizational level (see Figure 5).

CCL has utilized its foundation of leader development (individual competencies, skills, etc.) to begin exploring and experimenting in this vast space. The areas we have begun to target at the organizational level include: developing leadership practices for interdependent work; building connections across boundaries; and developing interdependent cultures. Underlying these areas is the belief that to remain agile in an ever changing environment, organizations must begin utilizing collaboration, shared mental models, and action learning to drive leadership capability and eventually more proactive organizational response to challenges.

One example of a recent intervention utilizing this model of leadership development had CCL partnering with one of the largest organizations of any kind in the world as it works to transform a well-institutionalized approach in order to face the challenges of an increasingly competitive and unpredictable environment. The intervention is designed to address an array of targets: individual self-awareness, patterns of group interaction, and organizational practices and systems. By creating a challenge-focused, action learning-based ''practice field,'' opportunities for development occur at multiple organizational levels. As a result, participants are able to work more effectively across boundaries and practice new ways of setting direction, creating alignment, and building commitment.

We have identified some key insights in developing an emerging practice in the area of leadership development. First, for organizations to begin examining organizational capacity for leadership, individual leader development is a necessary starting point. Without a common language guiding the interaction of individuals and small groups, interdependence at a systemic level is impossible.

Figure 5 An updated framework of leadership in a time of paradox and complexity



Secondly, the methodologies that have guided leader development to date (assessment for development, coaching, tactile learning, module-based training, etc.) are no longer sufficient. To create higher levels of organizational capacity for leadership, customized, action learning-based interventions that are built around the culture, complex challenges, and structure are a necessity. Whereas in individual leader development, these organizational inputs are often treated as constraints or supports to development, in leadership development they are the central content.

Lastly, organizations must be willing to make a significant and long-term investment to building leadership capability from the middle of the organization out. Leadership development must focus on the middle of the organization as this is where strategic intent and values/norms become permanently melded with stakeholder (customer, supplier, societal stakeholder) expectations. If developmental interventions addressing complex challenges are attempted at either the bottom or the top of the organization, there is a high probability that the very nature of the complex challenges, the strategic intent, the values/norms, or the resource limitations will be miscalculated and development will be compromised.

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The meanings of social entrepreneurship today

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Abstract

Purpose – *Aims to explore the historical development and current usages of the concept of social entrepreneurship.*

Design/methodology/approach – *The paper first examines the socio-political conditions leading to business repositioning in the traditionally governmental role of catering to the financial needs of civil society. It then reviews several models of social entrepreneurship and the leaders who have emerged as social entrepreneurs within those frameworks.*

Findings – *In discussion the paper questions some of the motives of social entrepreneurs and warns against uncritical acceptance of a blurring of the boundaries between sectors of society.*

Research limitations/implications – *This is a theoretical paper. Follow-up research will examine in detail case studies of social entrepreneurship.*

Originality/value – *Social entrepreneurship is a new and rapidly rising field of practice that is, as yet, under-researched. This paper synthesizes the limited yet diverse current literature on social entrepreneurship. It also offers a critical perspective that needs to be taken into account before the practice is accepted as a common-sense salve to social difficulties.*

Keywords *Entrepreneurialism, Privatization, Leadership*

Paper type *General review*

An important avenue toward responsible and sustainable business is ''social entrepreneurship,'' although its appearance has been more marked in practice than in academic research. Indeed, there is but a nascent body of academic literature published on the subject, with a smattering of studies across disciplines. In this paper we draw on that literature, as well as popular discussions and contemporary case studies, to explore the development of the concept of social entrepreneurship and its motivations, its promises and its implications. At the outset, we stress the diversity of economic, political, and social phenomena associated in one way or another with the term ''social entrepreneurship'' while also emphasizing the broad appeal of the term.

The renaissance of social entrepreneurship: historical and socio-political perspectives

Central to any discussion of social entrepreneurship are the questions of who should and who can take responsibility for the needs of civil society. Indeed, ideologically based questions emerge regarding the continuance and health of a civil society that is necessarily distinct from either the political or economic sectors. Answers to these questions have varied throughout modern history according to the prevailing, predominantly economic, theories upon which national governance has been based.

In the years immediately following the second world war and until the early 1970s, the governments of most western democratic countries followed the Keynesian model of social democracy, with fixed currency exchange rates to guard against inflation, nearly full employment, and a solid welfare system in place for those who needed it. Social services such as health and education were provided by the state. The economic and social stability enjoyed at that time ensured hegemonic acceptance of the model. That hegemony met with serious challenge at the time of the major oil shortage in 1974 when rising inflation undermined the logic of fixing exchange rates.

From the early 1980s many of those countries that had maintained their welfare state systems for over 20 years shifted to a new economic paradigm of *laissez-faire* or free market neo-liberalism. This model, in contrast to its predecessor, is characterized by deregulated markets and privately owned enterprises, with minimal involvement of the state in the economic sector. Part of the process of moving over to neo-liberalism required the ''corporatization'' and eventual privatization of previously state-owned assets. Very often, those assets were in the key economic areas of transport, energy, and communications. Marketization and varying degrees of privatization were also extended to the sectors of health and education and, in some cases, to corrections and disaster relief. As the role of the state was withdrawn, income tax rates were typically lowered as individuals were encouraged to take responsibility for their own welfare. The shift towards deregulated economies in countries throughout the world was encouraged by those who pursued the concept of a global economy. Once policy deregulation began to include capital and securities markets, from 1987, financial trading grew exponentially, as investors sought to capitalize on shifts in national currency values, leading to economic instability in several less industrialized countries. The growth in financial trading was facilitated by the development of new communication technologies (Castells, 2000).

By the late 1990s it had become apparent that the neo-liberal model was not ensuring the welfare of all people. Indeed, the growing gap between rich and poor individuals (and countries) had become clear. Large corporations, because of their ability to choose where to invest capital, could wield economic power to an extent that made regulation difficult (Gray, 1998; Grossman, 1998; Karliner, 1997). The extension of market principles into government and civil society (by virtue of individual rather than collective responsibility) has led to a blurring of the boundaries between these sectors beyond even what had been experienced in the form of public-private partnerships before the 1990s.

Although *laissez-faire* approaches to economic governance have featured in other periods of our history, it is arguable that once the Keynesian model with its system of social welfare had been experienced, people were no longer prepared to accept governments that abdicated responsibility for those who could not fend for themselves. It was the rejection of the neo-liberal model and its negative consequences that led to the rise of a compromise, commonly referred to as ''the third way'' (Giddens, 1998). Embraced by Britain's current New Labour government, New Zealand's current Labour government, the former US government of Bill Clinton, amongst others, the third way reinstates government responsibility for social services such as health and education but also embraces a free market for business and supports unbridled free trade as the goal of both national and global economies – including the specialization of national economies in areas where they can presumably best compete with low prices on the world market. The third way looks for the rebuilding of a strong civil society through community effort in partnership with government, but without resource to an entitlement based approach to social welfare (Mendes, 2000). The third way model, however, has not gained universal acceptance, and the US for example, has back pedaled from it under the administration of George W. Bush. Some of the resistance to third way economics is reflected in resistance to social entrepreneurship, as we discuss at the end of the chapter.

Governments today can no longer afford to provide social welfare to the extent that it was provided under the Keynesian model. Because they have sold the previously state-owned assets that not only were fundamental to the countries' infrastructure but also provided revenue streams, they have less income to redistribute. This is true as well in some countries

of northern and western Europe, even though their commitments to the welfare state have not been eroded as much as those in the US, the UK, and Australia. In many cases, revenue from income tax was also reduced. Raising taxes again would increase revenue but would be likely to be politically unpopular. To exacerbate the problem, technological advances in health care have increased human life expectancy rates, and have created a demand that is expensive to meet. These fundamental problems have contributed to the rise of a range of societal trends, organizational structures, and individual initiatives, all of which come under the generic umbrella term of ''social entrepreneurship''. We explore the range of uses of this term in the following section.

Models of social entrepreneurship

Introduction

As we have already indicated, there is no single way to characterize socially entrepreneurial ventures. This makes some ''mapping'' of the range of actual and possible projects and enterprises all the more important to us – in that the unifying symbol as well as its diverse practical implications represents an important cluster of trends today. In fact, it is both reasonable and common to identify certain ventures in the private, public, and third/independent sectors as examples of social entrepreneurship. While the term is most commonly used to apply to examples of ''a socially engaged private sector'' and ''more entrepreneurial approaches in the not-for-profit sector'' (Canadian Centre for Social Entrepreneurship, 2001), we also find initiatives largely or wholly within the public sector which are framed similarly (Dees, 2001).

In this section, we summarize key features of organizational models of social entrepreneurship, including the basic assumptions underlying these arrangements and the practical implications of them. Here we consider not only transformations of typical or traditional understandings of ''doing business'' in any one sector but also explore how partnerships across sectors are often pursued under the rubric of social entrepreneurship. We will now consider socially entrepreneurial ventures in each sector, private, not-for-profit, and public, respectively, while also commenting on hybrid or bridge forms.

Private social entrepreneurship

The recent academic and popular literatures suggest that working within the private sector gives the social entrepreneur an advantage in terms of the orienting to planning, profit, and innovation – three of the goals which are discussed most frequently. And, as we discuss in the section on social entrepreneurs themselves, CEOs and leaders on non-publicly-held companies report the greatest freedom to pursue their cherished values.

Socially oriented purpose business ventures can draw upon a wealth of experience in terms of market analysis and the conduct of feasibility studies (Campbell, 1998). They are already operating with profit in mind. And, depending on their accustomed market, they recognize the importance of innovation on a continuous basis. Perhaps the single most important activity for the new business start-up, or the business that is charting a new course into the social seas, is a systematic process for generating and screening ideas (Thalhuber, as cited in Campbell, 1998). A balance between the open and democratic generation of ideas and the discerning of genuinely good and feasible ones is crucial. Too much openness risks impracticality; too linear and controlled a process can mean a loss of potentiality.

Generally speaking, then, self-styled socially entrepreneurial enterprises assume greater latitude in adopting and adapting the popular business trends of the day. As we will see in the discussion of leadership that follows, much of this freedom or autonomy is held by value-driven, charismatic leaders.

Social entrepreneurship in the not-for-profit sector

In a very real sense, social entrepreneurship has been going on within the non-profit sector for a long time though without the label. Many social-movement organizations, social advocacy groups, and community initiatives have been started and sustained all over the

world through the passion, insight, and creative work of people that fit our contemporary application of the idea of the entrepreneur.

To be sure, part of the entrepreneurial trend in many non-profits has been increased competition for funding resources from private foundations and government agencies (De Leonardis and Mauri, 1992). This reality has made formerly foreign activities like market analysis and strategic planning part of the regular functioning of non-profits in a way not widely imagined as recently as the mid-1980s.

In a detailed study of social entrepreneurship in the realm of community economic development, Wallace (1999), looks especially at non-profits that set up profit-making activities in needy urban environments. These activities range from the offering of specific health and educational resources to small-business incubators. While the specific governance, fiduciary, and organizational structures of such enterprises vary greatly, most of these ventures involve at least these characteristics: an orientation toward the regeneration or expansion of economic activity, collective advancement of the public good rather than exclusionary support for private interests, community ownership or control, and participative democratic structures (Pearce, 1994).

Above all, as Wallace (1999) sees them, socially entrepreneurial arms of non-profits have the resources and freedom to experiment in ways not usually open to resource-and-regulation strapped parent organizations. Thus, she sees social-purpose enterprises as ways of bringing together the energies of all three sectors to combat entrenched economic and social problems in urban communities.

Non-profits that assume an entrepreneurial posture are less hesitant to implement concepts and practices from marketing, strategic planning, and systems for the analysis and control of costs. In other words, a certain blurring of sector boundaries is taken for granted, often as necessary for survival.

Public-sector social entrepreneurship

Theories and models of entrepreneurship in the public sector are derived in large part from economic applications of business and market models to the public sphere – an effort which began in earnest in the 1960s and 1970s. In one of the first papers on the subject, Ostrom (1964) considered how water resources management might benefit from some injection of entrepreneurial energy. Above all, she distinguished between private and public entrepreneurship by observing the significant political and administrative constraints on the latter. Public organizations have a more difficult time adapting to changing circumstances and innovating owing to constitutional, executive, legislative considerations, as well as to sheer habit. In other words, the private sector allows for greater freedom and experimentation, as seen from this standpoint.

As Shockley *et al.* (2002) explain, even through the 1990s, the theories and models of public-sector entrepreneurship overwhelmingly stressed rational economic calculation and especially direct responsiveness to market data. However, as Kirzner (1999) argued, this linear and rather mechanical idea of entrepreneurship as applied to public agencies overlooks the fact that true entrepreneurship is something more and beyond mere calculated responses to the environment of decision; it entails an ''alertness to hitherto unnoticed opportunities'' (p. 39). Thus, there is a process of discovery and creativity not fully accounted for in the traditional rational-economic model, and it is precisely that ''spark'' that the idea of entrepreneurship is meant to convey.

As we have already discussed, so-called third way economic and social policy is especially amenable to the symbols and methods of entrepreneurship, as an essential part of this ideology is that there is no inherent alienation between public and private interests.

Conclusion

If there is one theme that runs through the discussions of social entrepreneurship in every sector, it is adaptability. According to Baumgartner and Jones (2002), ''feedback loops'' are

crucial to the success of socially entrepreneurial ventures: positive feedback loops are self-reinforcing, whereas negative ones help adjust an organization that is clearly off course:

> A successful policy entrepreneur is able to correctly assess which goals will be most attractive to the constituency groups she is targeting and will adjust her tactics accordingly to maximize her chances for success (Feeley, 2002, p. 126).

In this way, the core message is one that is compatible with the contemporary themes of organizational agility, self-correcting systems, and the learning organization. Nevertheless, as Johnson (2000) concludes from her extensive review, models of good practice and means of evaluation are lacking in this arena.

The social entrepreneurs: value-driven and charismatic leadership

Introduction

Having considered a range of meanings and models for social entrepreneurship, we now turn to consider the types of individuals who are adopting this label or who have been identified with it. As described in professional publications, popular magazines, and cross-over journals, these individuals fall into three general categories:

1. Newly emergent or experienced CEOs who style themselves and their organizations as both innovative and socially responsible.
2. Administrators of non-profits or social advocacy groups who import business and market-based models to improve their organization's performance and enhance its longevity.
3. At large philanthropists who see themselves as catalysts for both organizational and societal change.

Here we consider each type in turn before moving to the question of the centrality of charismatic leadership in social entrepreneurship.

In his book *The Rise of the Social Entrepreneur*, Leadbeater (1997) explained their emergence in terms of the social gap created by the shrinking welfare state in most industrialized countries. Further, the author argued that enterprising individuals, working especially at the community level, could well be encouraged to create new organizations as well as to reform existing ones. At the broadest level, Leadbeater envisioned, the three sectors could learn from one another if socially entrepreneurial efforts were allowed to flourish.

The CEO as social entrepreneur

Good examples of the first category of social entrepreneurs above, innovative and socially-conscious CEOS, are the founders of the companies The Body Shop, Ben and Jerry's, and Patagonia. In all three cases, the founders began with strong visions of socially responsive business and succeeded in instilling their values in the organization. Key to the successes of these founding CEOs – Anita Roddick, Ben Cohen and Jerry Greenfield, and Yvonne Chouinard, respectively – was their ability to ''imprint'' a privately held company with guiding values. For example, Anita Roddick, who founded The Body Shop in 1976 as an alternative to non-value-driven cosmetics firms, described her social commitments as developing in childhood and staying with her throughout her career with the company (Grant, 2004). In all these cases and other similar ones, the relative autonomy of the company has allowed for the consistent pursuit of social values – at times against the prevailing wisdom of financial analysts and in marked contrast to some competitors.

In a study of social entrepreneurs across sectors, Dees (1998) identifies five characteristics of such individuals:

1. Employing a mission to create and sustain social value.
2. Recognizing and pursuing new opportunities to support that mission.

3. Engaging in continuous innovation.
4. Acting boldly without being limited to existing resources.
5. Exhibiting a heightened sense of accountability to stakeholders.

Importantly, what distinguishes this set of qualities from those of ''regular'' entrepreneurs is the social commitment and the lack of interest in financial reward for its own sake. However, Drucker (1990) has argued that the traits of the social entrepreneur are not in fact substantially different from those of the standard business entrepreneur.

In her survey of social entrepreneurs in Canada's private sector, Johnson (2003) explains that these individuals begin with a strong sense of social justice, view for-profit activities as a means to an end rather than an objective in itself, and are able to use resources so that ''their reach often exceeds their grasp'' (p. 3). Interestingly, Johnson finds a growing number of young self-identified social entrepreneurs in Canada today.

Social entrepreneurs in the public and third sectors

In the public and not-for-profit sectors, the stage for social entrepreneurs is certainly different. Financial constraints may be far greater. Government regulations on policy and practices may be far more stringent. And, the mission of the organization may be largely shaped by the efforts of predecessors and by precedent. Still, new organizations do arise in the third or independent sector, and governmental agencies often engage in public-private partnerships and other joint ventures that involve creative combinations of organizational interests in a project-focused way.

With special attention to social entrepreneurship in the UK, Thompson *et al.* (2000) examine the role of social entrepreneurs in a society where the welfare state is stretched well beyond its means. They then look at several examples of community partnerships and centers that target issues such as joblessness, training, and after-school involvement. One of these is the Castleford Community Learning Centre of West Yorkshire, which represents a coming together of community groups which then engaged local social services and private sources (see also Thompson, 2002). Although exhibiting a variety of organizational structures and funding formulas, all of these programs feature a person or small group of individuals who are ambitious, driven, and focused on addressing a pressing social need. In every case, too, the objective of the organization is clearly defined.

One of the most famous cases of social entrepreneurship in the not-for-profit sector is the Grameen (People's) Bank of Bangladesh, which involves an elaborate network of field representatives who assist citizens, especially women, in the creation of small businesses (Papa *et al.*, 1995). Founded by Muhammad Yunus, the Grameen Bank is an extraordinary example of grassroots mobilization through the inspired and innovative efforts of a leader. At the same time, as is the case with many value-driven organizations, the bank demands so much of field officers that overwork, exhaustion, and burnout are common.

In organizations like the Grameen Bank, we may well find examples of what Sfeir-Younis (2002) calls ''spiritual entrepreneurship'': a paradigmatic shift away from traditional entrepreneurship expressed in the form of a personal challenge: ''How can I encourage everyone associated with this enterprise to work from the highest possible level of awareness?'' (p. 44). Such a vision entails profound commitments to ethics in the treatment of others (including competitors), the linkage of the organization to the idea of a self-realization, and constant reflection on the contribution of the organization to society. Although coming out of a United Nations agency context, Sfeir-Younis argues for the application of this term and model to the private sector as well.

Philanthropy and social entrepreneurship

Long before the terms ''sustainable'' and ''socially responsible'' business were in common usage, there were identified and self-styled philanthropists. As is well known, many of the so-called ''robber barons'' of the late nineteenth and early twentieth centuries – men such as Andrew Carnegie and John D. Rockefeller, in their later years bequeathed huge sums of

money to educational and other social service institutions. Today, the Bill and Melinda Gates Foundation is now the world's largest organization of its kind. Finn and Burton (2004) offer examples of successful businesspersons who are using low-interest loans as a kind of philanthropy to stimulate the creation of new socially responsible businesses.

Today as in the past, philanthropic work often represents a shift away from traditional business pursuits, or at least a parallel ''social stream'' for successful business leaders at turning points in their careers. The question remains, however, as to the marketing advantage of such efforts, as we will discuss in the final section of this paper.

The enduring question of charisma

All commentators on social entrepreneurs agree that exceptional personal characteristics, usually held by a single person though sometimes manifested by a group, are not only helpful but essential to success. In fact, Waddock and Post (1991) argue that significant personal credibility is key to the social entrepreneur's work and to her ability to enlist the commitments of others. These points revive a long-standing issue in the study of leadership and authority in organizations: can socially responsible, sustainable ventures succeed without charismatic leadership?

Weber (1978), of course, identified three ideal (or pure) types of authority, with corresponding forms of organization: charismatic, traditional, and legal rational. The classic situation of charismatic authority is the new religious sect, centered literally on the charisma of an individual (prophet, divinity, or just an exceptional person). Traditional authority is captured in royal lineage but also in the rationale for action that is expressed as ''that's the way we do things around here.'' Legal-rational authority is invested in the system of rules, standards, and practices: in other words, bureaucracy. With all its failings, bureaucratic authority and organization is thought to be the most modern, freeing individuals from the rigidity of traditional authority and the whim of charismatic leadership. However, the motivating power of charismatic leadership is undeniable, and most organizations (in any sector) will try to ''bottle'' the charisma of the founder for further use. ''The routinization of charisma'' was Weber's phrase for the paradox of an organization (whether value-driven or otherwise) trying to capture and maintain the charisma of the founding members.

A survey of writings on today's social entrepreneurs suggests that Weber's (1978) model of charismatic authority and leadership may need to be revisited. In one of the largest systems of worker-owned-and-managed cooperatives in the world, the Mondragón Cooperative Corporation in the Basque Country, Spain, many present-day employees sense a lack of the motivating force of the company's founder, a Roman Catholic priest. In the context of expansion, financial success, globalization of markets, and the importation of management systems and programs from abroad, the core social values at Mondragón are under pressure, and the company's very identity as a democratic and value-driven business is threatened. In a number of his interviews there, in 1992, 1994, and 1997, Cheney (1999) found both explicit calls for charismatic leadership among the older employees and a sense of ''something missing'' from younger ones. The personal nature of leadership in socially entrepreneurial ventures may be more than beneficial; it may be necessary.

Discussion

Depending upon the way in which we choose to view it, the strengths or weaknesses of the concept of social entrepreneurship lie in the fact that most of its applications are in the form of a hybrid between private, non-profit and public sectors. As described, one such hybrid is found in non-profit organizations with an entrepreneurial offshoot that generates revenue for the organization's social objectives. With greater emphasis on the private, for-profit sector, a hybrid model is emerging whereby businesses lend money and expertise to non-profits. Increasingly, this latter model is linked to public pressure for businesses to demonstrate a measure of social responsibility. Taking the model a step further, Porter (2003) argued that the most realistic and desirable way for any business to be socially responsible is through what he calls ''strategic philanthropy'': selected giving in areas tied directly to the company's interests and in arenas that the company can justly claim to have knowledge and a direct

stake. His use of the term clearly suggests an indirect financial return on the philanthropic investment. Indeed, Porter stated that the exercise of traditional philanthropy does not make good business sense as it does not provide a tangible return. In a more refined consideration of types of philanthropy today, Reis and Clobesy (2001) support the notion of strategic philanthropy yet emphasize that highly motivated and visionary business leaders can bring together networks of organizations in new community ventures.

Like the term ''strategic philanthropy'', ''social entrepreneurship'' is an articulation (Hall, 1986; Slack, 1996), a combination of two concepts that do not naturally fit together and yet which seeks acceptance as common sense. It is the lack of a natural fit that renders the term open to resistance and challenge. Challenges, implicit or explicit, range from different interpretations of how the terms might justifiably be joined to denial that they should be used together at all. Johnson (2003) suggests that the lack of examples of social entrepreneurship to be found in Canada, in comparison with Britain and the US, ''reflects a discomfort with the terminology of social entrepreneurship'' (p. 5). The reason for the discomfort, she further suggests, is that many Canadians reject the move towards the market as a means of income redistribution and still regard the state as their ''provider of choice'' for social services.

Language is a key component in the shift towards rationalization of the concept of social entrepreneurship. This is because discourse acceptance precedes or runs in parallel with material acceptance. Thus we see the emergence of terms that were previously restricted to the business sector, such as ''social venture capital'', ''social return on investment'', ''invest'' rather than ''donate'' (Canadian Centre for Social Entrepreneurship, 2001); ''revenue streams'', and ''client groups'' (Johnson, 2003) applied to the social and public sectors.

If the colonization of the social and public sectors by the language of business is accepted, the breakdown of barriers between the sectors becomes normalized. However, the terms cited are in contrast to the distinction made by Thompson (2002) between entrepreneurs who create social or artistic capital rather than financial capital, with social capital referring to that which is valuable to communities (p. 413). The concept of social capital, without a financial element, also emerges in David Bornstein's (Bornstein, 2004) descriptions of social entrepreneurs, with examples that include the Crimean War nurse, Florence Nightingale.

In its least problematic formulation, social entrepreneurship seeks to marry rational economic calculation and socially inspired vision (Shockley *et al.*, 2002). At a time when money for social initiatives is short, this could offer a way forward for non-profits in an increasingly competitive environment. It can also be seen as a way for business to balance profit with public responsibility (Reis and Clobesy, 2001).

On the other hand, opposition could arise from the close association of the term ''entrepreneur'' with the creative-destructive aspects of capitalism (Schumpeter, 1934). Those who are concerned about the negative aspects of business will be resistant to the blurring of the boundaries between public, private and civil society suggested by social entrepreneurship with the potential for increased influence of business beyond the private sector (Reis and Clobesy, 2001). The non-profit sector has long been associated with the creation and maintenance of a strong civil society. Marketization of that sector, then, calls that association into question (Eikenberry and Kluver, 2004) with concerns for the viability of an independent civil society. Furthermore, if business has the power to choose which non-profits are to benefit materially through socially entrepreneurial partnerships, what happens to those that are not chosen and therefore are marginalized?

