

Marketization of ethics; does it work?

Exploring the scenarios where firm's social behavior is not reflected in its market performance

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Abstract

Since early 1980s, there has been a gradual shift both in academia and among practitioners from deontological and normative corporate ethics to instrumental corporate ethics. In other words, the argument that higher social and environmental performance results in superior 'long term' financial performance has been used in many cases, to claim that markets are ethically self sufficient and will compensate decreasing negative and increasing positive social externalities. Consequently, the manager would manage the firm's externalities as part of his/her fiduciary duty towards the shareholders. This also means the companies can be trusted to self-regulate their social behavior.

However, the current credit crisis has brought to question the capacity of the markets to incentivize the actors to act in a responsible manner and self-regulation is being increasingly seen as a less effective means of managing firms' externalities. Consequently, it seems to be a good time to reassess the balance between instrumental and normative ethics both in the academia and the marketplace.

In the same line, there has been a large amount of research, empirically exploring the relationship between environmental and social (E&S) performance and financial performance of the firms. Such research which is mostly based on the E&S ratings of the companies carried out by the rating agencies has not been conclusive in many cases. In addition there have been many academics questioning the possibility of reverse causality between E&S and financial performance.

In this paper, the feedback mechanisms that have been claimed to mediate the relationship between social and financial performance and their underlying assumptions are documented. This is followed by a qualitative analysis of several scenarios where the company has no or little incentives to focus on the management of its environmental and social externalities.

Analyzing scenarios where investing in social responsibility might have negative long term financial consequences for the firm can result in avoiding trust in instrumental corporate ethics as a dominant logic for managing firm's social externalities.

Keywords: ethics, corporate social responsibility, socially responsible investments, environment, sustainability, corporate social performance

Introduction

The role of the markets has been expanding in different aspects of the contemporary human societies. Originally the markets were perceived as instruments for regulating the relationship between producers and consumers. The markets as defined by Adam Smith (Smith 2007) represent centralized management of economic transactions with the aim of achieving the optimal production and price points. As Polanyi has described in detail in *The Great Transformation* (Polanyi 1957), in the 16th and 17th centuries, market based solutions started to become organized for the transactions related to resources not produced by human. The key examples that he provides are marketization of land (or in general natural resources) and that of labor.

In the past few decades, market-based solutions have expanded into the operation of the governments in the form of New Public Management and have expanded into several formerly government functions such as legislation, regulation and judiciary functions both in the national and transnational spaces. The production of soft laws and the competition between private sector players in the transnational governance space has been thoroughly studied by the scholars in this area (Dau-Schmidt; W. Abbott, Keohane et al. 2000; Djelic and Sahlin-Andersson 2006). While soft laws implies the marketization of legislative process, part of the regulatory process has been marketized in the form of the fast growing global audit industry (Power 1999). Finally alternative dispute resolution (ADR) mechanisms are private sector alternatives to the government's judiciary functions (Stipanowich 2004). Markets have also been increasingly expanding into the internal hierarchies of the firms in the form of internal firm markets and transfer pricing practices. Other areas of marketization have been education (Whitty and Power 2000), social risk pooling (Salamon 1993) and insurance, etc.

The latest summit that the markets seem to be attempting to