We suggest that a parallel can be drawn between the concept of social entrepreneurship and that of sustainability because sustainability is equally open to broad interpretation. Like social entrepreneurship, sustainability can favor either the social and environmental or the economic sectors, depending upon which model is adopted. The model of weak sustainability preferences the economic and so parallels the model of social entrepreneurship that seeks direct or indirect financial reward for the business entrepreneur. Strong sustainability favors the social and environmental over economic development, upholding the social values of a truly civil society based social entrepreneurialism. Interpretations are derived from the beliefs and experiences of

individuals. Social entrepreneurs and their work should ultimately be judged by the quality of the social outcomes, and that assessment should be made independently of the private interests of those entrepreneurs.

With concepts and movements such as social entrepreneurship, environmental sustainability, and social responsibility, it is crucial that we pay close attention to the persuasive uses of the terms as well as to their practical implication. All of them are contested, value-laden labels that can be used to reference a wide variety of interests, motives, activities, and outcomes.

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Operations and supply chain management
Social performance: key lessons from recent experiences within Shell

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Abstract

Purpose – *Seeks to summarize the findings of research undertaken by the Shell Group to better understand the business relevance, parameters, status and tools and approaches to manage social performance.*

Design/methodology/approach – *The paper is based on four detailed case studies that combined qualitative and quantitative research methodologies and included distinct operational, business and socio-economic contexts. The paper seeks to build theory around the concept of social performance.*

Findings – *Key findings include that: there exists a strong business case for social performance; good social performance is fundamentally concerned with the identification and management of core business impacts; social issues can be identified and managed in a systematic manner; and The Shell Group is developing and implementing a range of tools and approaches to assist effective management of social issues.*

Research limitations/implications – *The research is based on a limited number of cases from within Shell; further validation of findings could be achieved through similar research in other industrial sectors.*

Practical implications – *Research has highlighted the business case for social performance, key ''ingredients'' of social performance and provides a specific framework and tools for more effective management of social issues.*

Originality/value – *First time such research has been undertaken within the Shell Group and perhaps similar companies. Paper should be of potential interest value to practitioners (e.g. social performance and CSR managers), academics, policy makers and non-governmental organizations.*

Keywords *Performance management, Social policy*

Paper type *Research paper*

1. Introduction and background

This paper summarizes present understanding, approaches, tools and challenges in relation to the concept of social performance within the Shell Group, and provides recommendations for improved future performance.

Within Shell, social performance is defined as ''an ongoing process that incorporates all the different ways Shell operations contribute positively and negatively, directly and indirectly to the communities and societies where Shell operates''. This definition fits within the overall commitment of the Shell Group to sustainable development, as articulated in the Shell Group business principle. More specifically three related social performance objectives have been developed:

1. Avoid and/or minimize the negative impacts to local communities and other stakeholders from Shell's operations.
2. Optimize the positive opportunities to local communities and other stakeholders from Shell's operations.
3. Undertake activities to contribute more broadly to the societies and communities where Shell operates.

The findings of the paper are based on four detailed social performance reviews undertaken between 2001 and 2003. As part of a broader and growing strategic focus in the area of social performance, these social performance reviews (referred to as ''reviews'' in this paper) were commissioned to assist the Shell Group understand the key parameters of social performance including strategic and organizational approaches, and tools relevant to enhanced performance. The reviews were also intended to help understand the present status of social performance and provide recommendations on how to improve performance at individual review sites and more broadly across the Shell Group. To maximize potential learning, the reviews covered a range of operational, geographic and socio-political contexts and included one major operation from each of Shell's core businesses (Table I).

A team consisting of Shell International and local review site personnel, and local and international consultants undertook each review. In each case, the review process included document reviews and interviews with internal and external stakeholders and combined both qualitative and quantitative methodologies. In total over 200 internal and external stakeholders were consulted including local residents and community-based organizations; local and national non-governmental organization representatives; other companies; industry associations (e.g. trade unions, fishing associations); academics; and local and national government representatives. A structured participatory community assessment was also undertaken at three of the review sites, involving the participation of approximately 2,000 local residents.

Subsequent sections of the paper summarize the key findings and strategic and operational implications of the reviews focusing on the business case for social performance, key social issues and impacts, and a strategic approach, and management framework for Shell operations, including priority areas and actions for enhanced social performance.

2. The business case for social performance

Shell operations have social impacts – positive and negative – on people and communities beyond the fenceline, and societal expectations about how Shell addresses these impacts are rising. The review findings demonstrate that there is already a strong business case for social performance and if anything this is likely to increase. A number of areas were highlighted by the reviews:

- *Gaining and maintaining a license to operate and grow*. At a national level, governments increasingly include social performance ''criteria'' in the allocation of energy development licenses. At the same time there is also a growing tendency for governments through national and regional legislative frameworks to regulate the environmental and social performance of companies. At a local level, the reviews illustrate the impacts that communities and other stakeholders can have either through ''formal'' mechanisms (e.g. legislative frameworks including scope for public participation), or informal mechanisms such as direct protest, media campaigns and sabotage.
- *Reduced operational costs and delays*. Failure to adequately identify and manage social performance issues can have significant operational costs. In the case of Norco, Shell Chemicals and its refinery joint venture partner found it necessary to spend $50 million in order to address long-standing community grievances about pollution, a lack of local economic benefits and inadequate consultation.

Table I Social performance reviews

Shell business	*Operation and location*	*Web site*
Chemicals	Norco refinery, USA	www.shellus/norco/
Exploration and production	The Athabasca Oil Sands Project (AOSP), Canada	www.albiansands.com
Gas and power	The Oman Liquefied Natural Gas Project (OLNG), Oman	www.omanlng.com
Oil products	SAPREF refinery, South Africa	www.sapref.com

- *Facilitated access to project finance*. Multilateral development banks (e.g. World Bank, European Bank for Reconstruction and Development), as well as more commercial banks (e.g. HSBC, ABN Ambro) now include environmental and social risks as part of their lending appraisal processes (c.f. the Equator Principles). Adequate *a priori* identification and management of these risks is likely to avert potential funding delays.
- *Enhanced reputation*. Good social performance is an increasingly critical driver of Shell's global reputation. This may extend to the buying preferences of retail customers, the ability to attract and retain top ''talent'', the attitude of the investment community towards Shell, as well as the attitudes of governments and regulatory authorities in the granting and renewal of operating licenses.

The reviews indicate that the greatest management opportunities and social performance challenges are likely to be related to operations or activities with the following characteristics:

- major new projects causing permanent change in land use or long term change to local or national economic structures;
- facilities such as chemical plants, refineries, terminals, pipelines, oil depots with communities in close proximity;
- closure – especially where facilities are a key part of the local economy;
- operations with a poor HSE record which have damaged, or are perceived to have damaged the environment, natural resources or health;
- joint ventures with companies without strong HSE/ethical/social performance systems – because of the barriers this presents to integrating social performance into operations; and
- operations in sensitive locations.

To conclude good social performance is now expected of Shell and can be achieved in a way that adds value to the business and society at large. Moreover despite their complexity, social issues can be systematically identified and managed in a structured manner similar to other core business issues such as health safety and environment (HSE).

3. Social impacts

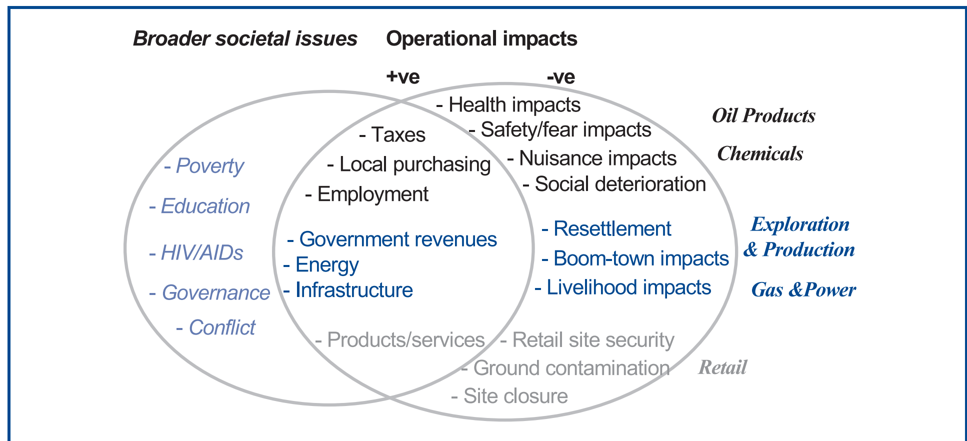
The reviews highlight a number of ways in which Shell operations have positive and negative impacts on the communities and societies where they operate. First and foremost are the impacts associated with Shell operations themselves. These include direct and indirect, short- and long-term, positive and negative impacts. Second there are other ways in which operations can contribute more broadly, principally through social investment programs. Some of the generic positive and negative impacts associated with Shell's major businesses, as well as areas of broader contribution are highlighted in Figure 1.

3.1 Negative operational impacts

The reviews demonstrate there will always be some negative impacts where communities live close to existing or planned Shell operations. For new operations, key negatives usually relate to impacts on, and disruption to existing livelihoods, without evidence of local benefits; whilst for existing operations, key impacts generally relate to health, safety and nuisance concerns related to day-to-day operations. More specific impact types include the following:

- *Livelihood impacts*. Shell operations sometime require temporary or permanent access to areas of land or sea that have previously formed the basis of economic livelihood for local people. In their most extreme form projects may require the permanent physical relocation and resettlement of communities. Under such circumstances Shell operations have the potential to cause uncertainty, disruption and stress in all circumstances and can damage communities' bases for livelihoods and access to important cultural or recreational sites. Moreover and as highlighted by both the Norco and SAPREF reviews,

Figure 1 Generic social performance impacts associated with Shell's major businesses



short-term mismanagement of such issues can create long-term (i.e. over 40 years) negative legacies among local stakeholders.

- *Health, safety and nuisance impacts*. Shell operations can cause negative health and safety impacts, as well as more general nuisance impacts. During the construction phase of projects, factors such as an increased probability of road accidents and increased disease exposure (often associated with migrant work-forces) – especially to sexually transmitted diseases – are most prevalent. During the operational phase, and especially in the cases of major facilities such as refineries with communities living in close proximity, health and safety, and nuisance impacts (real and perceived) of living close to such facilities represent the major social performance issue for local stakeholders.
- *Cultural and community lifestyle impacts*. Shell operations bring social change and especially in culturally and socially sensitive contexts, have the potential to undermine and ultimately destroy local traditions, cultures and values. Typical factors contributing to such a decline include: the interaction between ''outsiders'' and local communities; introduction of monetarised exchange system as well as increased disposable income; and damage of the assets (for example hunting areas) on which traditional culture and livelihoods may be based.
- *Social infrastructure impacts*. Shell projects can place significant added pressure on existing social infrastructure, including housing, roads, schools, and hospitals, due to the associated influx of workers, other service providers and people looking to benefit speculatively from a project. If infrastructure is limited in the first place, the impact can be significant and generate project opposition from users whose access to services has been reduced and from those responsible for service provision (e.g. municipal and local government).
- *Insecurity and violence*. Security for Shell operations can – if not appropriately managed – intimidate communities and be open to abuse by militias or other armed forces. Moreover certain Shell operational practices such as employment and contracting and land compensation payment can also be the (unintended) cause of conflict within and between communities. Finally Shell operations, particularly during the construction phase often act a ''magnet'' for numerous individuals and organizations seeking to economically benefit from the project (the so-called ''honey pot effect''). Not only can this lead to increased conflict during the construction phase, but frequently once the construction phase is complete, migrants remain and in the absence of other economic opportunities turn to crime as a means of sustaining themselves.
- *Indirect economic impacts*. Oil and gas production can have the indirect effect of damage to the non-oil economy (e.g. by fuelling local inflation) particularly during the

construction phase of projects and where during operation phase the net economic contribution of a project (i.e. particularly via government revenues) is large relative to the regional or national economy as a whole (the so called ''Dutch disease'').

3.2 Positive operational impacts

The reviews also show that Shell operations can and do bring a number of significant positive impacts. These include a number of direct and indirect, short- and long-term benefits at a local, regional and national level. Moreover many of the previously identified negative impacts can, if managed effectively become positive, rather than negative. Other key areas include the following:

- *Local economic development*. A consistent theme in all the reviews is the priority local stakeholders place on the contribution Shell operations make to the local economy; in particular through direct and indirect (i.e. via major contractors) local employment and supply chain opportunities (Fossgard-Moser, 2003). Against this background, it is worth noting that the significant contribution Shell projects often make to the national economy (for example the OLNG project contributes 18 percent of Oman's GDP), and the efforts made by Shell operations to procure products and services nationally are not perceived locally as relevant.
- *Social infrastructure, including energy services*. Despite the additional pressures Shell projects can place on existing social infrastructure the reviews also highlight that with adequate coordination and planning with relevant governmental authorities, there are often opportunities to improve social infrastructure in such areas as roads, housing, health facilities and availability of energy services. For example the OLNG project worked with local government to upgrade the quality of a number of roads and assisted in the design and implementation of a world-class waste disposal facility.
- *Revenue management*. Another very important benefit that accompanies Shell projects is the royalties and accompanying revenues paid to producing country governments. In some cases such as Nigeria, Colombia and the Philippines, there are explicit provisions for a proportion of these revenues to be returned to producing areas; in others it at the discretion of national government. Although an area that Shell cannot directly control, it is one in which Shell operations can and will be increasingly expected to play a role.

3.3 Broader contributions

The reviews also show how Shell operations make important contributions through their social investment programs, although as discussed further in section 4, social investment alone, however well managed, is only one element of good social performance. The review findings support existing best-practice learning; in particular that Shell social investment programs:

- are the outcome of consultation with potential beneficiaries and include their input in project design and implementation;
- complement rather than duplicate or conflict with other local and regional development plans and programs;
- are usually undertaken in partnership with others;
- focus on capacity building, rather than ''bricks and mortar'';
- contribute not only financial resources, but other intangible assets, such as the use of the Shell operations (for example health facilities) and products (for example solar panels), as well as human resources and skills; and
- have a clear business rational, are managed in a professional manner, and include a well-defined exit strategy.

4. Delivering social performance

4.1 Strategic approaches

A number of strategic approaches are available to Shell operations including social impact management, strategic social investment, social investment and philanthropy. Importantly and in relation to delivering greatest business and societal benefit, the reviews highlight most emphasis must be placed on how operational impacts are identified and managed through good social impact management, and how project related opportunities (such as local employment) are enhanced through strategic social investment. Of lower significance, operations should also seek to make broader contributions through well-structured social investment programs (Figure 2)[1].

Social impact management concerns ongoing and routine activities to enhance local and national socio-economic benefits and avoid and minimize negative impacts from Shell's operations and activities. It includes for example the design of a pipeline route to minimize adverse impacts on local communities. Another example is the engagement in policy debate around use of oil generated revenues.

The reviews highlight three important element of social impact management:

1. The management of core project impacts is critical for good social performance and the accompanying realization of associated business and societal benefits.
2. There are clear links between social performance, environmental performance and operational excellence. For example health fears among local communities are often related to the real or perceived concerns related to Shell's environmental emissions. Moreover, given the close links between operational excellence and good environmental performance, good social performance is often ultimately linked to operational excellence.
3. Whilst Shell operations have direct control over many social performance impacts, for example refinery emissions and project employment; there are other indirect impacts, such as the economic impacts deriving from the way in which oil revenues are managed, where Shell can only aim to ''assist and influence'' (see Figure 3).

Whilst it is first and foremost critical that Shell operations identify and manage those impacts over which they have direct control, Shell operations will increasingly be judged by the extent to which they also recognize and seek to assist and influence the management of indirect impacts (Box 1).

Strategic social investment concerns activities undertaken by Shell operations linked to operational impacts and concerned with enhancing project related opportunities to local communities and other stakeholders (Box 2). Strategic social investment is about leveraging stakeholder opportunities related to Shell projects and activities. In general this requires a

Figure 2 Delivering social performance

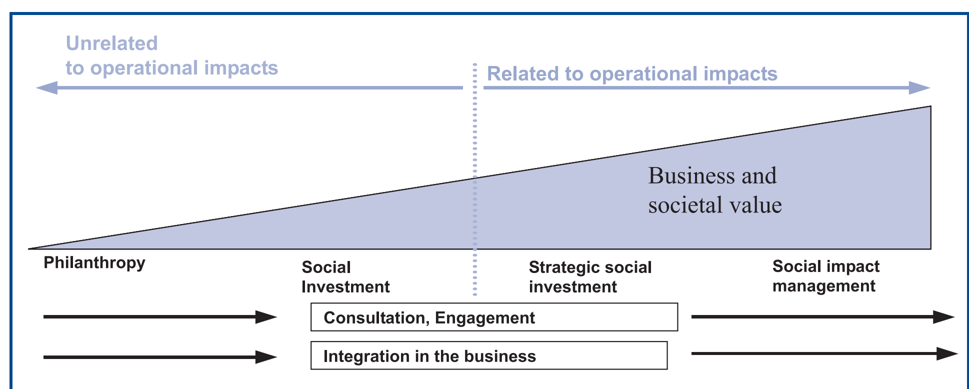
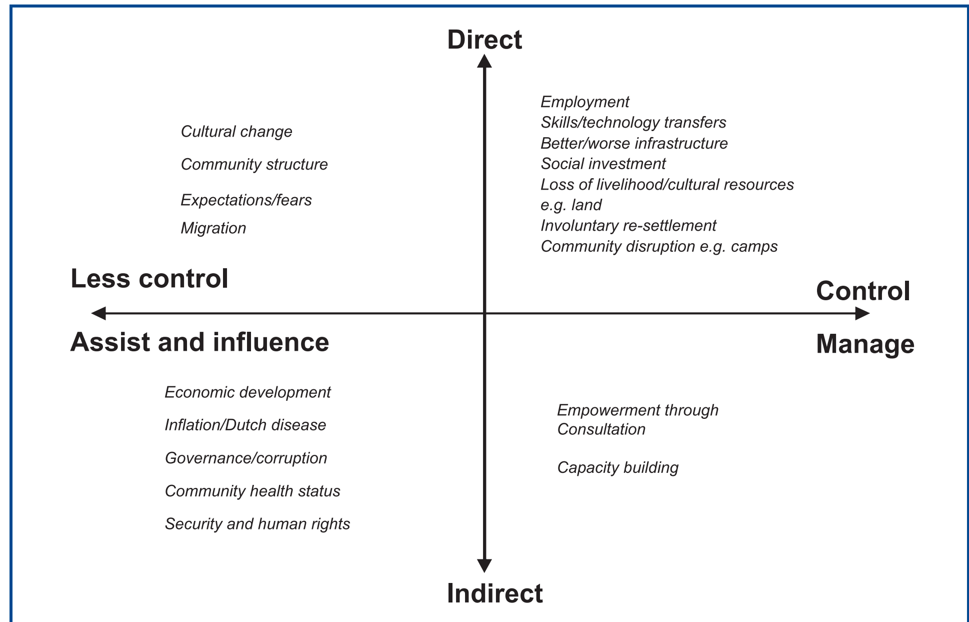


Figure 3 Social impact management strategies for direct and indirect impacts



Box 1 Examples of assisting and influencing by Shell

At an international level, and in relation to more transparent use of government oil revenues, Shell is participating in and supporting the UK government-led extractive industries transparency initiative. The initiative's aim is to increase transparency both in terms of the payments made by extractive companies to governments, as well as the subsequent use of these revenues by governments.

Box 2 Example of strategic social investment

In Slovakia, Shell Retail is making retail space available (and thereby providing market access) for a number of products being produced through a micro-credit program operated by the local NGO Integra and supported by the Shell Foundation.

more open and flexible ''mindset'', including for new projects, opportunities being identified and integrated early into project design.

Social investment concerns the support for activities unrelated to a project's direct impacts, but related to the operation's overall social, economic and environmental responsibilities and business objectives (see Box 3). It includes grants and donations programs, as well as more structured social investment programs and foundations. There are also growing external expectations for Shell to participate and positively influence public policy in relation to broader societal issues.

Philanthropy is the giving of grants and donations usually unrelated to an operation's social and environmental responsibilities or its business objectives (e.g. donation to a local youth

Box 3 Example of social investment

In response to the opinions and priorities expressed by local residents, the Norco chemical plant established the Norco Community Development Foundation, the purpose of which – working in collaboration with relevant local stakeholders – is to support programs in the areas of: job creation and workforce development; business development/attraction/retention; youth programs; and housing development and rehabilitation.

football team, support for an arts program). This is an area in which there have historically been – and in some contexts remain – strong societal expectations. Nevertheless, the reviews suggest that philanthropy is the least important aspect of social performance.

4.2 Stakeholder engagement as the corner-stone of social performance

The reviews highlight that the cornerstone of any social performance strategy and plan is stakeholder engagement. Effective identification, assessment, delivery and communication of social performance issues can only be achieved through sustained and structured external and internal dialogue. Stakeholder engagement is crucial to better understand the distribution of impacts; focus on those who are most impacted and would otherwise not benefit; and ensure that interventions are welcome and appropriate. From a Shell perspective, stakeholder engagement helps operations achieve business objectives and is also the key mechanism to ensure Shell employees themselves have a realistic understanding of the social consequences of their activities.

In realizing the above benefits, the reviews have further highlighted the importance of Shell operations consulting not only those stakeholders perceived to be important for their ''formal'' license to operate (e.g. government ministries), but also other stakeholders important for their ''informal'' license to operate among others community leaders, local businesses, business partners, academics, media, etc.

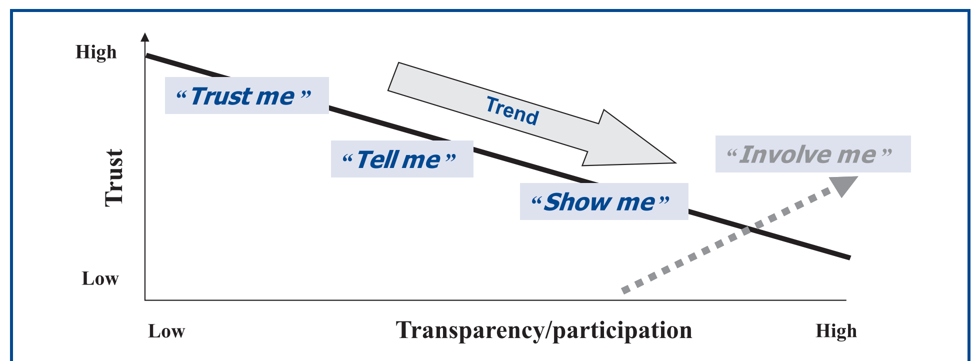
''Good'' stakeholder engagement is about two-way dialogue and agreed actions. It includes involving stakeholders in the identification of potential impacts and issues, and collaborative development of possible solutions to these and their subsequent implementation and monitoring. In this regard the reviews have all highlighted – irrespective of levels of local democracy or history of NGO activism – the movement from a ''trust me'', to a ''tell me'', to a ''show me'', to an ''involve me'' world (Figure 4).

For new operations, the key consultation challenge is how to involve stakeholders in relevant aspects of design and construction in order to minimize negative and optimize positive impacts. For existing facilities where local communities live in close proximity, the key challenge is to ensure that environmental and social performance plans are developed collaboratively and consequently reflect key concern areas (e.g. noise, flaring, air emissions etc)[2]. External stakeholders should also be involved in activities concerned with monitoring the impacts of such plans (e.g. community based air monitoring programs), including the development of agreed environmental and social performance measures.

In terms of the ''how'' of stakeholder engagement the reviews show that:

1. Effective stakeholder engagement requires Shell operations to approach stakeholder engagement in a structured and professional manner.
2. Ownership and responsibility for stakeholder engagement must lie with Shell and not be outsourced externally.

Figure 4 Changing societal expectations



3. Different tools exist to assist managers in the identification, prioritization, and engagement with stakeholders (for example participatory community surveys).
4. A range of informal and formal mechanisms exist by which Shell operations can ensure a structured and ongoing approach to stakeholder engagement (for example the Residential Advisory Board).
5. Key principles of good stakeholder engagement include:
   - under committing and over-delivering;
   - clear definition of boundaries of what is and is not possible;
   - focusing on developing mutually agreed processes that lead to long-term relationships; and
   - ensuring that any commitments made by Shell are fully delivered on.
6. When external stakeholders do not have the pre-requisite levels of organization and skills to engage effectively with Shell operations, Shell should support capacity building of local stakeholders to engage on a more ''level footing'' with Shell.

4.3 Organization and responsibility for social performance

The importance of organization and leadership in the effective delivery of social performance is another important finding of the reviews. Specifically:

1. The presence of a senior champion and senior management support for social performance is typically critical for effective delivery of social performance.
2. Responsibility for the actual delivery of social performance is ultimately a shared responsibility of the management team and is likely to involve, in particular, the HSE, human resources, security, contracting and procurement and external affairs functions (Fossgard-Moser, 2003).
3. Projects with significant social performance issues are likely to require a dedicated social performance manager with the overall responsibility of coordinating and championing Shell approach on a day-to-day basis.
4. To achieve a sense of shared responsibility of social performance requires:
   - including a range of managers in the review team for social impact assessments;
   - establishing a social performance working group to develop and monitor the social management strategy and plans;
   - providing internal training to line managers to increase awareness of social performance; and
   - including relevant social performance targets on line managers scorecards.
5. Ensuring in the selection of senior managers for operations with existing or potential social performance issues, adequate awareness of and sensitivity to social performance.
6. Many of the impacts associated with Shell's operations result from actions by contractors and their sub-contractors. Shell's approach to social performance therefore needs to extend beyond its own internal boundaries.

In conclusion this section has sought to summarize present understanding within Shell in relation to where the focus of social performance activities should be; the different strategic approaches for managing the direct and indirect impacts associated with Shell operations; and the underlying importance of stakeholder engagement for the effective management of all aspects of social performance.

5. Social performance management framework

5.1 Social performance framework

Figure 5 summarizes the key aspects of a social performance framework developed as a consequence of the reviews. The framework is best managed as part of existing management systems and as part of engagement and partnership with external stakeholders. Using this approach, the core tasks for Shell managers are to:

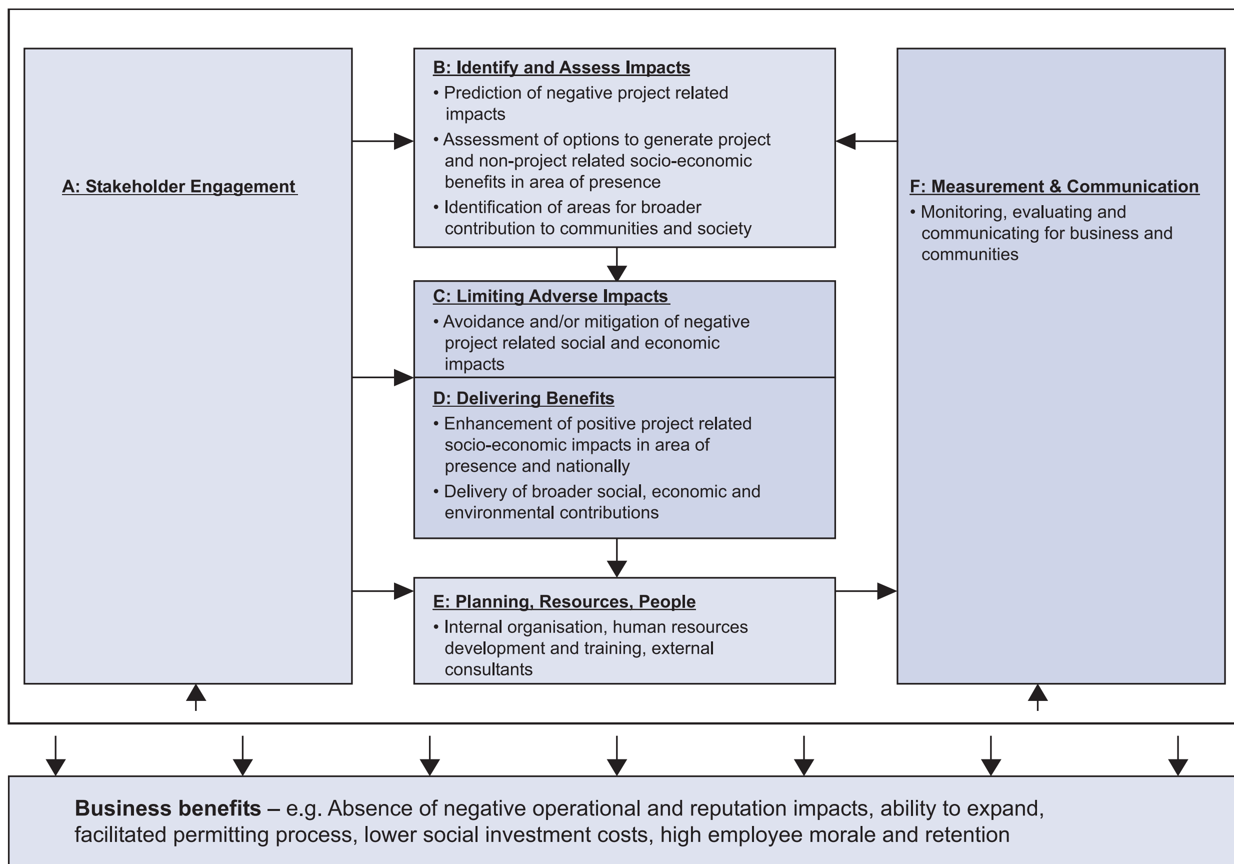
- identify and assess the potential impacts of Shell operations;
- limit adverse impacts and deliver project and non project related benefits;
- track and report performance; and
- organize and train human resources for social performance management.

5.2 Social performance plans

The reviews have highlighted the value of Shell operations developing and implementing social performance plans. Building upon the management framework presented previously, these are intended to incorporate the following elements:

- overall social performance vision and objectives;
- summary of the business and social context;
- summary of key stakeholders and their issues;
- actions to minimize negative impacts;

Figure 5 Social performance management framework



- actions to enhance project and non project related benefits;
- actions to measure and report on social performance;
- budget and resources to implement the plan; and
- a timetable for periodic review of performance against objectives.

5.3 Social performance guidance notes

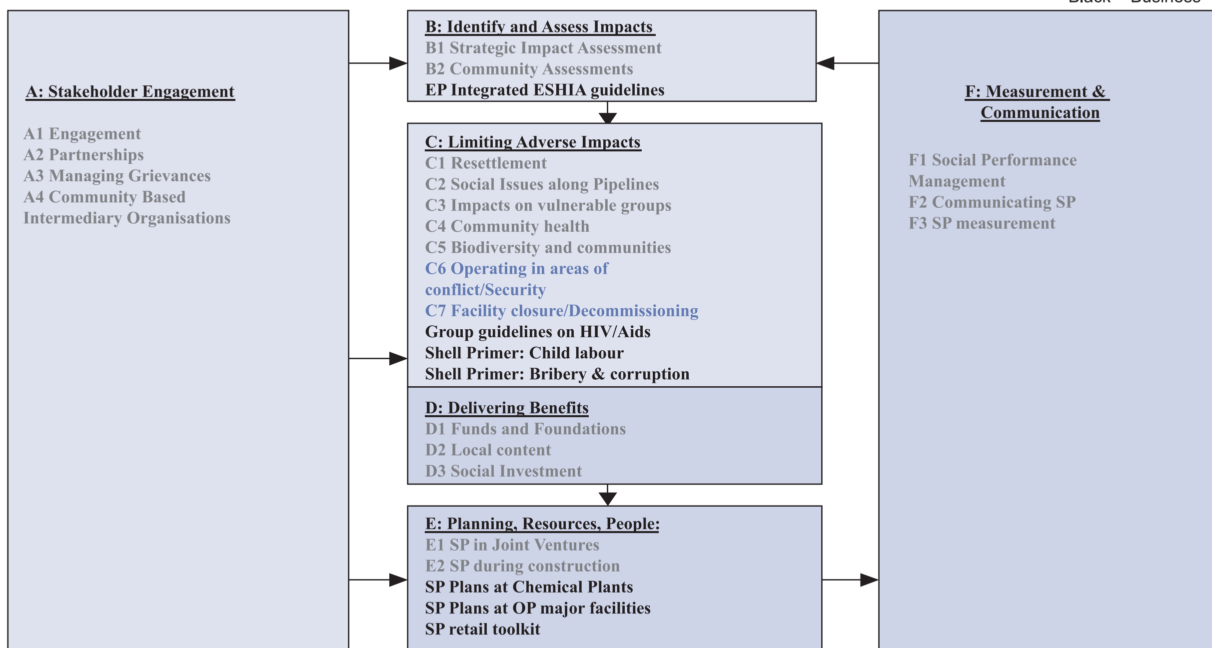
To facilitate management actions in the area of social performance, including the development and implementation of social performance plans, a series of Shell social performance guidance notes are being developed. These notes build upon existing Shell policies and guidelines and provide practical and succinct guidance to managers on a number of key social performance themes (Figure 6).

5.4 Social performance reviews (SP review)

Building upon the four initial social performance reviews (that form the basis for this paper) and six subsequent reviews, SP reviews are in themselves becoming an important tool within Shell providing:

1. An assurance tool for the operation and business (e.g. gas and power, oil products) on how SP is understood and implemented within the relevant operation.
2. A mechanism for the operation to identify gaps in its processes, procedures, organizational approach and implementation of social performance.
3. A mechanism for engagement with external stakeholders and the development/enhancement of a common action plan.
4. An additional opportunity for input and local plan development and thereby demonstrating to stakeholders the operational commitment.

Figure 6 Social performance guidance notes and other tools within Shell



5. An opportunity to share best practices around SP implementation both within group and externally.
6. A mechanism to raise social capabilities amongst the business or operation's team.

SP reviews have been important in helping the Shell Group develop an overall management process for social performance, a template for SP plans and specific guidance on how to manage key social performance impacts, as well as a mechanism to help ensure assurance and ongoing learning. As considered in the final section, the key challenge now is to ensure integration of this framework and tools into Shell's businesses and their operations.

6. Social performance integration, gaps and way forward

The reviews indicate that despite much progress a number of important gaps in Shell's capacity, understanding and management of the social aspects of its business operations remain. Overcoming these gaps will be key to ensuring greater consistency in social performance standards across the Shell Group. This chapter seeks to summarize the activities already underway to respond to these gaps, as well as identify future challenges and approaches to address these.

6.1 Social performance integration

In response to the growing importance of social performance to the Shell Group, a number of activities have taken place at both a corporate and business level to ensure more systematic and integrated approach to social performance.

At the Shell Group level, there is presently no specific social performance standard. Nevertheless a number of related standards and policies exist, including:

- Shell Group reputation standard, including the requirement for every business and operation to have a stakeholder engagement and social performance plan;
- Shell Group minimum health standard;
- Shell Group security standard; and
- Shell Group ESHIA requirement that all new operations and major modifications to existing projects undertake an integrated environmental, social, and health impact assessment (EHSIA).

An additional response to improved social performance management has been the creation of the Shell Group Social Performance Management Unit (SPMU) in early 2002. The objective of SPMU is to develop the capacity within Shell business areas and support functions to deliver leadership in managing the impacts of operations and products on communities and society. The four core areas of work are to consolidate and validate the framework for social performance (work with the business to capture existing experiences and pilot new approaches), provide competence development and training (raising awareness and building capacity), communicate learning (internally disseminate learning tools), and provide strategic consultancy services.

At the businesses level, Shell's major businesses (chemicals, exploration and production, gas and power, and oil products) have also undertaken a range of activities to better integrate social performance into business operations (Box 4).

6.2 Gaps and next steps

SP understanding and implementation is still in its early days. There remain important challenges to achieving group-wide excellence in social performance, including:

- ensuring that there is greater consistency in social performance across the Shell Group and its different operations;
- maintaining the present momentum, particularly as Shell responds to the 2004 reserve re-categorization issue and accompanying reorganization and adapted strategic focus;

Box 4 Example of activities at the business level

- The requirement that all new projects in Shell undertake an integrated environmental, social and health assessment.
- Agreed business target that all major facilities with a potential community impact (e.g. refineries, chemical plants, pipelines) should have a social performance plan in place by end of 2004 (Shell Chemicals), and 2005 (Shell Exploration and Production).
- The inclusion by Shell Chemicals of social performance indicators in the performance contracts of all chemical plant managers.
- The commissioning in all of Shell's major businesses of further social performance reviews.

- the integration of social performance principles into joint venture projects where Shell is not the operator and/or operates in social political contexts potentially in conflict with some social performance principles;
- further developing Shell's understanding and approach to those issues and impacts over which it does not have direct control, but can play an ''assisting and influencing role'';
- further developing understanding and accountability for social performance particularly among senior and ''line managers'';
- working with internal and external contractors responsible for the construction of many Shell operations to ensure Shell's social performance principles are included in their business practices;
- developing an internal cadre of social performance professionals; and
- ensuring succession planning for senior managers – particularly for facilities with a social impact – includes social performance criteria.

In this respect social performance priorities for the next few years are likely to include:

- Maintaining the momentum achieved in the businesses in developing social performance systems and tools and monitoring progress on implementation.
- Focusing corporate/business attention on accelerating social performance management by the operations/facilities that present the greatest social performance risks to the group.
- Awareness raising on social performance amongst key audience not yet engaged, e.g. business developers, human resources – succession planners, supply chain managers and managers of ''high risk'' operations and facilities.
- Measuring social performance at corporate and business level through ''process'' indicators, i.e. implementation of the social performance management framework.
- Measuring social performance at OU/facility level through evidence from community based surveys of external satisfaction with social performance and progress in meeting locally determined targets and objectives.
- Developing Shell minimum standards for social performance.

In achieving the above, it is important that there continues to be senior management recognition that social performance is a critical element in earning the trust that underpins business performance. Major steps have been taken, and significant lessons learned from past experience. The challenge now is to ensure integration such that SP becomes routinely managed similar to other core business functions.

Notes

1. Historically Shell's approach to social performance has been more concerned with social investment and philanthropy than social impact management and strategic social investment.
2. It is important to note that despite the growing adoption by the Shell Group of the international environmental standard ISO 14001, this standard does not include external stakeholder input, and as a consequence at a community level is not widely understood or trusted as a credible measure of a refinery or plant's performance.

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Going global: how to identify and manage societal expectations in supply chains (and the consequences of failure)

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Abstract

Purpose – *Multinational companies that want to be reputable global citizens need to manage divergent and often conflicting societal expectations. Aims to show that some do this by using a universally applicable set of policies, approaches, rights and responsibilities, while others believe it is better for companies to manage the issues most material to where they are operating.*

Design/methodology/approach – *This paper, drawing on empirical studies in five continents, examines how companies identify and manage societal expectations when the notion of society itself is undergoing change, and the relationship between business and wider society is being revisited.*

Findings – *Discusses the experience of employing global social and environmental standards, the value of thinking in terms of a global ethic, and whose interests are served by this approach. Argues that, with certain important caveats, current approaches to managing the social and environmental dimensions of global supply chains provide at best a crude means of tackling societal expectations that can mislead managers into thinking they have the problem in hand.*

Research limitations/implications – *This paper has consequences not only for those whose expectations are ignored, but also for company managers who think they are doing the right thing but are actually being blinded to important material issues. Argues that this is a direct consequence of how values and power are overlooked in corporate citizenship theory and practice, and that one needs to be more open and thoughtful about what expectations can and should be met.*

Originality/value – *These observations in this paper challenge aspects of corporate citizenship's orthodox thinking and require that new consideration be given to the challenge of working with and distinguishing between global communities of need and of expectation. They provide a timely reality check for those propounding and employing popular contemporary approaches to managing the business-society relationship, and at the same time suggest more effective ways of addressing expectation management in the future.*

Keywords *Business ethics, Responsibilities, Society*

Paper type *Research paper*

Managing relationships through global supply chains[1]

At the heart of corporate citizenship is how the relationship between companies and wider society is managed. For multinational corporations, managing these relationships on a global scale presents particular challenges, and global supply chains are one of the most important yet daunting areas of corporate citizenship.

In 1990, a senior manager for a multinational sporting goods company told me that his firm had no responsibility for what happened in its suppliers' factories (Blowfield, 1991). Yet within a few years we saw the emergence of codes of labor and environmental practice, and pioneering partnerships between companies and non-business organizations, so that come the new century there were hundreds of such standards, often forming part of the

buyer-supplier contract, and embracing environmental, welfare and human rights issues (Blowfield, 2000).

Any company that applies these standards to its supply base is implicitly accepting two principles:

1. An acceptance of responsibility on the part of the buying company for the behavior/practices of its suppliers, including those aspects where there is no legal liability.
2. A willingness on the part of the buying company to be accountable for and to impose limitations on the practices of its suppliers even where those practices may be seen as a factor of competitive advantage.

The content of these standards today is surprisingly uniform given the early disputes about what should be included (Varley *et al.*, 1998; Kolk *et al.*, 1999). Nowadays the disagreement is whether or not to accept any responsibility for supply chains, rather than what social and environmental dimensions to take responsibility for. Indeed, amongst companies that acknowledge a responsibility, there is a consensus about the content and implementation of standards that boils down to three elements:

1. Setting out acceptable behavior in codes of conduct.
2. Auditing, monitoring or some means of inspecting supplier performance against the code's criteria.
3. Some form of interaction with groups held to be stakeholders.

The form and formality of this interaction still varies considerably, with some multinationals simply entering into dialogue with non-business organizations, some partnering with other firms, and some entering into formal partnerships with non-government organizations, trade unions and others from civil society (Jenkins, 2002). Nonetheless, partnership of some description is widely advocated, and is now firmly embedded in the orthodoxy of responsible supply chain management (see Sethi, 2003; Wick, 2001).

An insufficient orthodoxy

One of the most remarkable things about the orthodoxy that has grown around managing the social dimensions of global supply chains is how little is known about its impact, especially on the intended beneficiaries. The Ethical Trading Initiative, for whom I once worked and which deserves great respect for its contribution to understanding how to implement voluntary labor standards, did not commission a worker-level impact assessment until 2003. Other company and partnership initiatives have focused more on how to improve their codes, inspections, auditing etc., rather than asking more basic questions about the relevance of the codes to their intended beneficiaries (e.g. workers, communities, the natural environment).

What evidence is available shows the importance of asking these questions. For instance, various studies demonstrate the challenges of accurately inspecting company performance against specific standards (O'Rourke, 2003; Kwan and Frost, 2002; Markopoulos, 1999). The Ethical Trading Initiative's annual reports also provide a useful summary of company monitoring. The essential message of such work is that we need to improve the way we implement social and environmental standards within the supply chain. A separate body of work reveals how certain groups and issues are excluded by the use of standards. For instance, not only are women-specific issues not included in labor codes of conduct, but certain categories of worker where women predominate are less likely to benefit because of the way these codes are implemented (e.g. casual workers in African horticulture) (Barrientos *et al.*, 2003). Similarly, some priority issues for small producers are not included (e.g. terms of trading, land security) while the relationship such producers have with their workers and communities is not recognized in international standards (Blowfield, 2004a).

Different culturally-related values have long posed problems for managers (Carroll and Gannon, 1997; Donaldson, 2003), and supply chain standards are an example of how

applying a uniform approach to a diverse supply base, and ultimately fails to recognize certain identities and values accurately (Blowfield, 2004b). Even where a more sophisticated view of society and culture is incorporated into a standard, the desire to find universally applicable taxonomies with which to categorize beneficiaries can lead to inaccuracies, and may even force certain people to reinvent their identity in order to win recognition as being morally significant (Blowfield, 2004c).

An explanation of deficiency

Instead of a robust system for managing social relationships, what we see, therefore, is an orthodoxy that may be failing to deliver promised benefits. However, studies of supply chain standards tend to be oriented towards technical-instrumental problem solving (e.g. how to make codes of conduct more inclusive or how to make auditing more effective). What I want to explore are the structural dimensions of these approaches.

One thing that is very clear is that the current approaches represent a one-sided view of the world: the view of business management. Early fears expressed by NGOs and trade unions that companies would ignore contentious issues such as freedom of association have started to fade, but this does not mean that what exists today is free of bias and self-interest. On the contrary, governments and civil society organizations that support supply chain initiatives largely accept a number of assumptions that reflect the interests of business management. For example, the instruments used to manage the relationship with society are ones with which managers are comfortable and familiar such as codes of conduct, monitoring and auditing. This in turn puts an emphasis on measurement, standardization and quantifiability that I have argued elsewhere influences what is and is not included as legitimate social issues (Blowfield, 2005).

The use of business management instruments is indicative of a wider phenomenon where the norms of business are presented as an objective reality against which other systems and views are tested for true or false value. We can see this for instance in how the language of business is employed to discuss and therefore think about wider society (Thrift, 2002). We see it also in debates about ''materiality'' that frame social, economic and environmental issues in terms of what is material for business, and give little consideration to what is material for wider society.

The influence management thinking has over how social relations are managed is also evident in the way that certain concepts and terms have become accepted. For example, we often hear about companies managing their ''stakeholders'', putting wider society on a par with quality management, marketing, product development and other spheres of management competency. Indeed, the premises behind stakeholder theory (e.g. that issues and entities can be atomized) are ones that suit the needs of business, and do not necessarily provide a robust framework for understanding society.

We should not be surprised, therefore, that company acceptance of responsibility for the social and environmental impacts of their global supply chains is justified or dismissed based on the business case, i.e. the contribution to business goals. However, there is cause for concern when the business case is used to define what and who is included or excluded as morally relevant, and indeed to shape what ethics can mean (Blowfield, 2004d).

Consequences for managing relationships

When we base our decisions on false or too limited information, then there is a strong likelihood we will make mistakes. Company managers are currently acting on information that gives them only a partial idea of what is material for others. Moreover, they are limiting themselves to using standards and instruments that recognize and reproduce norms and values derived from a particular culture and social system. Litvin provides a series of examples drawn from over 300 years of capitalist enterprise of what happens when companies ignore or fail to understand the culture, perceptions and priorities of the societies in which they operate (Litvin, 2003). From the British East India Company via Chiquita to News Corp, he shows the damage companies can do to host societies and themselves, not

just by inaction but more importantly because of flawed action. This is the situation with global supply chains today.

For example, standards that do not address the priorities of workers and local communities may not simply be irrelevant, but rather may create expectations that in turn lead to unrest if they are not met. The argument that there needs to be a single set of criteria so that suppliers worldwide are working from a common base is ultimately a business argument (e.g. standardization, cost control, risk management), even if it is sometimes framed as upholding what are claimed to be a universal set of human rights. It is ironic that as company managers increasingly find themselves talking about and acting on ethical dimensions of their supply chains, they appear to become less likely to question what is right and acceptable to those they hope to benefit. This is a potentially dangerous situation because nothing makes us more blind to reality than the belief we have right on our side.

An upshot of this, especially amongst early-mover companies in this field, is that managers can become frustrated with others in the supply chain for being slow to act. Over the years many managers in intermediary companies have complained to me about the pressure put on them by major retailers or brand owners to adopt and enforce codes of conduct or to join what are described as voluntary partnerships. The use of pressure to achieve change may be legitimate, but a consequence is that companies that on the one hand espouse their moral commitment are regarded within their supply chains as bullies[2]. It also distorts discussion because often these intermediary companies are too concerned about their contracts to risk disagreeing with their major customers.

Similarly, suppliers are typically treated as objects of suspicion rather than partners. Buying companies have tended to take on a policing role in relation to labor and environmental standards, even in some cases to the point where suppliers must adopt criteria that the buying company itself does not abide by. For instance, The Body Shop International was an early promoter of the Ethical Trading Initiative base code amongst its suppliers at the same time the company refused to acknowledge union representation for its own workforce. The company changed this policy in 2001, in part because of ETI, but similar disparities are found in other firms that use voluntary labor standards in their supply chains. Such inconsistencies in turn contributes to the sense of distrust between supplier and buyer that leads not only to non-compliance with the standards but more importantly to attempts to deceive the auditors and inspectors that visit supplier facilities (Kwan and Frost, 2002).

Some companies are now shifting from a policing role to one where more emphasis is put on supplier understanding and ownership, analogous to the shifts in policy and investment related to quality control that took place a decade or more ago. This may increase the sense of ownership amongst both workers and managers. However, it may also reinforce the belief that there is a universal set of values and a single approach to implementation. Already there are examples where such a belief has influenced the issues national-level managers address. For example, in South Africa in the 1990s some companies prioritized reduction in crime and increased employment as social programs because these were issues with material consequences for their business. However, such issues rarely appear in international standards of good corporate citizenship. Therefore, when multinational firms in South Africa began to adopt such standards, local issues took second place to those with more resonance at corporate headquarters.

Ideals and influence

Culturally specific values treated as universal, business priorities presented as synonymous with those of wider society's, and the paramountcy given to business thinking and interests: these are some of the largely unrecognized factors that affect how social relationships are being managed in global supply chains. This may appear to support those who dispute that companies can or should manage these relationships in the first place, whether that be for reasons of business efficiency or social justice[3]. In reality, companies have always strived to manage their relationships with others, and will continue to face the same dilemmas traders have throughout history due to the area of moral conflict they occupy (Evers and Schrader, 1994). The issue is not therefore whether, but how to manage that relationship.

(1) The need to recognize values

The discussion this far might imply that companies should engage in a strategy of moral relativism, adjusting their values to suit the location. This challenges the notion of a shared set of human values, the subject of considerable debate in philosophy that is beyond the scope of this paper[4]. Rawls usefully distinguishes between universal and universalizable ethics. The former is founded on the assumption that there are universal moral principles/truths that are applicable wherever they are enacted, and is evident in ethical theories from Plato and Aristotle through Hobbes and Bentham to Posner and Sidgwick. The latter, rather than focusing on fixed moral truths, holds that actions can vary according to the situation, the principles behind them should always meet two conditions, i.e. they must be applicable to everyone in a similar situation requiring them to act in the same way, and they must require actors to act in the same way whenever they encounter the same situation both now in the future (Rawls, 1971).

This distinction is based on the deontological ethics of Kant and Rawls, and is attractive in that it appears to provide company managers with the means to address local differences using globally applicable principles. There are problems with this from a philosophical perspective (for example, Rawls seems to imply that what one person should do everyone else should also do, which contradicts the idea that everyone should act in their own self-interest), but we should also recognize that company actions are already underpinned by a particular set of moral principles rooted in the notion of universal rather than universalizable ethics. This is a subject I have explored in depth in other papers (see Blowfield, 2004c; Blowfield, 2004d), where I have concluded that approaches to managing the ethical dimensions of supply chains are underpinned by a neo-utilitarian ethic. In the context of this paper, it is sufficient to acknowledge that companies are promoting a universal ethic, and that this sets parameters to what company managers can or cannot do.

When companies talk about managing social relationships, they are essentially managing the positive and negative possibilities that arise from companies being members of society. Although corporate citizenship is often portrayed in terms of ''risk management'' or maintaining a ''license to operate'', what underpins both of these concepts is the tension between the values underpinning the behavior of a company and the expectations, norms and desires of others in society. In other words, companies are part of a moral environment where values, rights and responsibilities are claimed, enforced and mediated through various institutions. Some would claim that corporate citizenship as an emerging area of management competency is one such institution, mediating the expectations of companies and non-business ''stakeholders''. At the very least, ethical supply chain management can claim to be part of a system of justice seeking to establish and enforce the non-financial obligations of companies.

It is impossible to manage something if we are unaware of its existence or the potential for it to occur. Thus, if managers do not recognize the relevant ethical values that shape perceptions and expectations of the company, they lack guidance and direction for tackling problems, whether global, environmental or otherwise. What is more, they even lack a satisfactory basis for identifying problems in the first place (Attfield, 1999).

One might expect this to be addressed in business ethics, but in much of the business literature, ethics is described as something that is necessary to achieve business imperatives such as profitability, growth and shareholder value, rather than something that is at the heart of business behavior and a prime determinant of what that behavior should or should not be.

This in turn encourages business managers to think that there has to be a financial/business case for being ethical, something that, as noted earlier, has been encouraged in corporate citizenship. It is not that the business case is unimportant, but that we need to recognize that this case itself is an expression of ethical belief (e.g. the right to make a profit, the right to hire and fire at will, the right to own property). In the context of this paper, there are three important things to note about these beliefs:

1. A distinction needs to be made between ''absolute'' and ''optional'' or ''negotiable'' values. The ''absolute'' are ones that are fundamental to the company's self-interest and survival, and are typically beyond any individual company's control.
2. Some ''absolute'' values are not universal, and may contradict the norms or beliefs of some societies. For example, early Christian and modern Islamic societies place severe limitations on how profit is earned and distributed, and ambivalence about profit affects attitudes to trade in many societies (Evers and Schrader, 1994).
3. The values of ''the company'' are not necessarily synonymous with those who work for or own stock in the company. Indeed, there can be significant differences in the values of the workforce and the behavior of the company (Barrett, 1998), even where there is emphasis on becoming values driven (Jones, 1995; Hebrew Union College-Jewish Institute of Religion, 1980).

These observations in turn alert us to two important aspects of managing social relationships globally. First, they highlight the fact that the company demands to be treated as a distinct entity, even from its workers and stockholders – in other words, the company wants to be a citizen in its own right (Nace, 2003) with rights, duties, obligations and entitlements that may be different from people and the natural environment. Second, they remind us of the potential for conflict when the values a company takes for granted as being universal clash with those of particular cultures, societies and individuals.

(2) Recognizing power

Company managers need to be aware of values and the degree to which they are negotiable. They need to understand that managing a company's social relationships is part of a moral mission that is no less a part of the hegemonic form of globalization than particular theories of economics, governance and knowledge. Thus, the ethic that underpins business practice is as much of a universal norm (and hence non-negotiable) as free trade, neo-liberal economics and liberal democratic government.

It is only by recognizing absolute values and distinguishing these from negotiable ones that managerial confusion and the creation of false expectations can be avoided. It is essential too to realizing the oft-stated corporate citizenship goal of embedding social responsibilities into the heart of business practice. And it is also important for those who wish to change or oppose the role of business in society.

Some may find this moral clarity disturbing, but it is nothing more than a reflection of power and influence in global supply chains. Power is a term that is missing from most discussions of corporate citizenship beyond mention of the financial muscle of a relatively small number of multinational corporations. However, insofar as there are competing values and ideas of justice being managed through corporate citizenship, it seems inevitable that exhibitions of power will affect both processes and outcomes.

The supply chain has been described as a model of governance where companies that act as gatekeepers to the most lucrative markets can exert enormous influence over the behavior of other companies (Gereffi, 1999; Humphrey and Schmitz, 2001). We need to recognize that how power is exerted affects events: whose values are prioritized, who is engaged in discussions, what views are heard, etc. In the supply chain context, an important factor is the nature of relationships, and whether and how these constrain or increase the opportunity for a particular entity's or group's values to be represented. For instance, a supplier whose connection with the multinational is through a contract is in a very different position in terms of its relationship than a wholly-owned subsidiary.

Corporate citizenship, with its extensive references to stakeholders and multi-stakeholder partnerships, recognizes many of these relationships but tends to draw on a very limited understanding of negotiation along the lines of Nash's theory of bargaining and Midgaard's theory of cooperation (Barry, 1976). However, theories of psychology, knowledge and politics all concur that power is not always observable in the actions of particular individuals or groups. Prior to any physical negotiation, for instance, there is a perhaps unnoticed

process where the capacity to engage is assessed, and decisions taken about the right to exercise power (i.e. who consents), the right to decide who is engaged or not, and the choice of discourse that underpins any negotiation. Then there are the terms of the negotiation itself, what issues are ruled in or ruled out, and the set of values, beliefs, assumptions, rituals and institutional procedures that can be used systematically to influence decisions. Indeed, it is possible that some may not realize how the introduction of particular biases into negotiation is used to shape and determine their wants.

It is this hidden dimension that is most obviously missing from corporate citizenship analysis, i.e. how power is not just something held by individuals or groups, but in a sense is something that adheres to systems themselves (Giddens, 1991). Furthermore, power does not emanate from a single source, but rather as Foucault showed is exercised through techniques of normalization (e.g. particular institutions, instruments and mechanisms) which structure thought and discourse into mutually exclusive categories such as correct-incorrect or desirable-undesirable (McKinlay and Storkey, 1998; Faubion, 2000). Thus, for instance, it is not just that auditors have power over the people they audit, but that the process of auditing itself helps determine what is acceptable or unacceptable behavior. Such instruments in turn can relate to a value structure that rewards patterns of behavior that are useful or non-threatening to the powerful (Lucas, 1992).

A more sophisticated understanding of power is important for those charged with the social relations dimensions of supply chains because to understand what has happened in the past and what the best alternatives are for the future, managers need to know where they have power to affect change, what power others have and how it is expressed. Experiences in countries such as Russia and China show that power can be exercised in very different arenas than US managers are familiar with (see Ayios, 2003; Chatterjee and Pearson, 2003; Redfern, 2004). If we ignore both the nature of power in different contexts and the avenues or arenas where it is influenced, then we are likely to miss a significant part of the story of how values are identified, promoted and upheld, and also of the best ways to effect change.

It is not necessarily that these power relationships can be radically altered, but effective management depends on acknowledging them and their consequences. This will not lead to the sort of win-win, non-conflictual partnerships portrayed in corporate citizenship literature. Rather, it will allow a distinction to be drawn between areas of probable dissent and consensus about what companies can be held responsible for. This in turn provides the basis for both managers and wider society to develop appropriate approaches for pursuing their aims.

Conclusions

Incorporating values and influence into management practice is a work in progress, and this is the first in a series of outputs. What it suggests is that, regardless of why companies and managers are first drawn into corporate citizenship on a global stage, the central management issues relate to the moral relevance of the values espoused explicitly and implicitly. This makes it easier to understand and hence manage the parameters of possibility, and in turn helps companies realize what is material to them (i.e. by distinguishing absolute and negotiable values), and identify what is material to others. Much of the tension between elements of the supply chain is a result of the values of one culture butting up against each other. The areas of greatest tension are likely to be where there is greatest difference over absolute values. Where both sides are bargaining over ‘‘negotiable values’’ there is more likelihood of mutually acceptable outcomes. Equally, companies might benefit most where what constitutes an absolute value for others is a negotiable value for the company, i.e. where company managers can give something of real value to other audiences.

Recognition of moral relevance can also bring clarity to decision-making, For example, it encourages managers to understand the elements and consequences of a universal vision of values versus a more relativist one.

Alongside this awareness of values, an understanding of power can also assist the ongoing management of supply chains' social and environmental dimensions. This means understanding the nature of power, the arenas and institutions through which it is expressed, and the outcomes of using power (e.g. who is included/excluded and why; the fora where discourse is shaped; inclusion/exclusion of issues).

Recognition of the centrality of these issues, for instance, allows managers to develop decision trees along the lines of:

- What do I/don't I have power over?
- Where I have power, what can I give up to others that will bring me advantage?
- Where I have power, what can I give up to others that will bring me no disadvantage?
- Where I do not have power, what will be the material impact of any inaction?
- Where I have insufficient power, what can I do to increase it?

If this seems an especially blunt way of looking at supply chain management, it should be remembered that justice is a necessity not a nicety. Furthermore, by bringing clarity to the management of social and environmental dimensions, we are laying the groundwork for a more rigorous and insightful external analysis of corporate citizenship, allowing us to answer questions about what and whose values are acknowledged, what power is exerted or surrendered and how, and whose interests are ultimately included and excluded.

Above all, these observations challenge aspects of corporate citizenship's orthodox thinking (e.g. regarding stakeholders, partnerships and performance measurement), and require that we give new consideration to the challenge of working with and distinguishing between global communities of need and of expectation. They provide a timely reality check for those propounding and employing popular contemporary approaches to managing the business-society relationship, and at the same time suggest more effective ways of addressing expectation management in the future.

Notes

1. This paper draws on two periods of research. The first was conducted in Europe, Asia, Africa and Latin America from 1997-2001; the second is the recently started Going Global project at the Center for Corporate Citizenship at Boston College, USA. Parts of this research have been published in a wide range of journals and rather than repeat the different arguments, I have cited this work in the endnotes.
2. An early example of this was the first Ethical Trading Initiative conference in 1999 when, after a poorly attended first day, managers from J. Sainsbury, a founding member, sent out an ''all hands'' message to their key importers to ensure a better turn out on day two. I have also documented elsewhere an example of how retailers and importers exerted force on African suppliers (Blowfield, 2003, pp. 331–337).
3. For very different perspectives questioning the validity of corporate citizenship see Kelly (2000) and Henderson (2001).
4. An overview of the evolution of universal ethics is presented in Barry (1989).

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Finance and accounting

Corporate social responsibility and financial performance

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Abstract

Purpose – *This paper aims to investigate the interaction between sustainability and financial performance. Can socially responsible investors, integrating environmental, social and ethical issues in their investment policy, expect the same return as traditional investors?*

Design/methodology/approach – *Based on the sustainability ratings of a specialized rating agency, Vigeo, a Fama and French approach is performed to adapt for style biases in the performances.*

Findings – *The results indicate that, on a style-adjusted basis, high sustainability-rated portfolios have performed better than low-rated portfolios, but, probably due to the short horizon, not to a significant extent. The same results are found for four out of the five sub-ratings of which the sustainability rating is composed, suggesting that sustainability is a broad and multidimensional concept that cannot be attributed to one specific theme or topic. The results also indicate that investors are ready to pay a premium for companies with good management of their relations with shareholders, clients and suppliers.*

Research limitations/implications – *Owing to the rather new concept of socially responsible investing and in order to avoid survivorship bias, only a relative time horizon is considered.*

Practical implications – *There is no cost involved in integrating sustainable dimensions in the investment policy.*

Originality/value – *The paper shows the relevance of socially responsible investing when one adjusts for style differences within the portfolio.*

Keywords *Social responsibility, Economic sustainability, Ethical investment*

Paper type *Research paper*

Socially responsible investment (SRI) combines investors' financial objectives with their concerns about social, environmental and ethical (SEE) issues (UK Social Investment Forum[1]). SRI is an investment process that considers the social, environmental or ethical consequences taken into account in the selection, retention and realization of investments, both positive and negative, within the context of rigorous financial analysis (Mansley, 2000).

The question that arises with SRI investments is the profitability of those strategies. Is the performance of SRI strategies as good as or as bad as traditional investment strategies? A way to investigate the performance of SRI investment strategies is to evaluate the financial performance of so-called ''socially responsible companies'', namely companies that are integrating social and environmental factors into their global strategic decision-making policies and practices. A socially responsible company puts the interests of its shareholders on a par with the social, community and environmental interests of third parties or stakeholders involved in its activities. By controlling the impact of its activities on stakeholders, it targets a threefold economic, social and environmental performance through which it contributes to the overall objective of sustainable development. That is why socially responsible companies are also called sustainable companies.

As socially responsible investors are typically invested in these sustainable companies, the performance of socially responsible companies is a key element in their performance. We will investigate the interaction between the corporate social responsibility of a company and its financial performance. The question is whether this focus on social and environmental issues will have a positive or negative effect on shareholder interests. A negative impact could be explained by the fact that the integration of third party interests could lead to a sub-optimization of shareholders' interests, resulting in an under-performance of the share price. A positive impact could be explained by the fact that an integration of the interests of all stakeholders could create shareholder value by reducing non-financial risk and creating long-term growth opportunities for the company.

The aim of the paper is to investigate the interaction between corporate social responsibility and financial performance. We will do this both for overall corporate social performance and for responsibility on specific dimensions, like environmental or social responsibility.

The paper is organized as follows. A literature overview locates the subject. The data segment explains the figures used in our study. The methodology describes the way of working for this paper. Afterwards, we will discuss the performance results, before and after correction for style biases. The conclusion summarizes our findings.

Literature overview

Many studies have described the performance of socially responsible investments, with somewhat different results.

Orlitzky *et al.* (2003) performed a meta-analysis of 52 studies in search for the relationship between corporate social performance and corporate financial performance. The results confirm that socially responsible investing pays off. The relationship is strongest for the social dimension within corporate social performance. When isolating the environmental responsibility we come to the same conclusion but to a lesser extent.

Diltz (1995) and Sauer (1997) concluded that there were no statistically significant performance differences between socially responsible investments and traditional investments. Diltz examined the alphas and abnormal returns for 28 socially screened equity portfolios in order to obtain this conclusion. There was no adjustment for style factors. Sauer investigated the Domini Social Index performance by risk-adjusted performances and came to the same conclusion.

Bauer *et al.* (2002) investigated the performance of international ethical mutual funds, corrected for investment style. The results show no significant difference in risk-adjusted returns between ethical and conventional funds for the period 1990-2001.

Kneader *et al.* (2001) investigated the financial performance of 40 international ethical funds and 40 international non-ethical funds against their benchmark. The results show no statistical difference between their performances. They found that ethical funds have lower risk in comparison to their non-ethical counterparts. The cross-sectional analysis indicates that the risk-adjusted returns are not significantly related to the size, age or ethical status of the fund.

Other studies isolate the impact of separate ''social'' factors on financial performance.

Derwall *et al.* (2003) include the Innovest eco-efficiency scores for US companies, meaning that they only look at the environmental factor. After controlling for risk and investment style, they found that the high-ranked portfolio outperforms the low-ranked portfolio. The results become significant when adjusted for industry effects.

Becker and Huselid (1998) focus on the relationship between human resources management and firm performance. An analysis of more than 500 multi-industry US companies shows that a high performance HRM system has an economically and statistically positive effect on company performance.

Gompers *et al.* (2003) focus on the corporate governance aspect. They construct a ''governance index'' using 24 governance rules on 1,500 large US firms. An investment

strategy that purchased shares of well-governed firms and sold shares in badly-governed firms earned an abnormal return during the 1990s. The paper implemented style-adjustments.

Bauer *et al.* (2003) also analyzed the effect of corporate governance on stock returns and firm value. They used the Deminor Corporate Governance ratings to build a portfolio of well-governed companies against a portfolio of companies with bad corporate governance. They find a positive result for style-adjusted returns, with weaker positive results after adjustment for country differences.

In summary, most studies report an out-performance for SRI portfolios compared with more traditional investment approaches, even if differences are not always statistically significant. When we look at specific dimensions of sustainability, more significant and positive results arise, indicating that some aspects of corporate social responsibility could also add shareholder value.

Data

In order to measure the sustainability of a company, we used the Vigeo corporate social responsibility scores. Vigeo is an independent corporate social responsibility agency that screens European quoted companies on CSR.

The scores of Vigeo contain information on five dimensions of corporate social responsibility:

1. Human resources.
2. Environment.
3. Customers and suppliers.
4. Community and society.
5. Corporate governance[2].

For each dimension, Vigeo assesses the corporate social performance with a sustainability score. For the purpose of this paper, we constructed a total sustainability score as a summation of the ratings on the five individual dimensions. The Jarque-Bera test indicates the normality of the total and individual sustainability scores.

The Vigeo scores have been available since 2000 for a representative sample of euro zone companies. The period of investigation ranges from 1 January 2000 to the end of November 2003. Companies that disappeared because of merger or acquisition events were excluded from the investment universe for the year the event took place. Table I gives an overview of the number of companies for which data were available. The table shows that over the years, the number of screened companies has increased.

The data for share prices, market capitalization and book values were obtained from DataStream.

Table I Sector composition

	2000	*2001*	*2002*	*2003*
Consumer discretionary	40	56	52	57
Consumer staples	15	20	22	28
Energy	5	8	10	9
Financials	50	64	75	65
Health care	6	12	16	14
Industrials	29	37	45	45
IT	16	32	40	31
Materials	21	29	22	25
Telecom	10	16	17	12
Utilities	12	15	16	18
Total	204	289	315	304

Methodology

Construction of four portfolios based on total sustainability rating

In order to measure the impact of corporate social responsibility on performance, we have constructed four different portfolios based on the companies' total sustainability rating. All portfolios are market-cap weighted. The first portfolio (called ''Best'') consists of the companies that within their sector have a sustainability rating of at least one standard deviation above the mean. The second portfolio, called ''Good'', consists of companies with a sustainability rating between the sector mean and one standard deviation above. Further, companies with sustainability scores between the mean and one standard deviation below are combined in the ''bad'' portfolio and finally, the ''worst'' portfolio consists of scores that are lower then one standard deviation below the sector mean. The advantage of this method is that each sector is equally represented in the four portfolios (Table II).

As could be expected from a normal distribution explained earlier, the two medium portfolios have the largest number of companies.

Performance analysis

On first January each year, the portfolios are recalculated and rebalanced. In the first part of the result segment, we give descriptive performance statistics, like the monthly return over the period, the standard deviation of the return and the minimum and the maximum return. A second part makes a deeper investigation of the subject in order to correct for risk and style factors, like market sensitivity, size and value. This analysis enables us to isolate the pure sustainability effect in the performance differences. We have based our analysis on the Fama and French (1992) model, which not only incorporates the market factor but also the size and book-to-market variables, as determinants of financial performance. The analysis will give us the opportunity to examine what part of the difference in performance can be explained by differences in financial characteristics and what part is caused by differences in sustainable characteristics.

The Fama and French model can be expressed with the following OLS regression:

$$R_{it} - R_{ft} = \alpha_i + \beta_{0i}(R_{mt} - R_{ft}) + \beta_{1i}SMB_t + \beta_{2i}HML_t + \varepsilon_{it}$$

where:

- Rit = return on portfolio i at month t.
- Rft = one month Euribor rate.
- Rm = return on a broad market index (MSCI EMU).
- SMB = the return difference between a small cap portfolio and a large cap portfolio.
- HML = the return difference between a value portfolio and a growth portfolio.
- ε_{it} = error term.

Results for the individual sustainable dimensions

We also implemented the same methodology as in the previous part for the scores on each of the five individual dimensions Vigeo uses (human resources, environment, customers and suppliers, community and society and corporate governance). This analysis gives a better

Table II Composition of the four portfolios

	2000	*2001*	*2002*	*2003*
Best	51	62	62	63
Good	65	82	104	103
Bad	62	101	107	89
Worst	26	44	42	49
Total	204	289	315	304

insight into the underlying mechanisms driving the interaction between corporate social responsibility and financial performance.

Results

Financial performance of the total sustainability rating without style adjustments

The relative performance of the four portfolios, reflecting different levels of sustainability is given in Figure 1. The ''bad'' portfolio, namely the portfolio with the below-average sustainability score, performs the best of the four portfolios. The worst performance comes from the ''best'' portfolio: the portfolio of companies with the highest overall sustainability rating had the worst performance over the period. This can be observed in Table III, which also shows that the bad portfolio had the lowest volatility. The table shows that raw return differences between the four portfolios are relatively low compared with the differences observed in volatility. Analysis confirms that the differences in raw returns between portfolios are not statistically significant.

The observed difference in performance between the different portfolios does not permit a conclusion as to the interaction between total sustainability rating and financial performance. The question is what part of the performance difference can be attributed to the differences in total sustainability rating and what is due to differences in financial characteristics. This question is addressed by making a Fama and French correction for market and style factors.

Figure 1 Relative performance of market-weighted portfolios ranked on total sustainability scores versus MSCI EMU

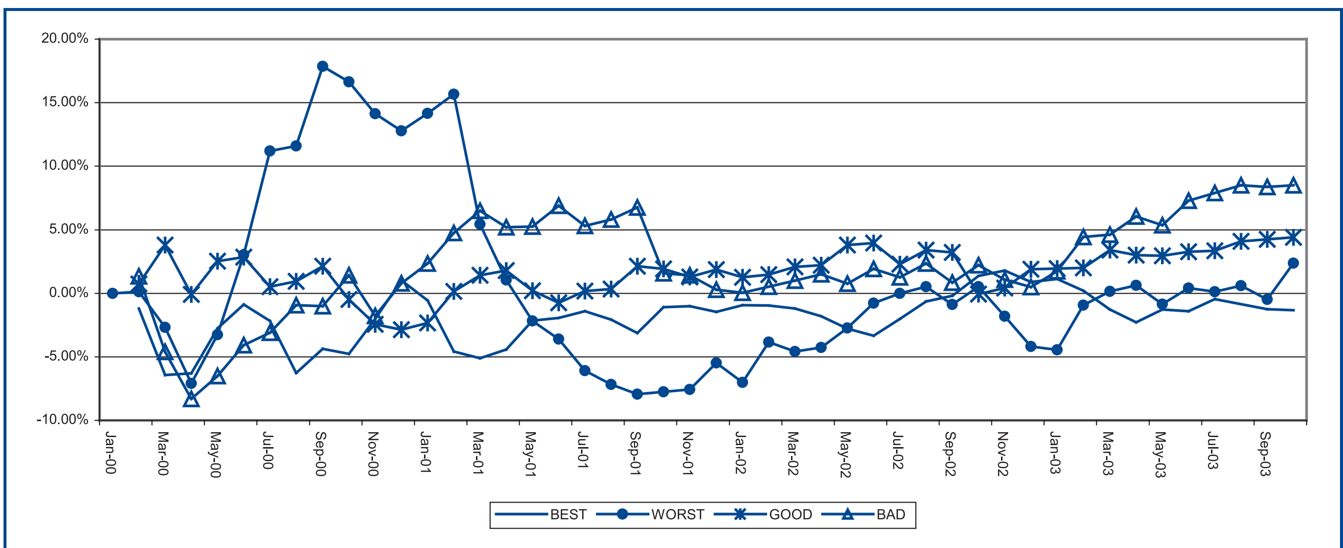

Table III Raw results of the total sustainability rating

Portfolio	*Average return* (%)*	*SD (%)*	*Max. (%)*	*Min. (%)*
Best	− 1.09	6.58	15.25	− 15.12
Good	− 0.86	6.85	13.99	− 18.72
Bad	− 0.77	5.93	9.61	− 18.38
Worst	− 0.96	6.76	9.91	− 16.44

Note: *Monthly returns

Financial performance of the total sustainability rating with style adjustments

The results of this analysis are shown in Table IV. Overall, the Fama and French model is able to explain more than 90 percent of the performance for three of the four portfolios and more than 77 percent for the worst portfolio. The market factor (MARKET) is the most important factor in explaining the performance of the four portfolios. We notice that the market sensitivity of portfolios with an above-average sustainability rating (''best'' and ''good'') is higher than the market sensitivity of portfolios with a below-average rating (''bad'' and ''worst''). The small cap factor (SMB) is significant for the performance of the ''bad'' portfolio, showing that this portfolio had a considerable over-weighting in small caps. Even if the other results are not significant, it is however noteworthy that both portfolios with a below-average sustainability rating (''bad'' and ''worst'') have a positive exposure to the small cap factor, whereas the above-average sustainable portfolios have a negative exposure. This suggests the existence of a large cap bias in sustainability ratings.

The value factor (HML) is not significant for any of the four portfolios. Nevertheless, we again notice a different sign for above and below-average sustainability scores: the value factor is negative for low-rated portfolios and neutral or positive for high-rated portfolios. The Fama and French analysis thus show that when analyzing the performance differences between the four portfolios, the raw returns need to be corrected for differences in market sensitivity and small cap biases, and to a lesser extent for a value/growth bias.

The result of this style correction is also shown in Table IV, where the column alpha gives the corrected, unbiased performance of the four portfolios. On a style-adjusted basis, the best performing portfolio is the ''good'' portfolio, which had a monthly out-performance of 20 bp, whereas the bad and the worst portfolios under-performed by 34 and 19 bp respectively. Even if the alphas are not significant, the sustainable effect was positive during the observation period. The fact that this was not the case for raw returns is due to the more sustainable portfolios tending to be biased towards higher market sensitivity, higher capitalization and growth biases that lead during the observation period to under-performance. The existence of a sustainable alpha nevertheless gave the opportunity to investors, in particular socially responsible investors, to exploit the sustainable effect to create out-performance.

Financial performance of the human resources rating

The rating on human resources regards the continuous improvement of employment conditions, evaluation of job skills and employability (Table V). The improvement of industrial relations is also a subject of this domain. The social dialogue between management and employees is the most important factor here.

Even if the style-adjusted performance differences are not statistically significant, it is interesting to note that the best human resources portfolio delivered the best performance, with a style-adjusted performance of 21 bp. The companies with the best human resources policy tend to have a higher market sensitivity, whereas companies with lower scores tend to be small-cap biased.

Table IV Style-adjusted performances of total sustainability rating

Portfolio	*Alpha %*	*MARKET*	*SMB*	*HML*	*Adj. R^2 %*
Best	0.00	0.96***	−0.0482	0.0073	91
	(0.03)	(21.29)	(−0.69)	(0.13)	
Good	0.21	1.02***	−0.0098	0.0144	94
	(0.79)	(26.78)	(−0.16)	(0.32)	
Bad	−0.34	0.84***	0.2087***	−0.0336	91
	(−1.14)	(20.39)	(3.32)	(−0.68)	
Worst	−0.19	0.9***	0.1567	−0.0874	77
	(−0.38)	(12.16)	(1.39)	(−0.99)	

Notes: *Significant at 10 percent level; **Significant at 5 percent level; ***Significant at 1 percent level

Table V Style-adjusted performances of the human resources rating

Portfolio	Alpha %	MARKET	SMB	HML	Adj. R^2 %
Best	0.21	1.06***	0.0821	−0.0200	91
	(0.59)	(20.70)	(1.05)	(−0.33)	
Good	−0.09	0.97***	−0.0762	0.0371	93
	(−0.34)	(24.02)	(−1.23)	(0.77)	
Bad	−0.09	0.85***	0.1509***	0.0051	91
	(−0.33)	(20.52)	(2.41)	(0.10)	
Worst	0.04	0.96***	0.1529	−0.1519	82
	(0.09)	(13.88)	(1.45)	(−1.84)	

Notes: *Significant at 10 percent level; **Significant at 5 percent level; ***Significant at 1 percent level

Financial performance of the corporate governance rating

The corporate governance domain rates the transparency and the efficiency of governance towards shareholders and other stakeholders (Table VI).

Overall, above-average corporate governance portfolios perform better than those ranked below average, but care should be taken because the alphas are not significant. The bad governance portfolios tend to be more small-cap oriented. The value factor is negative and significant in the case of the best portfolio. This finding is in line with the results of Gompers *et al.* (2003) and Bauer *et al.* (2003).

Financial performance of the society and community rating

With regard to the society and community domain, the rating is based on the way the company integrates the interests of the community and the territories in which it operates (Table VII). The community involvement looks at the contribution of the company towards the community, such as public causes and local employment training.

The pattern is less clear for this dimension than for the other dimensions: the ''worst'' portfolio has the highest out-performance, but the ''best'' portfolio has also a positive out-performance. The sensitivity to different style factors is more mixed.

Financial performance of the environment rating

The rating for the environment domain is mainly based on the way the company considers the impact of its activities on the environment (Table VIII).

The only portfolio with a positive alpha is the ''best'' portfolio, environmental excellence leading to a monthly out-performance of 22 bp. There is no significant small-cap or value bias inherent in these portfolios. A surprise is the very low beta for the environmentally worst-performing portfolio. We do not find a higher market risk attached to environmentally badly-performing companies. This is in contrast to the findings of Feldman *et al.* (1997), who report that well-performing companies at an environmental level, tend to have a significantly lower beta.

Table VI Style-adjusted performances of the corporate governance rating

Portfolio	Alpha %	MARKET	SMB	HML	Adj. R^2 %
Best	0.26	1.03***	−0.0134	−0.1133*	89
	(0.65)	(18.45)	(−0.15)	(−1.70)	
Good	0.14	0.93***	−0.0528	0.0345	96
	(0.72)	(32.33)	(−1.20)	(1.00)	
Bad	−0.19	0.94***	0.1781***	0.0305	91
	(−0.62)	(21.15)	(2.63)	(0.57)	
Worst	0.12	0.85***	0.1166	0.0200	78
	(0.25)	(12.63)	(1.13)	(0.25)	

Notes: *Significant at 10 percent level; **Significant at 5 percent level; ***Significant at 1 percent level

Table VII Style-adjusted performances of the society and community rating

Portfolio	Alpha %	MARKET	SMB	HML	Adj. R^2 %
Best	0.25	0.99***	−0.0568	−0.0116	93
	(0.88)	(24.39)	(−0.91)	(−0.24)	
Good	−0.03	1.03***	0.1246***	−0.0055	96
	(−0.14)	(31.80)	(2.53)	(−0.14)	
Bad	−0.26	0.90***	0.0870	0.0504	93
	(−0.97)	(23.39)	(1.48)	(1.10)	
Worst	0.37	0.84***	0.0609	−0.1716*	72
	(0.66)	(10.58)	(0.50)	(−1.79)	

Notes: *Significant at 10 percent level; **Significant at 5 percent level; ***Significant at 1 percent level

Table VIII Style-adjusted performances of the environment rating

Portfolio	Alpha %	MARKET	SMB	HML	Adj. R^2 %
Best	0.22	0.96***	0.0070	−0.0018	93
	(0.76)	(23.96)	(0.11)	(−0.04)	
Good	−0.02	0.98***	0.0332	0.0535	92
	(−0.07)	(22.34)	(0.49)	(1.02)	
Bad	−0.04	1.03***	0.0865	−0.0617	91
	(−0.13)	(20.90)	(1.15)	(−1.04)	
Worst	0	0.60***	0.0135	0.0856	73
	(−0.01)	(10.99)	(0.16)	(1.31)	

Notes: *Significant at 10 percent level; **Significant at 5 percent level; ***Significant at 1 percent level

Financial performance of the customer and supplier rating

A socially responsible company has to look at the needs and demands of its clients and suppliers, a flexible and transparent attitude towards them will result in a high rating for this domain. An adaptation of the supply chain to social and environmental factors and the information around the products can lead towards better client relations. A clear business contract strategy can result in easier relations with the suppliers (Table IX).

The companies with the best customer and supplier ratings out-performed by 38 bp, whereas the worst companies under-performed by 52 bp. The companies with the best customer and supplier ratings have a significant growth exposure, suggesting that investors are ready to pay a premium for these companies. The lowest customer and supplier portfolios have a significant small cap exposure.

Conclusion

Analyzing the impact of corporate social responsibility on financial performance is a complex issue. Comparing the raw performances of sustainability-screened portfolios with traditional portfolios does not answer the question, because performance differences are

Table IX Style-adjusted performances of the customer and supplier rating

Portfolio	Alpha %	MARKET	SMB	HML	Adj. R^2 %
Best	0.38	1.05***	−0.0814	−0.1441***	89
	(0.95)	(18.47)	(−0.94)	(−2.12)	
Good	−0.27	0.85***	0.0064	0.0313	94
	(−1.18)	(26.22)	(0.12)	(0.81)	
Bad	0.28	0.99***	0.0627	0.0672*	95
	(1.18)	(29.35)	(1.22)	(1.67)	
Worst	−0.52	1.09***	0.2208***	−0.0816	85
	(−1.05)	(15.44)	(2.05)	(−0.97)	

Notes: *Significant at 10 percent level; **Significant at 5 percent level; ***Significant at 1 percent level

more biased by differences in financial characteristics. After making style corrections by using the Fama and French model, we see that during our observation period the portfolios of companies with a low sustainability rating under-performed the market (between 19 and 34 bp on a monthly basis) whereas the portfolios with high-rated sustainable companies out-performed (between 0 and 21 bp). The observed performance differences are not high enough to be statistically significant. This is also a consequence of the relatively short time horizon used in the study, due to the fact that the sustainable analysis of companies is a relatively new phenomenon. Given the long-term orientation of sustainable development, successful performances from sustainable investing may result from a longer time horizon.

The results suggest that investors, especially sustainable investors, could exploit this sustainable effect in order to create out-performance. Our results also indicate that it is a necessary condition to manage style biases because these biases tend to outweigh the impact of the sustainability factor. Our analysis shows that high-sustainability portfolios tend to have a higher market and large-cap exposure, which if not properly neutralized in the portfolio construction process, can offset the positive sustainable alpha. Successful SRI performances result from the integration of high quality sustainable screening and rigorous risk management, which can be further leveraged by active management.

In order to understand the underlying dynamics of sustainability and financial performance better, we made the same analysis for five dimensions of sustainability ratings. The style-adjusted performances of four of the five dimensions were very similar, as for the global sustainability rating, suggesting that sustainability is a broad multi-dimensional concept, adding value by interaction with the different stakeholders, and cannot be attributed to one specific theme or topic. Only on one dimension – society and community – was no out-performance of the best-ranked portfolios observed. These positive (but once again not statistically significant) results were observed for corporate governance, human resources policy, clients and suppliers and environment. It is also interesting to note that the best-rated portfolios on corporate governance and clients and suppliers have a significant growth exposure, indicating that investors are ready to pay a premium for companies with a good management of their relations with shareholders, clients and suppliers.

Further research needs to be carried out in order to investigate the dynamics of sustainability and performance, e.g. by analyzing longer time periods, other investment universes or other rating models than the Vigeo ratings we used in this paper. Investigating the origin of the large-cap bias in sustainable universes is another topic: the question is whether this is really linked to a higher corporate social responsibility among large caps, or whether this is due to a weakness in the sustainability screening process.

In any event this study confirms the findings of other studies: after correction for style biases sustainable investments performed slightly better than traditional investments – but not enough to result in a statistically significant out-performance. It at least shows that if properly managed, there is no cost involved in integrating sustainable dimensions in the investment policy.

Notes

1. Social Investment Forum (SIF), available at: www.socialinvest.org
2. Since January 2004, Vigeo has created a separate rating for human rights. During our research period, human rights was part of human resources, community and society and customers and suppliers. Available at: www.vigeo.com

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Meeting objectives and resisting conventions

A focus on institutional investors and long-term responsible investing

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Abstract

Purpose – *This paper seeks to unravel some of the challenges associated with responsible investment from the institutional investor's perspective, focusing on how dominant conventions influence investor behavior and their ability to invest responsibly.*

Design/methodology/approach – *The research draws from three longitudinal case studies that were carried out on UK institutions that have adopted a responsible investment policy.*

Findings – *Evidence of behavioral obstacles to responsible investing were found, including short-termism, gravitation towards defensible decisions and reluctance to integrate corporate responsibility factors into the core investment process. Based on the case study evidence these appear to be driven by the influence of prevailing dominant conventions, reinforced by institutional herding tendencies.*

Research limitations/implications – *The paper introduces some preliminary thoughts as to how conventions might be resisted and changed over time through the institutional herding mechanism. Further research is required (and is currently under way) to more closely examine the potential impact of investor collaboration for challenging dominant conventions.*

Practical implications – *Collaboration amongst institutional investors is key for mobilizing institutional herding tendencies so that responsible investment might get built into conventions.*

Originality/value – *The research combines responsible investment literature with behavioral finance studies on investor behavior, herding tendencies and the influence of conventions. It also illuminates the complexities in investor behavior from which other institutional investors might learn in implementing a responsible investment policy.*

Keywords *Social responsibility, Short-term planning, Conventions*

Paper type *Research paper*

1. Introduction

Corporate scandals have become a common headline in the financial news across the world over recent years, including high profile collapses such as Enron, Worldcom and Parmalat. At the same time societal expectations of what is acceptable corporate conduct has shifted, with concern expressed about the impact of corporate activities on the environment, local communities, labor standards, human rights and business practices in developing countries. This shift in societal expectations has corresponded with the birth of socially responsible investment (SRI) and increased shareholder activism. This will be referred to throughout this paper as long-term responsible investment (LTRI)[1], defined as the situation whereby investors integrate financial, corporate governance, social and environmental criteria into the investment process in the pursuit of long-term portfolio returns.

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As a large and powerful investor pool[2], institutional investors could potentially play an important role in promoting more responsible corporate behavior; indeed regulatory changes have been introduced in many countries to encourage their increased involvement[3]. Whilst some institutional investors have become more involved, such activities are still unconventional[4]; unless LTRI becomes more widespread then it is debatable as to whether the investment mechanism will be a viable vehicle for integrating corporate responsibility into the market system. The focus of this paper is to unravel the conventions and herding tendencies that act as obstacles to investing in a long-term responsible manner and to consider if/how these might be overcome.

The outline of this paper is as follows:

- section 2 begins with an overview of the relevant SRI literature;
- section 3 outlines the methodology adopted in carrying out the longitudinal case studies and data analysis;
- section 4 presents empirical evidence on the behavioral impediments to LTRI;
- section 5 builds on this evidence to explore how internal and external conventions might be altered as a means of mainstreaming LTRI through the institutional herding mechanism; and
- section 6 concludes and identifies areas for further research.

2. Academic contribution and aim of research paper

The academic writings in the SRI field have built a strong case for institutional investor involvement in the promotion of corporate responsibility from the business ethics perspective (Mackenzie, 1997; Cowton and Crisp, 1998; Sparkes, 2001; Sparkes and Cowton, 2004) drawing from the agency problem literature (Berle and Means, 1932; Jensen and Meckling, 1976; Coase, 1988) through to stakeholder theory (Freeman, 1984). There is also extensive associated literature on the performance implications of SRI and shareholder activism with varying results[5]. Whilst these studies have produced somewhat inconclusive results as to the benefits of shareholder activism and SRI, they found that there at least does not appear to be a performance penalty from such activities.

The vast body of normative studies on the subject of investor responsibility do not address the issue of what ''investor responsibility'' actually necessitates in terms of changing investor behavior (or whether such change is achievable). SRI has been researched from the perspective of individual investors to better understand their behavior (Lewis, 2002), but institutional investors' warrant closer attention given their aforementioned power as significant shareholders. Studies by behavioral financiers are relevant here and there is a need to link this body of research with the investor responsibility literature. Most relevant for the purpose of this paper is the evidence that institutional herding exists (Sias, 2004; Nosfinger and Sias, 1999; Grinblatt and Titman, 1989; Grinblatt *et al.*, 1995; Wermers, 1999, 2000) and the models of investigative herding outlined in Froot *et al.* (1992) and reputational herding of Scharfstein and Stein (1990). These insights will frame the analysis of the case study evidence presented in this paper to consider how conventions, reinforced by herding tendencies, affect institutional investor behavior and their ability to invest responsibility.

3. Methodology

The paper draws from qualitative data collected through longitudinal case studies on three institutional investors in the UK who have to varying degrees introduced a policy of responsible investment across the management of their assets. The institutions are large representatives of the UK investor community, together accounting for some £80 billion of assets as at the end of 2003 and span the insurance and pension fund sectors.

The research approach was inductive and set out with the aim of gaining a better understanding of investor behavior, the factors that influence it and how this might affect an institution's ability to invest in a long-term responsible manner. It was therefore important for participants to be free to tell the story from their own perspective and to feel that, as the

researcher, I was not there to judge the institution but to act as a co-inquirer of the environment in which they operate and the challenges the institutional investor community face in moving towards integrating LTRI into their investment philosophy and process. With this in mind, the method was influenced by the participatory action research (PAR) approach where participants become involved in both the questioning and sense making that informs the research with respect to a particular issue or development (Reason and Bradbury, 2001).

The case studies were carried out over a period of 6-12 months, which provided some degree of longitudinal analysis and insight into how each organization changed and evolved over that time. The data collection process involved: six unstructured ''exploratory'' meetings with individuals across the participating institutions to guide the nature and focus of the research project; textual analysis of documents produced by the participating institutions including investment philosophy documents and the ''statement of investment principles'' (SIP) that amounted to over 250 pages; 20 semi-structured interviews with fund managers lasting an average 1.5 hours that were recorded and fully transcribed for analysis; informal communication and observation of participants through meetings, ongoing e-mail correspondence and telephone conversations; and diary observations and self reflection on my role and the progress of the research.

The data was distilled into themes and analyzed through the development of grounded theory and the constant comparative method (Glaser and Strauss, 1967; Haig, 1995; Strauss and Corbin, 1998). The ground theory data analysis method was infused with elements of PAR in two primary ways: firstly, the participants were involved in the questioning and sense-making of the data at different stages of the research process (double-loop inquiry); and secondly, the diary observations and self reflections were referred to in analysis of the data. Grounded theory allowed the ''data to speak'' and for theory to emerge from the data, whilst iteration with participants and self-reflection as expounded by PAR acted as a means of validating the data and staying true to the research aim.

4. The case study evidence on institutional objectives and investor behavior

Analysis of the three case study institutions' policy documents revealed that they all use similar discourse when outlining their responsible investment policy; namely, the aim to be responsible long-term shareholders of companies and markets in which they invest. They also invariably refer to the need for fund managers to pay appropriate regard to corporate governance, social, ethical and environmental considerations in the selection, retention and realization of all fund investment, in so far as that is consistent with the institution fulfilling its investment objective and legal obligations.

Despite the fact that these objectives exist at the institutional level, it became apparent during analysis of the case study data that there are behavioral obstacles to overcome at the actual fund manager level[6] to meet these objectives. These ''behavioral obstacles'' fall within the following three categories:

1. The pull towards short-termism.
2. Gravitation towards the defensible.
3. The LTRI objective being viewed as separate from the core investment process.

4.1 The pull towards short-termism

Being pulled towards the short-term was repeatedly mentioned by some fund managers as a challenge that all investors grapple with, not only those who aspire to be ''responsible'' investors. In the behavioral finance literature, short-termism is most commonly referred to as myopic behavior and the resulting tendency to over-emphasize the present (near term cash flows) at the expense of longer horizons (Frederick *et al.*, 2002)[7]. Whilst all fund managers interviewed throughout the case studies felt that it was better to stay focused on the long-term given the nature of their respective institution's liabilities and the difficulties with trying to forecast short-term market movements, subsequent comments revealed that ''making forecasts'' within that period is seen as an essential requirement of an ''active'' fund

manager's job[8]. The following statement made by one fund manager illustrates some of these short-term pressures:

> . . . I mean it always tough, people talk about time scales, but the issue is more about size of out-performance. In other words, we're looking for things that we think we can outperform by 15-20 percent or more . . . that may come in a few months or it might take longer . . .

This statement, and many more like this throughout the interview process, suggest that in those institutions that operate an active fund management policy, there is a disconnect between what investors believe they should do in principle and what they actually do in practice. Investors focus on staying ahead of price movements and, where they are actively managing against a benchmark, maximizing the degree of out-performance relative to that benchmark; the time scale issue is seen as being a secondary consideration. Noteworthy is the observation that short-termism was not something that dominated the discourse of fund managers within institutions that operate a ''passive'' approach to fund management with the emphasis on active engagement[9], as these investors are not incentivized to ''beat the market'' as such but to own it and to improve its performance through engagement activities.

The convention of ''active'' management may therefore keep the focus of investors on shorter-term goals and more closely linked to the rest of the market as they in effect see themselves as competing for returns against other investors. Indeed, many investors argued that because the rest of the market invests with a short-term horizon, they feel they also have to do so. This fits with a paper by DeLong *et al.* (1990) that noted the main drawback with investing based on a long-term horizon is that the price may take some time to gravitate towards its fair value, hence the long-term investor will be vulnerable to short-term investors' dominating the determination of the market price for a prolonged period of time. To further illustrate this, the following comment was made by a fund manager in regard to the perceived risks with taking a long-term horizon:

> If the whole market became more long term and was trading on a ten year outlook then it would be fine [to be longer term], but they're not so you just have to trade on what they're trading on . . . it's just what you've got to do really . . . if I were to take a ten year forecast it would be hopeless . . .

The interviewee goes as far to say that investing over the long-term would be ''hopeless'' given that the rest of the market is ''trading'' on the basis of a short-term horizon. The discourse used, such as ''trading'' rather than referring to the task at hand as ''investing'' was how many interviewees described their job and further illustrates the disparity between investors' own objectives and that at the institutional level (as described earlier in this paper). From the fund manager's perspective, taking a longer-term view is riskier as they fear that if they got it wrong for a period of time then they would be penalized (through a lower annual bonus payment or even losing their job), as indicated by the following statement made by one investor:

> I think any fund manager will tend to focus more on short term goals because you have to be very brave to take a long-term, say a five year view, because if you get it wrong for the first three years, the chances are that you're going to get fired before the five year period is up!

As another fund manager stated, the institution's objective might be long-term, but in reality investors are pushed towards managing against shorter-term goals since that is the basis upon which their performance is measured and assessed:

> Trustees will tell you that they have a five year time horizon and yet they still focus on the quarterly performance numbers and don't half get stressed if over a quarter you're 3 percent below the index . . . you know, you're meant to be looking at it as a five year mandate, not on a quarter by quarter basis . . . but that doesn't really stop them.

Based on fund managers' descriptions, short-termism therefore appears to not only be a bi-product of ''active'' management, but is also a reflection of the shorter-term performance measurement and review cycle whereby quarterly review and annual bonus payments are conventional practices. Indeed, this is supported by a study by Baker (1998) where evidence was found to suggest that the quarterly relative performance monitoring process encourages short-termism.

4.2 Gravitation towards the defensible

Another challenge associated with LTRI that emerged from analysis of the case study data was the gravitation towards decisions that are considered by fund managers to be easier to defend (both internally to colleagues and externally to clients). Based on discussions held with fund managers, it appears that many believe that decisions based on more ''conventional'' criteria will be easier to defend than those that are unconventional or go against prevailing consensus opinion for any length of time. This apparent pressure to adhere to conventions is something that was mentioned by fund managers across all institutions, including those with a ''passive'' investment and active engagement policy.

The decision to either buy or sell a stock, or to engage with a company requires some action on the part of fund managers that they will need to justify to others. Consequently, the reason for their actions must be robust enough to be able to convince others about why they made a particular investment decision or chose to expend resources through engagement activities. The need to publicly justify the rationale for a decision and the pressure that investors come under is illustrated in the following comment made by one investor:

> . . . you have got to get it absolutely right, otherwise you can get talked out of it quickly – well, not really talked out if it but questions on why on earth are you in this thing will follow. So you've just got to get it absolutely right . . .

Tried and tested conventions that are accepted in the market reportedly make it easier for investors to justify their decision to others, hence minimizing the risk of getting ''talked out of it quickly''. Since responsible investment is still a relatively new development and is unconventional, investment decisions that are more heavily weighted to these issues might be harder to substantiate, as they are less widely ''trusted'' and applied across the market. Indeed, in the words of one fund manager, investors need to believe that they can trust people to support the basis of their investment decisions; the less trust that is in place the more they will be tempted to make decisions that are underpinned by more conventional and ''popular'' criteria that will be easier to defend in the event that it proves to be wrong:

> . . . if the trust is not in place, you are far more likely to get a fund manager making decisions looking over his shoulder. He tends to gravitate towards those decisions which can be most easily defended after the fact in case he gets them wrong. And that's a natural human instinct. And we don't want that.

The reference to ''trust'' made by this investor therefore refers to that which exists between the fund managers and the market (the degree to which fund managers believe they can ''trust'' the criteria upon which the market operates); and the strength of the relationship and degree of trust that exists between fund managers and the institution whose assets they manage. The weaker the level of trust that exists between the reliability of the investment criteria and the fund manager/institution, the higher the risk that investors will gravitate towards easier to defend decisions. As further evidence of this connection, one case study investor explained that loss of trust between ''customers''[10] and fund managers due to poor performance increases the pressure on investors to revise their investment decisions:

> When it goes wrong, customers run out of patience and they [investors] are forced to close the position . . . when customers lost their trust then you are forced to change your stance.

The power of ''customers'' to influence investment decisions is made clear by this statement, as is the fear that investors might be ''forced'' to close their position or change their stance. The risk that ''customers'' might run out of patience and lose trust in an investment process applies universally, but where there is a perception that the investment style is different to convention in some way then they may have even less patience or tolerance towards under-performance. Indeed, as Keynes (1936, p. 158) wrote:

> Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.

This is an important point to consider in the context of LTRI because it is unconventional and may therefore be more open to criticism in the event that it ''goes wrong''.

4.3 LTRI not integrated into the core investment process

Another recurring theme that emerged during analysis of the case study data related to the difficulties associated with integrating and valuing the intangibles associated with LTRI. This was a factor that all fund managers within the participating institutions referred to as a challenge when making an investment decision or formulating their engagement strategy. Whilst most investors generally believe there is theoretical merit with taking these issues into account, in reality they explained that it is difficult to incorporate these into the prevailing and well-accepted (market wide) conventions, whereby valuations and investment decisions are largely underpinned by identifying short-term mis-pricings based on well accepted financial criteria[11]. The following statement was made by one fund manager on the subject of corporate responsibility:

> You know, it is all about customer relationships, supplier relationships, you know reputational risk, brand reputation, you know it's in there . . . so you've got to look at it. If you can somehow get it into a financial ratio somewhere it should be done . . .

The interviewee appears to believe that corporate responsibility is an important part of evaluating a corporation's long-term value and such issues should be taken into consideration; however, the discourse also suggests that incorporating these intangibles into financial ratios and therefore investment decisions is by no means a straightforward task, as illustrated by the use of words such as ''somehow'' and ''somewhere''. In the case of investors that favor engagement over divestment or ''active'' management, there still appears to be a lot of reluctance to go beyond corporate governance related issues for the same reasons cited above – because they are not confident, or do not trust, that such issues will add value to the companies in which they are invested and tend to view such issues as being ''separate'' to the core business model.

Reflecting the apparent different approach required for LTRI, the participating institutions have all hired an external or created an internal specialist team of ''responsible investment'' researchers that operate separately (but feed into) the core investment teams. At face value this could be seem to be an effective way in which investors might attempt to overcome the challenges with valuing intangibles and imbed these into their process. However in reality, based on the discussions held within the participating institutions, the teams appear to have different objectives, time horizons and minimal interaction with each other on a day-to-day basis. It could even be argued that the so-called ''two-team'' approach to responsible investing takes some of the pressure off core investors to incorporate these issues into their investment decisions, allowing them to continue investing on the basis of more conventional financial criteria, as indicated by the following comments made by two different investors:

> Tangible financial criteria is the most important thing . . . if we were going to bring in socially responsible factors then I'd only be interested in those if I thought they were going to have an impact on the tangible financials . . .
>
> It depends on what the market really looks at, you've got to know what's going to drive the share price and if it is responsible investment then you're going to have to be up to speed on those issues . . .

The statements that ''tangible financial criteria is the most important thing'' and that ''it depends on what the market really looks at'' re-state the interdependence of market agents and the important role that dominant conventions have on investor behavior. It also tells us that tangible financials are given a higher priority by investors than other less tangible inputs that might also contribute to long-term shareholder value; moreover, that these issues are considered distinct from each other. Follow up discussions on this topic revealed that some investors within the participating institutions are unconvinced about the merit of integrating LTRI into the core investment process and are actually slightly distrustful as to whether responsible investment would produce any benefits in terms of portfolio return, as one investor stated:

> The biggest hurdle that responsible investment has in trying to get accepted into the mainstream is that there is actually no proof that it works.

This distrust and lack of ''proof that it works'' builds on the evidence presented in the previous section that showed fund managers tend to gravitate towards easier to defend decisions based on criteria that are widely used across the market. Other comments made by fund managers suggested that some believe that the focus on responsible investment is a cyclical phenomena and therefore temporary, as the following quote reveals:

> I think it [responsible investment] is cyclical . . . if everyone was making lots of money no one cares . . . investors have a memory but it's not as long as they would like everyone to believe . . .

As the comment above illustrates, there is a degree of skepticism amongst some fund managers as to whether corporate governance and responsibility issues will remain at the forefront amongst market participants and it is therefore not necessary to integrate these into the core investment/valuation framework. The belief that this might be a temporary phenomena might also be related to doubts amongst some fund managers about whether the executive/trustees of an institution truly want these issues to be integrated into investment decisions, or if the stated objectives and policy documents are more for presentational purposes[12]. The lack of integration of LTRI might therefore not only reflect fund managers' beliefs about what factors will drive corporate performance but also to what extent they think that the executive/trustees of an institution is genuinely interested in having its assets invested in a long-term responsible manner.

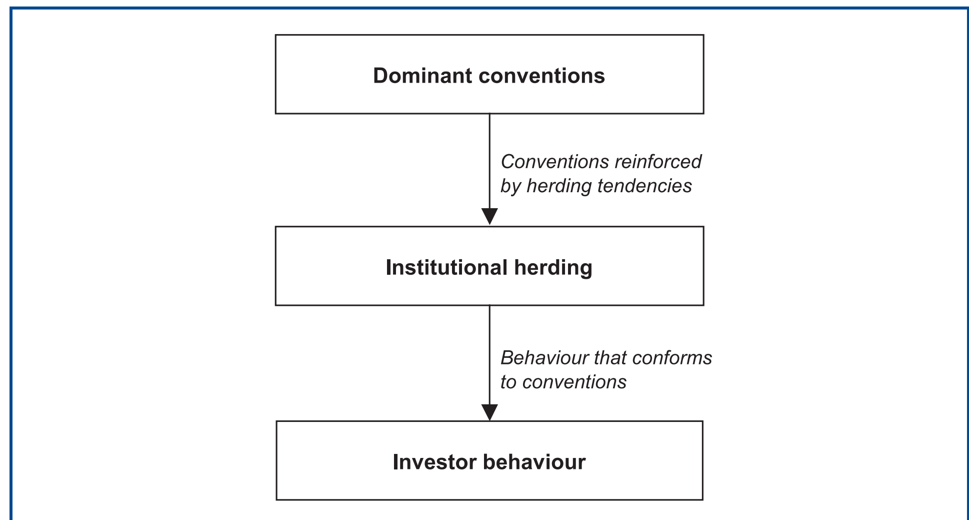
5. Conventions and institutional herding

Drawing from the case study evidence, the behavioral obstacles to LTRI all appear to be linked to the prevalence and adherence to dominant conventions – with institutional herding tendencies acting as the mechanism that reinforces these conventions (see Figure 1 for an illustration of this framework).

5.1 The herding mechanism

The Froot *et al.* (1992) model of investigative herding is relevant to interpreting the case study findings as it shows that when investors have a shorter investment horizon there is a tendency for them to ''herd'' and overuse short-term information (such as technical analysis) and underweight information that may be more relevant to long-term fundamentals (such as strategy, corporate reputation, stakeholder management, governance and environmental issues). The short-termist investor becomes intertwined with the rest of the market and will profit most from investments that are based on information used by other investors, such that it is subsequently incorporated into the market price. Extending the investment horizon and information set used by investors is therefore one of the challenges facing institutions that seek to invest their assets in a long-term responsible manner.

Figure 1 From ''conventions'' to ''behavior'' via the herding mechanism



Also of relevance to interpreting the case study evidence is the research by Scharfstein and Stein (1990) on reputational herding. Application of this model to the case study data suggests that herd behavior and adherence to conventions is a form of risk management given the need for investors to justify and explain their investment decisions on a regular basis (typically this is every quarter in a formal (external) sense, but investors also come under more informal (internal) scrutiny from colleagues on a daily basis). To the extent that engagement with corporations and incorporation of LTRI principles into the investment process is unconventional amongst institutional investors, it is considered to be riskier to integrate and therefore potentially damaging to their reputation and career prospects. The potential implications of both investigative and reputational herding tendencies in terms of mainstreaming LTRI are many; the focus for this (and ongoing) research is to consider how these tendencies might best be mobilized such that investors' perception of risk towards LTRI might be reduced.

5.2 To be or not to be conventional?

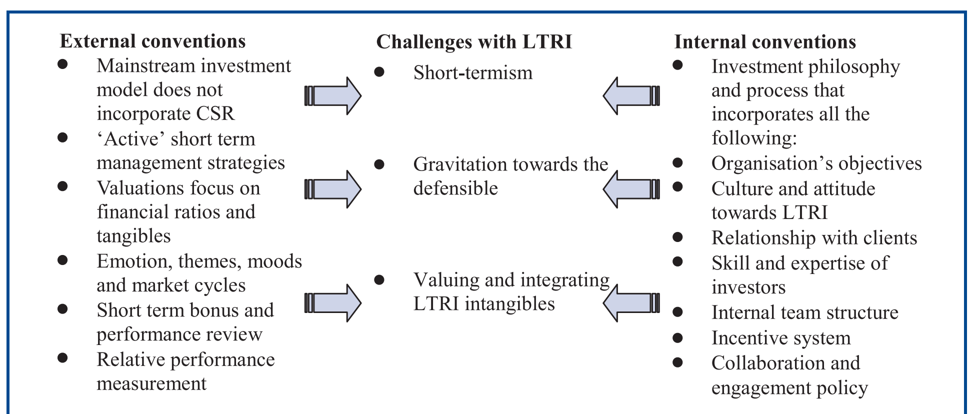
First and foremost we can safely say that it is still not conventional amongst global institutional investors to apply an active responsible investment policy across their asset base (Haigh and Hazelton, 2004). The case study participants and other investors that adopt a LTRI policy are therefore challenging prevailing conventions, outlined below in terms of those that are external and those that are internal to the institution.

External conventions refer to conventions that prevail across the wider market that all investors will be exposed to in some way. Figure 2 lists the external conventions (on the far left hand side) that were most commonly referred to by the case study participants in this study.

Many investors that were interviewed throughout the case study process actually felt that, as one institution, they would be unable to singularly re-define these external conventions and it is therefore easier for them to play by the rules of the market and follow the herd, despite their objectives being different to the mass. However, drawing from the insights of the ''investigative'' and ''reputational'' herding models described earlier, there may be alternative ways and means for individual institutions to offset or reduce the influence such external conventions have on investor behavior, such as through the design and implementation of the internal conventions within an institution. Internal conventions refer to those conditions that are particular to an investment institution (as listed on the far right hand side of Figure 2).

Drawing from Bandura's (1977) writings on social learning theory, if we accept that the interaction of social pressure and behavior of group members are interdependent (in this case how investors interact in the market), further consideration needs to be given as to how group members might be able to change prevailing conventions. That is, to think of this dilemma in terms of the role that investors can and do play in creating and reinforcing certain

Figure 2 Internal and external conventions



conditions and conventions through their collective actions. Going back to Figure 2, the case study evidence found that the internal conventions of most prominence in thwarting investors' ability to invest in a long-term responsible manner include the higher priority given to tangible financials than to LTRI in the investment process; benchmark investing and relative performance measurement; and the quarterly review and annual bonus cycle. Reconsidering the design and implementation of these internal conventions within institutions may be a means of overcoming some of the fears with challenging those market conventions that are detrimental to achieving an institution's goal of being a long-term responsible investor.

5.3 Exporting ''internal conventions'' to the wider market

In addition to re-thinking internal conventions that prevail, institutional investors could influence the dominant external conventions through their relationships with external market agents. For example, when investors ''engage'' with companies on wider issues related to their LTRI principles, they are conveying their expectations to the companies in which they are invested on appropriate corporate conduct. Furthermore, by seeking to be involved in collaborative initiatives with other investors, these institutions may be able to exert more influence over corporate behavior and long-term performance. In this way, the institutions' internal conventions are being transmitted to the companies (via engagement activities) and other investors (through collaboration initiatives) and act as a means of influencing the market conventions that prevail. There are some examples of collaborative initiatives amongst global institutional that seek to advance long-term issues relevant to an individual company or sector[13], although such activities on the whole remain at the margin across the institutional investor community. Increased collaboration between institutional investors could assist in overcoming and indeed mobilizing the investigative and reputational herding tendencies such that LTRI becomes an imperative rather than a risk.

6. Conclusion

This paper presented evidence to suggest that even in those instances where an institution has a LTRI policy, the influence of dominant conventions on investor behavior makes it difficult to achieve this in practice. The aim of this paper was not to criticize the participating institutions' approach to responsible investment but rather was an attempt to explore and illuminate the complexities and to highlight the areas that might require further consideration. In particular, it raises some questions about the important potential role of collaborative initiatives as a mechanism to mobilize investors through the apparent institutional herding tendencies. Further research on how collaboration might assist in overcoming some of the behavioral obstacles to mainstreaming LTRI is currently underway. Other areas worthy of further research include how internal conventions might be redefined to discourage short-termism amongst institutional investors (such as incentive systems and performance review) and the effectiveness of engagement and collaborative initiatives on changing corporate behavior.

Notes

1. LTRI is a broader concept than the widely adopted SRI, since the latter places more emphasis on the promotion of social, environmental and ethical (SEE) criteria and does not necessarily highlight the importance of engagement with corporations and the investment horizon *per se*. Defined in this way, LTRI encompasses corporate governance and corporate responsibility considerations and advocates a holistic rethink of the investment management conventions that prevail across the institutional investor community.

2. Davis (2002) adapted national balance sheet data to examine equity holdings across the G7 nations and estimated that the US and the UK own around 40 percent of domestic equity, approximately 20 percent in Germany, Japan and Canada and 10 percent in France and Italy (as at the end of 2000).

3. For example in the UK the July 2000 amendment to the Pensions Act requires a fund to disclose its policy on SRI in a Statement of Investment Principles; similarly, in October 2001 the SRI disclosure guidelines for insurance companies was issued by the ABI; and the Myners Review in March (Myners Review, 2001) recommended reforms to encourage fund managers in the UK to take a longer-term, more active approach to their investment management.

4. For example, Haigh and Hazelton (2004) report that SRI funds under management (retail and wholesale) accounted for no more than 0.4 percent of total funds under management in Europe between December 1999-2001; 0.2 percent in the US for the period September 2000-2002 and 0.3 percent in Australia over the same period.

5. For example, on the performance implications of SRI see studies by Statman (2000), Teoh *et al.* (1999), Verschoor (1998), Asmundson and Foerster (2001), Waddock and Graves (1997), and Guerard (1997). For studies on the performance implications of shareholder activism see Gompers *et al.* (2003), Davis (2002), Smith (1996), Nesbitt (1994), and Admati *et al.* (1994).

6. The fund manager(s) or investor(s) ultimately carry the responsibility for analysis, engagement and the decision to buy or sell securities that are held within an institution's portfolio. The distinction between the ''institution'' and the ''fund manager'' is important as an institutions' objective to be ''responsible'' should ultimately be reflected in investor behavior in terms of how that institutions' assets are being invested. The terms ''fund manager'' and ''investor'' are used interchangeably throughout but refer to the same group of people.

7. The case study evidence of short-termism is also supported by empirical evidence at the aggregate level (for example, Black and Fraser (2000) found evidence of short-termism across international markets, whilst Nickell and Wadhwani (1987), Miles (1993), and Cuthbertson *et al.* (1997) found some evidence of its existence in the UK).

8. Active management prevails when managers believe that, to varying degrees, the market is not efficient and there are opportunities to outperform an index or a benchmark (i.e. to ''beat the market'') that may prevail over shorter time periods. Active managers are typically paid an annual bonus that is linked to their ability to outperform a specified benchmark (Sharpe *et al.*, 1999, p. 799). When a fund is passively managed against a benchmark or index it means that managers believe the security market is on the whole, efficient, and therefore they do not attempt to outperform or exploit market inefficiencies. Passive management involves ''holding securities for relatively long periods with small and infrequent changes.''

9. ''Active engagement'' is the situation whereby investors can exercise their rights as owners of corporate equity to raise issues of concern with company directors/CEOs on matters that may impact on a company's long-term performance prospects. As Eurosif (2004) explains, engagement can take place at three levels: (1) general dialogue between investors and company directors/CEOs; (2) proactive dialogue when an investor raises a specific issue for the company to address and change; and (3) reactive dialogue when an investor reacts to a problem that has emerged and focuses on how best it can be managed and avoided in the future. This ''dialogue'' can take place through informal (private) means, such as through meetings or writing letters through to more formal (public) means such as filing resolutions at AGMs or divestment.

10. The term ''customers'' used here refers to trustees and/or the fund executive of wholesale institutional funds (pension and insurance funds that are company managed schemes not available to the public) or private individual investors of retail institutional funds (funds that are open to the general public).

11. The financial criteria most commonly referred to by interviewees as conventional in the market place include the net present value of the stock's expected income stream such that cash flow return on investment can be estimated. Close attention is paid to financial ratios such as return on equity, return on capital employed, sales growth, price/earnings ratios and technical/momentum indicators (see Hellman, 2000, for a comprehensive evidence based study of information used by institutional investors).

12. For example, an SRI survey conducted by Deloitte and Touche (2002) on 65 organizations who are responsible for managing some $US1,400 billion of assets on behalf of their clients reported that: ''. . . 48 percent of the fund managers surveyed felt that pension fund trustees had little or no real interest in SRI and had become engaged on the topic purely to protect their own reputations and deflect potential criticism from government or pressure groups . . . ''

13. For example, the Pharma Futures group, led by institutional investment professionals, is aimed at bringing together the pharmaceutical industry and its stakeholders to better address the wider issues this sector faces in managing its long-term risks and opportunities in an environment of changing societal expectations. Available at: www.pharmafutures.org

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Policy making and the role of government Changing governance patterns and CSR

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Abstract

Purpose – *The discussion around CSR has so far centered on methods and on scope rather than on the potential relevance for corporate governance and governance more general. This paper addresses this void.*

Design/methodology/approach – *After reviewing the discussion the paper maps out the broader context of change and of global trends. Focusing on stakeholders, it explores the potential influence of CSR as a different mindset to address corporate and public governance issues.*

Findings – *An innovative approach of constantly seeking for actions that take all stakeholders' perception into account is leading to more sustainable solutions in an economic, environmental and societal sense. System analysis has shown that even incremental repetitive adaptations can strengthen a system.*

Practical implications – *The paper addresses issues relevant for corporate and public governance and could open new areas for research.*

Originality/value – *The paper applies innovative insight from systems analysis and philosophy to CSR.*

Keywords *Corporate governance, Governance, Change management*

Paper type *Conceptual paper*

1. Introduction

During the last years an intensive debate about CSR has taken place. This debate was fuelled by increased media interest and in Europe by a joint campaign of progressive enterprises and the European Commission[1]. Additional factors to intensify the debate were the deteriorating economic climate, after the implosion of the dotcom bubble that resulted in a sharp economic down turn particularly in the related industries and the ethical scandals of ENRON, Tyco and lately Parmalat in Europe (Van den Ven, 2003). At least the latter have proven the debate on corporate social responsibility to be timely. A lot has been written about the subject but I will try to put the discussion in a wider context.

2. Global trends

If we look at the major trends of the last decades what do we see? Governments are becoming smaller and their direct influence is seen to be diminishing. Key notions in that context are liberalism and privatization, but also the end of communism in Eastern Europe after the fall of the iron curtain (Berend, 1996; Boissonneault, 2003)[2].

Enterprises have been merging at an increasing pace and intensity, in particular in banking, automotives, pharmaceutical and many other industries including the service industry. Mergers were a result of corporate restructuring after the abolishing of state monopolies but also an answer to the increasing globalization of businesses (Sclar, 2000; Finkelstein, 1999). There are over 37.000 multinational corporations employing over 70 million worldwide (Post, 2000). This globalization was made possible by trade liberalization in general and rapid progress in technology (*The Economist*, 2000a, c). Even medium-sized companies and in some industries small companies went global. One of the key technical innovations was that personal computers became widely available during the 1990s and their computing power is ever increasing. Others are linked to communication.

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The content of this paper reflects solely the personal view of the author and may not in any circumstances be regarded as stating an official position of the European Commission.

The concept of the civil society blossomed after the fall of communism (Zloch and Westport, 1994; Genov, 1999; Yoshikazu, 2001). Non-governmental organizations developed into a real force often closely linked to the media. This was particularly the case for environmental and consumer organizations that started to incorporate a global perspective in their undertakings. Media coverage, often even of the popular press has got a certain global component. Therefore citizens are being kept much more aware of international events or links. Consumers have also become more demanding. They want to reap the benefit of globalization through cheap high quality goods while at the same time feeling good about purchasing them. This means they do not want to be associated to events in the countries of production they cannot agree with like child labor and of which they are being informed about by NGOs and the media.

Linked to globalization another phenomenon worth mentioning are the increasingly global capital markets. They have extraordinarily expanded not the least because of a new brand of products, the so-called derivatives. According to data from the Bank for International Settlement the $19.5 trillion market in exchange-traded derivatives increased 31 percent between 1998 and 2001, far above the growth rate of the $10 trillion US economy. More ominous is the $90 trillion market for over-the-counter derivatives, which grew 6 percent last year alone (Whalen, 2002; *The Economist*, 2001a, b). As a result of the explosive expansion of the capital markets, the number of players and products has increased whilst the average retention time for financial instruments including stocks has been reduced significantly. It has been said that US pension funds have reduced their average retention time from about 57 months 10 years ago to about 7 months recently[3].

An important result is that the global financial sector has been increasingly characterized by short-termism. This means that companies increase their focus on short-term results as reported in quarterly presented accounts. This facilitated a predominant concentration on the shareholder perspective.

And finally the world is becoming ever more diverse, complex and interlinked.

3. Emergence of CSR

These major developments have been conducive to the existence and shape of CSR today. A lot of the debate on CSR turns around stakeholder involvement. In some sense it takes up the old debate on stakeholders versus shareholders. It centers on how businesses can, through such an intensified dialogue, become more successful in the long run and better linked and integrated into their environment. There is an argument that CSR is being used as a means to rebalance the stockholder perspective of the capital markets.

It is increasingly acknowledged that the short-term focus of the investment community may curb the development opportunities of enterprises in the long term. The exclusive concentration on the bottom line has caused some businesses to disconnect from their environments. Rapid mergers and globalization have fuelled this trend and are now not always being considered a success for shareholders[4]. CSR is to some degree a counter reaction or at least embedded in one.

Whatever the explanation might be such a rebalancing aspect could in any case complement the perspectives promoted by stock markets as it ensures the sustainability, including economic sustainability, of enterprises.

In that sense one has to acknowledge that CSR in its European form might also be an answer to the increased Anglo-Americanization of the business environment in the 1990s[5].

However, as a main focus this paper should demonstrate the importance of CSR for society at large, the public policy perspective and finally the contribution to long-term economic success of business:

> CSR can be viewed as a different form of corporate governance that links to a different form of public governance.

4. Corporate governance

The European Commission and its stakeholders have embedded the concept into a very wide notion of sustainability in the economic, natural and social environment[6]. Although the regulatory framework in general in an increasingly rapid changing and complex world may be a to tight one, as enterprises complain, living CSR principles might result in public authorities even to reduce some regulation in the longer run. Governments, however, will have to resist the temptation to outsource their own responsibility[7]. The legislative framework needs to remain adequate but flexible.

CSR is consequently about a change of the mindset of the economic actors and their stakeholders. There are arguments in the CSR debate that already fulfilling legal obligations is CSR, there are others that clearly ask to go beyond such legal requirements. There are also fears that CSR might lead to new legal requirements[8].

But in the general debate today we have a predominant focus on how to implement CSR, to describe what it might be and entail and how we would be able to measure it[9]. These are all very important aspects but they circle somehow around the core without fully encompassing it.

If CSR is also a reaction to the factors described above than it pays to try to define it somewhat closer. I would tend to argue to see in CSR a kind of new behavioral pattern of enterprises as a reaction to a changed and ever faster changing world[10]. Of course to some degree CSR is about the old discussion of stakeholders versus shareholders. But I think it is clearly more.

Let's introduce an example. A multinational company that operates in developing countries must have an interest to create sustainable conditions in doing business there or in exploiting the natural resources. Most of these companies have grown – not only through the described mergers above – so big, that they are most likely here to stay for the next decades. This means these companies as organizations will be faced with the consequences of their past behavior. Management incentives have to be considered. A manager who is associated with an unsustainable but fast and lucrative deal is usually not punished in his career. Another manager will have to resolve the unsustainable situation. Since cleaning up is usually less rewarded than the quick fix this might in turn have a negative impact on his career. Such unsustainable solutions may have serious negative implications for the local community. Global media and NGOs now allow the consumer to take a stance. The reputation of the company is at stake:

> These long term sustainable interests of such a company may not always coincide with the short-term interests of share holders or managers, in particular in the context of today's short-term capital markets. Nevertheless without taking sustainability aspects into account even the medium-term performance may be suffering.

This may be why multinational and global enterprises are strongly present in the debate today. But also small and medium-sized companies have to integrate into their environment[11]. It might look differently and is for sure less formal and organized but the end result is comparable.

Now what could this difference in approach be? The speed of change or at least the perception of it appears today to be ever increasing. If this is the case, classical corporate and public governance is constantly being challenged by these ever changing conditions.

In such an environment players might do better that try to reconcile their actions with the perceived needs of all concerned (including predominantly their own of course). Such behavior causes a momentary equilibrium and allows adapting the behavior in the next time interval slightly according to the changed environment[12]. It is obvious that we are not talking about philanthropy but rather at an effort to consider the impact of each action on those concerned. Such a different attitude and intent may manifest itself only in quite immaterial different actions. But on an aggregate level the impact can be substantial.

Notions for this new behavior that have been introduced are among others ''adaptive management'' and the ''adaptive corporation'' (Meyer and Davis, 2003)[13]. A clear need for new, non-linear management skills is being pointed out in that context. Characteristics like empathy are being underlined.

But could this not be another description of a constant and fruitful stakeholder dialogue. Important however is that there is a slightly different way of thinking and of coming to conclusions than in many current business practices. The content of the business decisions, however, will in most cases differ only marginally.

Another constraint will always be that the environment becomes increasingly complex. There will always be incomplete information. Nevertheless trying to take into account different perspectives would allow generating more sustainable solutions:

> Increased diversity strengthens biological systems and is also considered to strengthen the capacity of an enterprise to adapt in a rapid changing environment. One might therefore even argue it might allow taking the better sustainable business decisions (Meyer and Davis, 2003; Toffler, 1984).

5. Public governance

But how does this link to public governance? First of all public decision-making has also seen an increasing interaction with civil society and the NGO community. But the more important aspect is that public governance is also called upon to act in an ever faster changing world with less and less resources at its disposal. In addition to shrinking government there is often a ''race to the bottom'' observed with regards to tax levels in the context of globalization. This is coupled with increased tendencies of tax avoidance and tax evasions also assisted through innovation linked to technological progress.

Small governments that have privatized activities have to constantly update the legal framework necessary for an increasingly complex world. Thus, the constraints of human resources and time as well as expertise are quite obvious. But there is also another aspect that we can derive by observing what happened in the new member states of the EU after the fall of the iron curtain. These countries also had to partly reconstruct their legal framework within all the above given constraints. And there we could clearly observe the time and the resources it needed to have the legal framework actually implemented by their citizens, enterprises but also their administrations and their courts. In that process the importance of voluntary compliance was stressed. As a precondition one needs to achieve ''a harmony between informal normative systems, or morality and law'' (Cepl, 2000).

If we allow ourselves to consider this reference for a moment we will see the following. Legislation or any kind of regulation requires a certain stable environment. I mean it must be homogenous for a certain minimum amount of time in order to add value by providing clarity to all players concerned. If such regulation is not being applied in an even manner throughout a certain territory than it actually brakes with the spirit of law whilst keeping the impression up that it is lawful. This is actually kind of the case when laws have become utterly complex so that neither the law maker, nor the intermediary (judge or lawyer, administrator) have the capacity any more for an overview.

Having considered the above we might come to the conclusion that it will be increasingly more difficult by public authorities to intervene by generally applicable rules and regulations. If this would be the case then alternative ways have to be found to come to equitable solutions everybody can live with. This leads to allow different forms of self-governance. Of course there will always be some generally applicable rules and regulations. A working paper of the European University Institute in Florence examines conditions for such Meta rules. In addition new concepts are being introduced to qualifying the notion of ''equality'' to fit such a complex and diverse world[14].

We have generally only started this process in the public domain. Whilst in the context of European legislation there are some examples that might hint in this direction we are clearly only at the beginning of a long way on all levels of law making and administration[15]. An

example could be the new and global approach in internal market legislation that is built on the notion of responsibility of the manufacturer and is trying to limit state intervention to a minimum. Governance in that regard is a notion that tries to signify a changed perspective and action of government taking into account more intensively and comprehensively the view of stakeholders.

Nevertheless we will need additional and different ways and specific mechanisms to traditional approaches. One current example is a certain trend to replace jurisdiction by mediation, in private affairs as well as in business matters. What is the difference? The first solution is based on a historic right, the latter a process on trying to find rapidly a solution both parties can live with. So it is more open to compromise and adaptable to the circumstances of all concerned and thus a feasible answer to fast changing and complex environment. Legal trials are currently taking ever-longer time periods. Long trial periods mean that circumstances have changed which render the more flexible and more rapid tool of mediation more attractive. It has however to be noted that mediation can complement jurisdiction but probably not replace it as the ultimate recourse to law.

Having established the above we can conclude. Increasing regulation combined with shrinking public services does not always guarantee their sound implementation, e.g. even handed equal treatment of different economic actors in different countries and regions. Effects of globalization and increased complexity and diversity increase this process. Often fast changing legal requirements do not add to clarity, neither on the side of economic actors nor of administrative actors or of courts. Therefore new mechanisms of regulation, implementation and conflict resolution are being thought for.

6. Conclusions

Shrinking government in a fast changing, ever more complex and diverse world challenges and changes public mechanisms of intervention. Old style interventionist governance patterns have still to adapt to this changing environment:

> Nevertheless the last decades have seen both more regulation but also more freedom to business. For freedom to be sustainable it has to be matched by responsibility[16]

New mechanisms of governance such as promoting non-public conflict resolution mechanisms like mediation emerge. Such mechanisms do not rely on direct state intervention but they complement and reduce the stress on the public domain. They also show how a liberal state relies on different forms of self-governance[17]. Ways are being considered how to increase the adaptability of regulation and administration.

Voluntary applicable principles or rather a CSR mindset as outlined above are not able to replace compulsory regulation, but they might very well complement it and in specific cases even reduce the need for more regulation in specific areas:

> And most important of all CSR might stand for a mindset of constantly seeking for solutions that take all stakeholders' perception into account leading to more sustainable solutions in an economic, environmental and societal sense.

Such a shift would only be rather incremental and an enterprise will always seek economic viability. However such an incremental different perspective might have quite an overall impact on an aggregated scale on the sustainability of society[18].

Notes

1. The European Commission is supporting CSR Europe and has put CSR high on the European political agenda through the endorsement of its importance with the European heads of state at the Council in Lisbon in 2000.

2. Privatization and public outsourcing have shown to increase the level of regulations.

3. Richard Sennet at a lecture in the European Commission, 31/10/2003.

4. Increasingly critical reports are being published about the success and the value creation of M&A in particular in its cross-border manifestation. Compare for many BBC ''Most international mergers fail'' 29/10/1999; KPMG found in a study in 1999 of 107 of the largest cross border mergers

completed between 1996 and 1998 that 83 percent were not successful in terms of value creation for shareholders. KPMG (1999); ''When battles commence'', *The Economist* (2000), 19 February, quotes a recent study of 4,136 US companies where the shareholders of the buying firms lost $240 billion (or 12 percent of the purchase price) in value in the period of 1998 to 2001.

5. Mullerat (2003) provides a break down of the differences between Anglo-Saxon shareholder and European stakeholder orientation (Steinherr, 2002). The US approach is considered to be rather rule based and the European principle based.
6. Communication from the Commission (2002) defines CSR as ''a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis''.
7. This fact has been stressed for instance in the UK contribution to the Commisson Green Paper on CSR (2001).
8. These discussions could be clearly observed in the consultation process to the Green Paper of the Commission. The UK contribution provides again a good example.
9. Compare the different elements of the European Multistakeholder Forum (2004).
10. It might be linked to concepts and notions like the ''adaptive enterprise'' compare Meyer and Davis (2003).
11. And they have done it for centuries. Their approach to CSR might differ in style related to their size but meets the same criteria drawn up in the debate for larger entities. Compare the study on good practices of the European Commission on ''Responsible Entrepreneurship'' (2003).
12. The Dalai Lama (2001) comes to a comparable solution since he describes ''universal responsibility'' in a comparable way, as ''the universial dimension of our every act and the equal rights of all others to happiness and not to suffer'' and furthermore ''to develop an attitude of mind whereby, if we see an opportunity to benefit others, we will take it in preference to merely looking after our own narrow interest''. He describes ''ethical discipline'' as ''a means by which we mediate between the competing claims of my right to happiness and all others' equal right''.
13. Increased diverse perceptions of reality, e.g. differing views from stakeholders help to make a business more robust against complexity and change.
14. George Schöpflin, has introduced in his most recent book (currently available only in Hungarian) the concept of ''parity of esteem'' as he recently elaborated on in a seminar at the European Forum Alpbach in August 2004.
15. An effort to determine conditions under which a modern concept of governance would allow for kind of an adaptive European law and administration compare George *et al.* (2001). Therein concepts of law as a learning process, law as a tool or the regulatory circle are introduced. These include experimentation (first rules), learning from the results (enforcement and application) and innovation (redesigning the rules) in order to adapt to a changing environment.
16. Fukuyama (1995) sees self governance as a precondition for a liberal state and further states that ''such a system depends not just on law but on the self-restraint of individuals.''
17. Fukuyama (1995) writes, ''a liberal state is ultimately a limited state, with government activity strictly bounded by a sphere of individual liberty. If such a society is not to become anarchic or otherwise ungovernable, then it must be capable of self-government at levels of social organization below the state.''
18. Watts (1999) concludes, ''that small amounts of random rewiring can achieve the same results as a massive addition of non-random edges''. This signifies for me the propensity that small but many erratic actions of actors in systems might have the same effect like a massive non-random intervention. The latter could represent government or public interaction. As a result in a world of scarce resources there should be a preference for many small random interventions, i.e. voluntary activities.

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Policy making and the role of government

Realigning business, government and civil society

Emerging embedded relational governance beyond the (neo) liberal and welfare state models

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Abstract

Purpose – *This article aims to explore the character of an emerging model of corporate social responsibility (CSR)-oriented societal governance in an exchange theoretical perspective and to examine the distinctive characteristics of the relations between civil society, business and government in the new model and the drivers behind it.*

Design/methodology/approach – *By analyzing typical roles and role-sets in political, commercial and regulatory exchange, the article pin-points characteristics of the embedded relational governance/CSR model contrasted against liberal governance and the Keynesian welfare state. The analysis is stylized and conceptually based, in line with the Weberian ideal type concept and brings out stylized juxtapositions of the three governance models based on previous studies.*

Findings – *An emerging model of corporate social responsibility (CSR) or embedded relational governance seems to share the basic market orientation of the liberal model, yet, at the same time, sharing many of the social and collective goals of the welfare state. This combination is apparently achieved by embedding the social dimension into civil society and self-regulatory market processes. Finally, the paper reflects on the drivers behind the new governance approach, in the context of a globalizing economy. The paper argues that NGO-driven communicative intermediation interfacing with an increasing CSR and corporate governance focus in financial evaluation may serve to retain some of the social agenda from the welfare state, under the CSR- or embedded-relational model, an agenda that seemed to be gradually losing out with the global competitive exposure of the welfare state.*

Research limitations/implications – *The article presents a stylized analytical framework of CSR/embedded relational governance that lays a basis for further exploration and systematic testing through comparative empirical studies.*

Practical implications – *The paper brings out the interplay between political, regulatory and commercial processes and gives a broader understanding of the societal implications of CSR.*

Originality/value – *Original contributions of this paper: first, the analytical formulation of the societal governance implications of CSR; second, the exchange theoretical conceptualization of this mode of societal governance.*

Keywords *Governance, Regulation, Social responsibility*

Paper type *Conceptual paper*

Introduction

Over the recent couple of decades, many European countries have seen extensive challenges to the welfare state. Some of these challenges have been political in their nature – in the form of liberal deregulation and privatization of public infrastructure, like Thatcher's radical privatization of ownership and competitive exposure in the UK. Driven by its effort to

level the European economic playing field, de-regulation policies have also become the hallmark of the EU.

However, the challenges have also been commercial and budgetary. A combination of growing demand for welfare services, an aging population that reinforces this trend and globalization that challenges its ability to draw sufficient financing from taxation, has created an overload on the public resources of the welfare state and motivated a search for new solutions[1]. Both the political movement towards deregulation and privatization and increased globalization apparently point towards a development with extended commercial freedom and a limited role for the state. Indeed, this development has often been labeled neo-liberalist. Yet over the last decade, there has been an increasing focus back on social issues, as corporate (social) responsibility (C(S)R) has risen steadily higher on the international agenda. Some of the initiatives are:

- the OECD guidelines for multinational companies;
- the UN's global compact;
- new social and environmental legislation at the national level;
- socially responsible investment; and
- successful launches of campaigns for sustainable development and human rights by civil society or non-governmental organizations.

These developments have taken a form and achieved a volume that leads us to ask whether we are witnessing the emergence of new forms of societal governance with characteristics that transcend the classical ideal types: the liberal market economy and the welfare state.

The new emerging model seems to share the basic market orientation of the liberal model, yet at the same time, it seems to share many of the social and collective goals of the welfare state. The way the new model seems to be able to achieve this combination is apparently by embedding the social dimension into civil society and self-regulatory market processes, with the state playing more of a facilitating and endorsing role.

To explore the character of this emerging new governance model, we have taken an exchange theoretical perspective where we examine the distinctive characteristics of the relations between civil society, business and government under this emerging model, compared to the neo-liberal and the Keynesian welfare state models. Based on recent social science analyses[2], we have tentatively called the new emerging governance model ''embedded relational governance''.

By analyzing typical roles and role-sets in political, commercial and regulatory exchange, the article seeks to pinpoint characteristics of the embedded relational governance model contrasted against the two other ''classical'' ideal types. The analysis is stylized and conceptually based, in line with the Weberian ideal type concept (Weber, 1964). It therefore brings out stylized juxtapositions of the three governance models and their implications for role sets and exchange relations between the actor sets.

The model descriptions are based on secondary sources and represent suggestive heuristic approximations. The liberal and the Keynesian welfare state models are well described in the literature and the analysis here only makes reference to well established standard presentations. The emergent embedded relational model is pr. definition less codified and is therefore given somewhat broader documentation. The ambition is only to draw out some main characteristics in a fairly rough sketch, as a basis for future research and comparative analysis, well knowing that governance models may, in practice, be subject to extensive national variation, and that one stylized model of governance hardly replaces another, but rather adds on new elements.

A final section discusses the drivers behind embedded-relational governance. We here draw on basic theory of economic organization to examine how certain (social) features of the emerging embedded-relational governance model can be explained in terms of challenges and opportunities in the modern economy.

The exchange theoretical perspective

In our stylized and minimalist approach, we have chosen to compare the emerging embedded-relational model with the welfare state and (neo)liberal models, with three core societal actor sets in focus, namely:

1. Civil society.
2. Industry.
3. Government (Figure 1).

In line with conventional theorizing in political and economic analysis:

- Civil society refers to an arena of actors that articulate and carry norms and values (free preference formation as anchored in the idea of the sovereign voter (Lipset, 1963), and that develop preferences in freely articulated dialogue (Habermas, 1979). In relation to the commercial domain, civil society represents the sovereign consumer (Smith, 1992; Kotler, 1967), yet civil society is also the carrier of fundamental human resources as a supplier of workforce to industry and thereby also (income) taxes to government.
- Industry is seen as provider of goods and services, but also as a contributor of jobs to civil society and taxes to government (Johansen, 1987).
- Finally, government is seen as the locus for legitimate political aggregation of collective interest (Weber, 1964), but also the provider of public service (Baumol, 1967).

Taking an exchange theoretical point of departure, we can define three broad exchange arenas between these three actor-sets: political exchange between government and civil society; commercial exchange between civil society and industry; and regulatory exchange between government and industry.

Our endeavor to define/profile embedded relational governance through comparison with the (neo) liberal and the welfare state models, thereby translates into an analysis of how these models affect the role sets of the three constitutive actors and the exchange between them. For each arena, the exchange theoretical perspective leads to a focus on the interplay between actors that control complementary resources/goods or services and their strategies to improve their welfare through exchange. The extended content as well as the possibility to transfer reciprocity from dyads to larger social systems has led Levi Strauss (1969) to speak of ''generalized'' exchange (Figure 2)[3].

In its social science applications, the notion of direct, reciprocal exchange has been complemented by a conceptual framework that also captures the less directly reciprocal and more general nature of social exchange[4].

The paper argues that the shift in governance paradigms from liberal market to the welfare state followed by a neo-liberal detour and then a shift towards an emerging

Figure 1 Actors and exchange arenas in societal governance

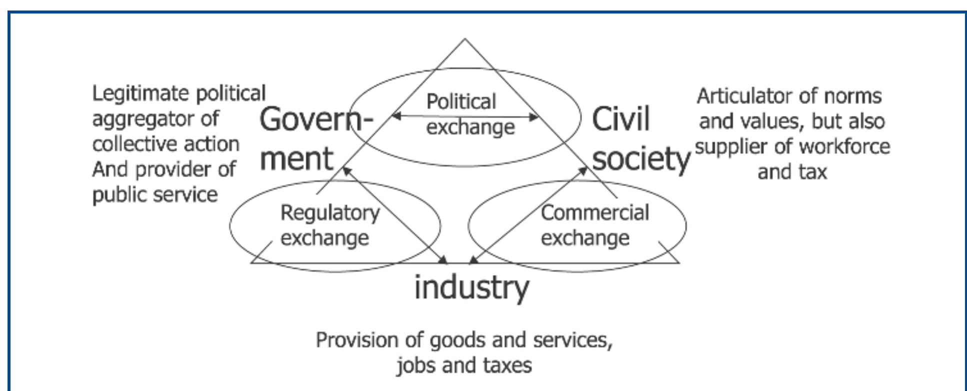
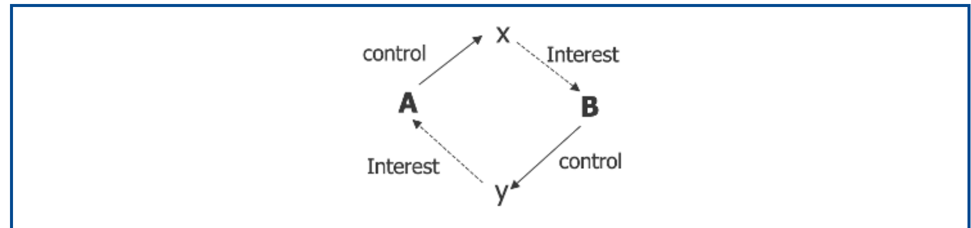


Figure 2



embedded-relational model, involves a reinterpretation of exchange relations between the three central parties. This includes both the political, commercial and regulatory exchange arenas, with a following shift in roles and role sets through which the actors mutually define their relations. The shifts also imply change in the coordination or generalized exchange between – and relative weighting of the three arenas in what we might term inter-arena or meta-exchange.

The (neo) liberal model

The liberal model which successfully served as an ideological framework for the expanding market economy of the nineteenth and early twentieth centuries, builds on pluralistic political exchange, competitive commercial exchange and a minimalistic market-constitutive regulation. This model was temporarily displaced in many European countries by corporatist and welfare state based mixed economy model in the middle of the twentieth century.

However a neo-liberal wave in the 1980s and 1990s represented a comeback for the liberal model with a return to stronger belief in market forces with a basis in pre-Keynesian liberalist tradition and with a program of market-exposure, deregulation, or de-composition of previously established public infrastructure regimes. This is what Jessop (1999) has termed ''the Schumpeterian workfare post-national regime'', characterized by labor market flexibility, innovativeness, structural or systemic competitiveness and international economic organization.

Commercial exchange

A central focus in the neo-liberal model is on the commercial exchange, where the (neo)liberals postulate a civil society that holds overwhelmingly individual welfare preferences, although committed to minimalist collective preferences for law and order.

Industry, the other party to the commercial exchange, is – in line with standard market economics – seen as oriented towards efficiency, competitiveness and profitability. The commercial maxim is profit maximizing without broader societal concerns (Friedman, 1970).

The core role-set in (neo)liberal commercial exchange is the supplier-consumer role set, where the members of civil society hold buying power and industry controls provision of goods and services. The worker-employer roles are less in focus and to some extent subsumed under the consumer-supplier roles.

Political exchange

The (neo)liberal model seeks to limit the political exchange as much as possible to core governance issues of law and order and other framework conditions for stabilizering the functioning of the economy (such as monetary policy).

The basic roles involving civil society and government, in political exchange, is the voter – role, with government primarily in the role of providing collective action. This core political exchange is underpinned by a financial flow that involves a taxpayer role from civil society matched by a service provider role from government.

Given the (neo)liberal focus on limiting the role of the state, this supplementary role set tends to be downplayed in the political exchange. The neo-liberal comeback has therefore made tax cuts and return to a more limited public service model a central issue. However, the massive heritage of extensive public services from the welfare state is hard to dismantle and the de-facto effects on government size have been smaller than expected.

Regulatory exchange

The regulatory exchange between government and industry under the neo-liberal regime is characterized by a formal legalistic approach preferably through government participation via an independent regulatory agency role. Industrial compliance with a minimalist set of basic market rules provides a basis for otherwise free pursuit of basic industrial interests with a focus on efficiency, competitiveness and profitability. The many deregulation efforts in various infrastructure sectors are good examples of neo-liberal attempts to re-establish such conditions (Lane, 2002; Savas, 1977; Kikeri and Nellis, 2004).

Intermediation between the exchange arenas

As far as the interface between the three arenas are concerned, the liberal market model presumes that the exchange arenas are fairly decoupled. The ideal of arms length distance between regulators and market actors indicates strongly the de-coupling of the regulatory and commercial exchange. The minimalist approach to policy also emphasizes the decoupling of economic and political control and/or pluralistic intermediation with actors competing for governance (Lipset, 1963). Figure 3 summarizes stylized characteristics of the (neo)liberal model.

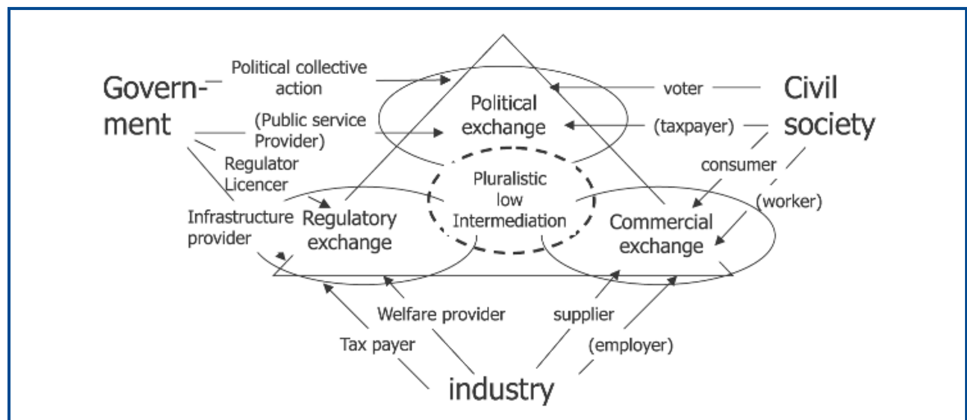
The Keynesian welfare state model

The analytical legitimacy for the active welfare state role in balancing the economy is largely derived from the Keynesian critique of the liberal concept of a self-balancing economy[5]. Later neo-corporatist welfare state expansions have developed further extensions with active industrial policies and active welfare provisions (Streeck and Schmitter, 1985; Katzenstein, 1985). As noted by Jessop (1999) the Keynesian welfare state model was national in its orientation, with the state playing a distinctive role in securing conditions for profitable business reproducing labor power and compensating for market failures and inadequacies.

Commercial exchange

The welfare state model, especially in its wider neo-corporatist extension, challenges the dominant individualistic orientation of commercial exchange in the liberal model and postulates a wider collective welfare preference held by civil society. This motivates broader collective bargaining, but also collective consumer organization in economic exchange.

Figure 3 The neo-liberal model



The traumatic experiences of unemployment in the 1930s and the political empowerment of the large industrial working class, has motivated a strong emphasis on worker-employer relations as the central focus in the commercial exchange arena. In the welfare state model (Berger, 1981; Streeck and Schmitter, 1985), the worker-employer role-set supplements the supplier-consumer role set that dominates the liberal model.

Political exchange

The broader collective welfare preferences held by civil society in the welfare state model also motivates a broadening of the political exchange. The minimalist liberal government program is supplemented with a wider engagement in public service provision, however, against a substantively higher taxation (Baumol, 1967). The political sphere thus acquires stronger influence over the economy and strategic decisions in economic exchange. Furthermore, the prominence of the political arena also places political negotiations at the core of intermediation between processes in other exchange arenas (Berger, 1981; Streeck and Schmitter, 1985).

Regulatory exchange

The Keynesian welfare state model redefines the regulatory exchange form a dominantly arms length – distant regulatory exchange to a broader industrial policy arena. In this arena, industry is supported by public funding and other forms of partnering, in response to socially responsible behavior.

Industrial preferences for commercial freedom under *laissez-faire* in the liberal model is supplemented, by preferences for access to public resources as a basis for profit-accumulation in the welfare state model. The extensive public funding and protective institutional support allows industry to be more sensitive to worker-interest in its employer role on the commercial arena. The build-up of national industrial championship in strategic sectors has been a classical instrument for this (Doz, 1986).

Intermediation between exchange arenas

Compared to the liberal market economy, the welfare state model and its further extension, the neo-corporative model, assumes a far tighter integration between the three exchange arenas. Furthermore, the exchange arenas are more complex, with additional role sets supplementing and to some extent substituting the role sets characterizing the liberal market ideal-type.

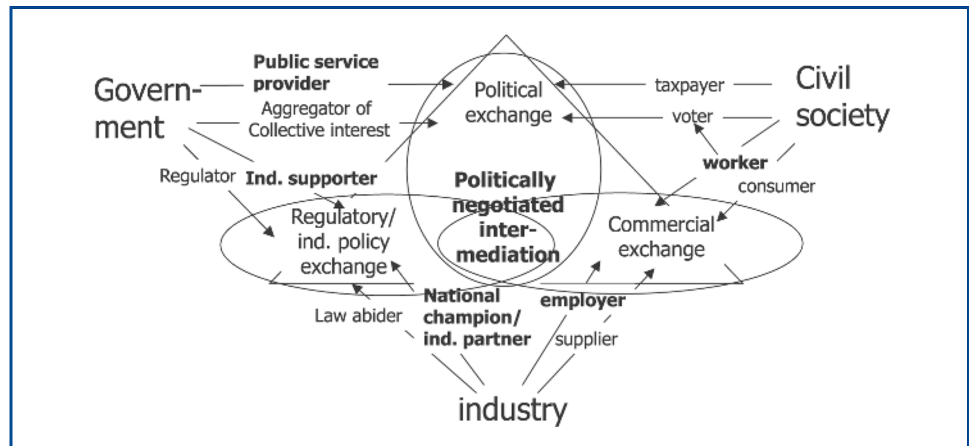
Last, but not least, the integration of the three exchange arenas through politically negotiated intermediation is a hallmark of the Keynesian welfare state, and even more of its neo-corporatist extension. Flexible coupling across arenas create new cross-boundary intermediation and negotiation, where problems and challenges in one exchange arena is compensated with intervention from another. Politically negotiated intermediation thus introduces cross-arena coordination and a higher level of meta-exchange (Marin, 1990; Streeck and Schmitter, 1985; Berger, 1981). Figure 4 summarizes stylized characteristics of the welfare state model.

The embedded-relational model

Following a period of neo-liberalist re-emphasis of the liberal market model in the 1980s, the emerging embedded-relational model reinstates a stronger social and environmental agenda. However, unlike the welfare state model it relies more on de-centralized civil society initiatives, media exposure and business self-regulation than on active state intervention (Zadek, 2001; Elkington, 1998; Andriof *et al.*, 2002).

In a situation of increasing globalization of the economy with strong internationalization of political governance, the embedded-relational model can be seen to reflect the expectation of social and environmental decency and a need for felt sharing of wealth from global corporate operations that still has remained in political focus. Large segments of the population, especially in rich welfare states are therefore sympathetic to mobilization against some of the negative side effects of the global market economy. The battle of Seattle and

Figure 4 The welfare state model



Genova, and other riots at WTO and World Bank meetings and international movements against globalization such as the formation of Attack, are symptoms of this.

Drawing on Polanyi's distinction between substantive and formal understanding of the economy[6] (Polanyi, 1944). Jessop (2001) argues that the primary sources of society's counter movement to the more extreme manifestations of the formal rationality of market forces can be found through governance based on more reflexive, dialogical rationality. This mode of post-welfare state governance includes the state in a strategic position, but also relies extensively on embedding governance in the market process and civil society.

The emerging embedded-relational approach has developed new ways of expressing concerns about sustainable development, adding new dimensions and role-sets to the three exchange arenas, as well as new modes of intermediation.

Commercial exchange

The emerging embedded-relational model follows the neo-liberal model in its emphasis on commercial exchange. However, as opposed to the neo-liberal model, it emphasizes the social embeddedness of the economy. The embedded-relational model thrives on the expanding role of civil society and the interplay between civil society organizations and global corporations in developing corporate social responsibility (CSR), which has been one of the major drivers for ''socializing'' the global economy (Zadek, 2001).

The motivation from the corporate sector to take part in this form of non mandatory socialization may come from several concerns, such as branding and reputation (Fombrun, 1996), enhancing competitive advantage (Porter and Kramer, 2002), embracing stakeholders that are key to success and long-term value maximization (Freeman, 1984).

Analytically, Freeman, Porter and others, have sought to include social/environmental responsibility into commercial exchange by inducing it into core business strategy, with reference to long-term value maximization or to stakeholder participation. In the emerging embedded-relational model, the firm itself, therefore, through its corporate social responsibility and transactions with stakeholders comes to promote a socially embedded economic exchange where (neo)liberalists focused more restrictively on short-term efficiency (Friedman, 1970) and Keynesian welfare state proponents would institutionalize social and environmental responsibility through government led regulation or negotiation.

The neo-liberal revival of the 1980s reintroduced the emphasis on supplier-consumer roles, and downplayed the importance of the worker-employer roles compared to the previous welfare state model. The CSR approach, which is central to the embedded-relational model introduces a new ''social partner'' role, responding to a ''concerned'' citizen and consumer role from civil society as, e.g. implied in the concept of corporate citizenship (Zadek, 2001).

This does not displace the supplier role, but adds a supplementary social and environmental dimension to the commercial exchange[7].

Political exchange

The political exchange under the embedded-relational model retains the liberal core of pluralist democracy to which a social dimension is added on just as much by pre-political as political exchange. Civil society appears with a multitude of non-political self-regulating social discourses, which feeds into the economic exchange through their effects on brand reputation and financial evaluation (Fombrun, 1996; Zadek, 2001).

The Keynesian welfare state model supplements the (neo)liberal concept of voter authorized minimalist collective governance, with substantive public service delivery as well as an active general industrial policy engagement, admittedly against the price of higher taxation. The embedded-relational model has retained the broader goals for political exchange, but has concentrated on social and environmental embedding of the economy through more informal ''pre-political'' means.

Political exchange in the emerging embedded-relational model thereby comes to interface more strongly with economic processes and with pre-political opinion formation in the social sphere. In intimate interplay with global media coverage, the emerging embedded-relational model comes to rely on civil society organizations being able to mobilize public opinion and corporate responses to further a global social and environmental agenda, without explicit democratic political mandates[8].

Regulatory exchange

Given its emphasis on non-formal market-endogenous processes the emerging embedded-relational model has tended to emphasize a non-authoritative self-regulatory approach (Andriof *et al.*, 2002; Zadek, 2001; Porter and Kramer, 2002).

The embedded-relational model strongly emphasizes a softer menu of regulatory exchange with a stronger emphasis on positive incentives. These softer incentives are not completely new with emerging embedded-relational model, however. In the Welfare state model, public authorities have extended their engagement into ''softer'' facilitating roles where public sector agencies enable or incentivate companies to engage in innovation and industrial development.

The emerging embedded-relational model has, however, taken this further and added both partnering and endorsing to the ''soft'' regulatory agenda (Fox *et al.*, 2002). In their partnership role, public sector bodies may act as participants, conveners or facilitators (Fox *et al.*, 2002). Public sector endorsement includes such issues as direct recognition of the efforts of individual enterprises through award schemes or ''honourable mentions''[9].

Intermediation

We have seen that the welfare state, particularly in its neo-corporatist approach, modifies the pure liberal market model with formal administrative-bureaucratic means, using the government apparatus in concerted action with centralized political organizations, the emerging embedded-relational model modifies the same liberal market model by informal re-embedding of the economy. One such vehicle of non-governmental socialization of the economy is socially responsible investment practices, now practiced by most banks and financial institutions.

Active engagement and negative and positive screening has become a major channel for CSR and the emerging embedded-relational model in the financial systems of major pension funds amongst others. Furthermore, media and communication processes also function as de facto intermediaries for social and environmental movements and issues through their agenda-setting and their dynamic shaping of the public debate.

Although less de-coupled than under pluralist liberalism, the intermediation between the three arenas under the embedded relational approach is far less political in nature than

under Keynesian Welfare state and neo-corporatist governance. Figure 5 summarizes stylized characteristics of the embedded relational model.

The embedded-relational model in comparative perspective

In comparative summary, one might argue that the preceding analysis shows emerging embedded-relational based governance in many ways bridging the apparent gap between the welfare state and (neo)-liberal models. In all exchange arenas the emerging embedded-relational model puts at strong emphasis on the social and environmental dimensions, in line with the welfare state model. Yet with its consistent emphasis on business and market forces playing a major role, the embedded relational model also concedes to the (neo)liberal model.

However, as opposed to both models, the emerging embedded relational model anchors the broader welfare concerns as well as more traditional governance concerns in direct civil society intervention and voluntary measures, more than politically mandated regulatory intervention[10].

This bridge building between the welfare state and liberal ideals, as well as the anchoring of social, environmental and traditional governance concerns in civil society, takes different forms in different exchange arenas. Through all three arenas the emerging embedded-relational model relies less on formal, democratically authorized and administratively implemented measures than on informal structures and processes. In commercial exchange the focus is on voluntary and self-imposed restrictions and consideration for societal concerns. In the political exchange the focus is more on pre-political rather than political mobilization. In regulatory exchange the focus is on soft, facilitating and partnering measures rather than mandatory.

The emerging embedded-relational (ER) model, therefore shifts the governance debate from plan versus market to centrally authorized versus more informal governance and thereby introduces a new dimension into the governance debate. This can be graphically illustrated as in Figure 6.

The traditional ordering along the horizontal axis puts the welfare state model, with a mixed economy, in the middle, between the planned economy and liberal market model on either side. The planned economy model (to the left) organizes the economy according to collective preferences under coordinated governance. The liberal model, to the right, organizes the economy according to individual preferences under atomistic competition, but under an authoritatively imposed regulatory framework. The Keynesian welfare state model combines the two, with a framework of collective concerted action on top of the market process.

Figure 5 The embedded relational model

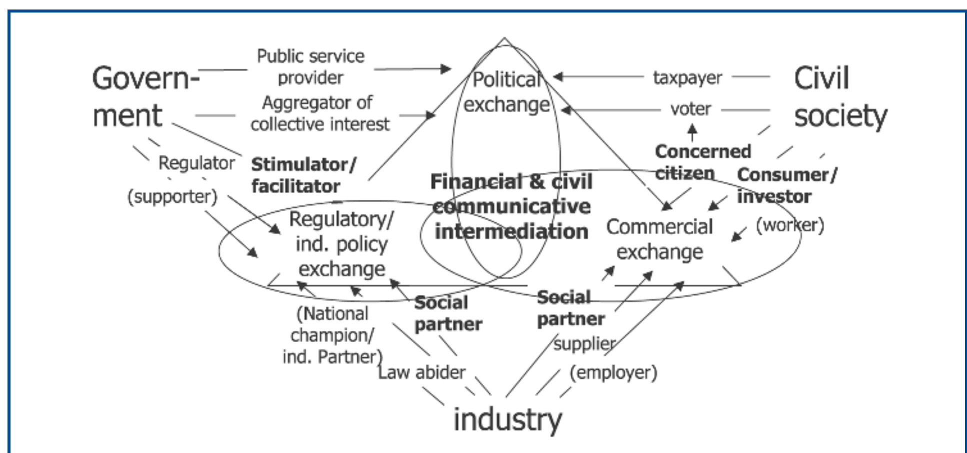
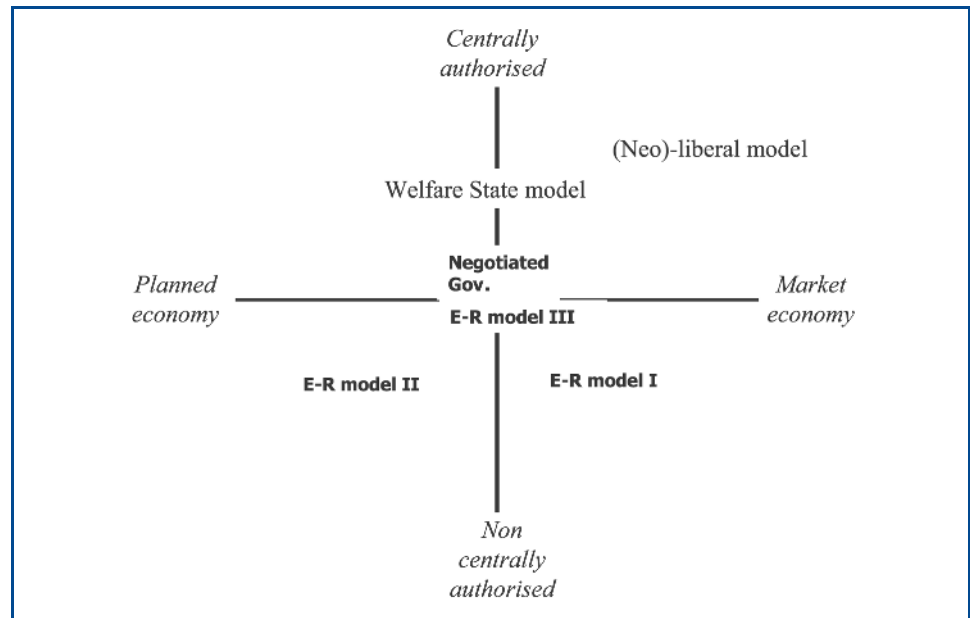


Figure 6 Governance, adding a new dimension



In this axis system the embedded-relational model moves economic governance along the vertical axis, from formally authorized regulation towards a more socially embedded economy with extensive self-regulation (Midttun, 1998). Non-authoritative economic governance was eminently discussed by Hayek, already in the 1940s (Hayek, 1948)[11]. More recently, in a broader social systems analysis, Burns and Flam (1987) have emphasized self-regulatory capabilities of social systems under the concept of rule system analysis.

The shift of emphasis from formal authoritative to more informal organization does not imply a complete cut-off from authoritative governance, however. While some proponents argue that CSR, a cornerstone in the embedded-relational model, is exclusively extra-legal, it is more and more recognized that the embedded-relational model involves important interfaces with formal regulation. As already mentioned above, embedded relational governance also involves government, but interfacing with it in a ''softer'' mode[12].

However, governance may also involve collective industrial self-organization (ER-model II). In such cases industrial associations themselves establish collective industrial solutions to CSR – challenges that presumably cause threats to the industry as such if left unattended. Trade associations may for instance, sponsor and administer environmental codes of practice, like in the US chemical manufacturers' responsible care initiative (Nash, 1998), the American Petroleum Institute's program: Strategies for Today's Environmental partnership (STEP) and the American Forest and Paper Association's Sustainable Forestry Initiatives.

These are examples of what one in our model may term ''private hierarchies'' or ''private planned economy''. Recognizing the limitation of industrial action and yet concerned with the urgency for the industry as such to show social responsibility, partial private planned economy is established within a market context. In some cases also in collaboration with authorities like in the petroleum industry.

Interfacing between the authoritative political and non-authoritative governance, the neo-corporatist extension of the welfare state model established an arena for tripartite negotiated regulation between labor capital and the state. One might also argue that negotiated regulation in the same interface occurs as an extension of the embedded relational model (ER III). Compared to neo-corporatist arrangements the negotiated interfaces are more cause-specific[13].

Drivers and opportunities behind the embedded-relational model: an economic organization perspective

Having profiled the embedded relational model against the welfare state and neo-liberal governance, the question remains: how can we explain its emergence? Two recurrent themes crop ut in our descriptive analysis: firstly, joint policies and institution building that would support traditional governance at the global level do not seem to keep up with the globalizing markets. We could call this ''the institutional deficit argument''. Secondly, it seems that technological advances in communication and information systems that facilitate the organization of global industries, also facilitate new forms of collective action that introduce a new governance potential. We could call this the ''communication and ITC facilitation argument''.

Both arguments can be linked systematically to basic theory of economic organization. Hirschman's (1970) work on reactions to performance decline in organizations argues that members have three basic ways of reacting: exit – permanent movement away from the organization; voice – attempting to improve it; and loyalty – support or acceptance.

Applying Hirschman's analysis to societal governance, one could argue that globalization allows exit strategies from industry in terms of traditional governance, while national government and civil society largely remain stuck with voice and loyalty.

Exit strategies from the increasing number of industries fundamentally changes the bargaining position of industry in the regulatory arena by basically undermining the regulatory power of government[14]. This obviously also affects political exchange. For civil society, voice through the political channel becomes less attractive in such cases. The weakened bargaining position of government in the regulatory arena implies that a strategy voiced though regular political channels has little effective outcome. Official politics, therefore, remains largely loyal to WTO rules and flagging out of jobs and businesses to tax havens through regular political channels, as no alternative strategy seems at hand.

The basis for government vulnerability under the industrial exit option, of course, lies in the enormous effort necessary to take collective regulative action in the international arena (Olson, 1971)[15].

As the industrial exit strategy redefines the regulatory arena from a national to a global level, following Olson's argumentation, it undermines the ability of new extended collectivity of nations to take relevant joint action. Unilateral action by any single nation state to socially and environmentally regulate global industry, may make it a looser in the industrial competitiveness game. That is, if the state does not control unique resources, which gives it a special leverage. Furthermore, one may add the institutional argument: It has taken a long and complex process of cultural integration and political legitimization to achieve the present governance capacity of the nation state. Replication of traditional governance at the global level may, if the analogy is relevant, lie a long way ahead.

Yet, the very same basic theory of economic organization that explains the failure of authoritative governance, can also be brought in to explain the emerging embedded-relational model. The communication and ICT facilitation argument claims that ICT allows scaling up of focused action on a global scale, with less and less organizational resources. Global branding strategies pursued by many global industrial players make them particularly vulnerable to this.

As action within the embedded relational model typically takes on a narrow focus and is directed at selected and vulnerable side of the business firm, the organizational logic, in Olson's terms, in many ways shifts from the large-scale to the small-scale logic. The scaling up of a global campaign, e.g. against child labor in a specific company, with reference to the company's corporate social responsibility can, with modern ICT and in interaction with mass media, be undertaken with limited organizational resources. The focus and narrow mobilization implies less collective decision-problems and lower barriers to collective action.

The targeted character and focused direction poses a realistic threat behind ''voice'' through a well-placed embedded relational model initiative, even in cases of ''state failure''

or failure of traditional governance. Many NGOs are multinational and carry global bargaining power in interplay with international media[16].

This mode of civil communicative intermediation crystallized to some extent by NGOs, re-establishes some bargaining power on behalf of social and environmental interests *vis-à-vis* a globalizing industry. Furthermore, social and environmental criteria also trickle down into financial markets through screening criteria or engagement strategies that are increasingly adopted by pension funds and other institutional investors. Their demands on industry also stretch beyond national boundaries and affect global industries when they seek capital in open markets. To the extent that the NGO driven communicative intermediation interfaces with CSR and corporate governance issues in financial evaluation, industry faces a socializing influence from two important sources, none of which have left it with easy exit options. Supplemented by strategic government initiatives, these factors may serve to re-establish some of the social agenda, under the embedded-relational model, that was lost with the global competitive exposure of the welfare state.

However, the embedded relational model may leave less room for national segmentation of social responsibility than the Keynesian welfare state model. As NGOs have to voice their claims to a globalizing industry on a potentially global arena, they may have a hard time legitimating unilateral nationalistic positions. Actions against, e.g. flagging out of jobs from one nation to another may hence be difficult, because the negative flagging out seen from the rich nation is mirrored by a positive export-led growth from the other. Actions for universal causes like protest against child labor, or other universal human rights may be more easy to justify.

Notwithstanding the focus on self-regulation and direct engagement from civil society, the embedded relational model still includes a role for traditional democratic politics. However, besides being a caretaker of certain constitutional prerogatives and rules of the game, parliamentary politics may, under embedded relational governance, becomes more engaged in symbolic issues management in an interplay with civil society, where more of the implementation challenges rely on industrial participation.

It should not be forgotten, however, that the embedded relational model with a strong reliance on self-regulation might also have its problematic sides. Firstly, the strong reliance on NGO's and *ad hoc* mobilization provides no clear and binding democratic grounding of basic elements of the model. Regulation heavily based on NGO intervention, or intervention by industrial associations may therefore easily develop a democratic deficit[17]. In the case of private governance by trade associations to further environmental and social concerns, there is the additional problem that they may softens competitive pressure, and thereby undermine public interest. We are, also for such reasons, likely to see an exposure of the embedded relational model to democratic critique.

To sum up, the model of embedded relational governance does to some extent provide an answer to Polanyi's concern with dis-embedded capitalism under globalization. Re-embedding the economy with the state as a strategic partner both through interplay with socio-economic processes in civil society and through media amplification, re-injects social responsibility in industry. In some cases, pre-political, market-endogenous socialization of commercial practices may be a first step towards more formal institutionalization and eventually state-like enforcement. However, given the cultural variety of the global arena, it is unlikely that consensus will be reached behind a strong government or global state. The embedded relational model is therefore necessary for its flexibility and dynamic adjustment capability.

Notes

1. As globalizing industry flags out labor intensive industry from high cost OECD countries and negotiates moderation in traditional welfare state expenditure, it limits the scale and scope of the welfare state.

2. This includes economic sociology, inter-organizational relations as well as political organization literature (Stinchcombe, 1990; Jones, 1997; Sauvée, 2001; Jessop, 1999, 2001; Mendoza, 1996 (quoted in Albareda *et al.*, 2004))

3. The exchange perspective has been most pervasive in economic analysis where the focus on exchange between suppliers and consumers (demanders) remains a cornerstone of market analysis. However, the transfer of the theoretical perspective also to the regulatory and political arenas also has a solid tradition in social science. Exchange theoretical reasoning has also played a central role in sociology (Homans, 1961, 1971; Coleman, 1986; Blau, 1964) and anthropology (Barth, 1966) and has also been used in political science (Marin, 1990). Exchange theoretical models within these disciplines has retained the focus on strategic orientation from economic analysis, but usually with less precise numerical calculation, because of the more complex exchange content and the lack of statistical information systems/bases. In its most simple form, following Coleman (1986) and Hernes (1975) social exchange involves: two actors A and B; two goods/services/resources X and Y; control and interest relations between actors and resources – that A controls X and B controls Y and that B is interested in X and A is interested in Y. Under the assumption that the actors are goal-oriented, and welfare satisfying they will choose to give up control over goods/services/resources, that interests them less, to achieve control over goods/services/resources, that interests them more. In this example, A will therefore transfer his right to X against B transferring his right over Y.

4. In contrast to restricted exchange, which occurs between two actors, generalized exchange inherently involves more than two. In generalized exchange, there is no one-to-one correspondence between what two actors directly give to and receive from each other. A's giving to B is not reciprocated by B's giving to A, but by C's giving to A, where C is a third party (Takahashi, 2000).

5. In response to economic instability of the 1930s, Keynes (1936) argument that the economy could settle at several equilibrium levels of income with varying degrees of unemployment motivates a role for government to use appropriate demand management policies to ensure that this equilibrium was met at full employment. The welfare state has been considerably more extensive in western European countries than in the US, featuring in many cases comprehensive health coverage and provision of state-subsidized tertiary education. However, the New Deal of president Franklin D. Roosevelt, the Fair Deal of president Harry S. Truman, as well as a large part of the domestic programs of later presidents were based on welfare state principles.

6. Polanyi distinguished between a formal definition of economics as rational, economizing behavior and a substantive definition of economics as want-satisfying behavior.

7. Several studies have pointed to the limited direct effect of social concerns in consumer behavior. With a few exceptions people continue to buy products and services with little consideration beyond their immediate self-interest. However, the indirect effect of social mobilization for brand reputation and evaluation in financial markets is nevertheless seen by many economic actors as having a highly tangible economic effect (Fombrun, 1996).

8. Centralized political exchange, whether embedded in the established party system or formal government apparatus, is challenged by a strengthening of non-state formal organizations, that in part rely on their policy implementation through commercial exchange (Andriof *et al.*, 2002; Zadek, 2001). On the one hand, the embedded-relational model here coincides with the liberalist maxime of minimizing formal public intervention in the market economy. On the other hand, however, the embedded-relational model advances a broader social and environmental agenda and stages more informal intervention.

9. As opposed to the (neo)liberal model in particular, but also the Keynesian Welfare state model, the emerging embedded-relational model does not draw strong demarcations between these regulatory roles (Fox *et al.*, 2002). Furthermore, the potential threat of more traditional authoritative regulation may also serve to motivate self-regulation.

10. As already pointed out before, it is not so much a question of direct consumer choice in their individual market-transactions, but rather a pressure through organized intervention by civil society in the interface between commercial and political exchange.

11. Expanding on von Mises' critique of planned economy and using the Mengerian concept of spontaneous order, Hayek examined the self-regulatory character of market-systems. In doing so he rejected the rationalist position of neoclassical economics with a focus on perfect competition

and equilibrium, and placed himself within an evolutionary tradition, where regulation was examined as emergent rules and developments.

12. This interfacing goes both ways, however. The embedded-relational model involves absorbing intermediary organizations into governmental policy making, but also to some extent to a privatization of public policy. Government in this regime is concerned with facilitating organizational development and institutionalizing the public status of intermediary groups. Intermediary associations thereby take over important public decision-making powers, and politics is no longer the central instance of society but only one, although a prominent one, among many discourses.
13. Among the collective industrial and industy-ngo-state initiatives within the embedded rational model are the codification of standards and principles for sustainability and corporate social responsibility initiatives. This includes approaches such as labor rights, ISO standards on environmental performance and recent ISO initiatives to develop a social dimension, as well as global reporting standards (GRI) on social and sustainability issues.
14. This is conspicuously clear in the case of internalization of environmental and social externalities in large segments of such industries as aviation, shipping and banking, where the threat of, or actual migration has allowed respectively amnesty from fuel taxation, amnesty from advanced labor legislation and amnesty from capital profit taxation as well as information sharing with the police.
15. As Olson (1971) argues: the larger the group (of nations), the smaller the fraction of the total group benefits any person/nation acting in the group interest receives; therefore, the less is the likelihood that any small subset of the group will gain enough from getting the collective good to bear the burden of providing it. The larger the number of members in the group, the greater the organization costs, and thus the higher the hurdle that must be jumped before any of the collective good at all can be obtained. That is, if the state does not control unique resources, which gives it a special leverage. Even when NGOs are nationally organized in the outset, issues can quickly spill over to the international arena through international news channels and other global networks and thereby generate global brand.
16. Even when NGOs are nationally organized in the outset, issues can quickly spill over to the international arena through international news channels and other global networks and thereby generate global brand and reputation damaging effects. Potential threats of this kind may also create arenas for more regular bargaining between cause-oriented organized NGOs and industry, where the NGO transforms from protest movements or action groups to ''responsible'' expert roles (Löhr, 2004).
17. This problem is most pronounced in the case of elitist or activist NGO's like Greenpeace, and less pronounced in the case of mass organizations like labor unions and many broadly based nature conservation organizations.

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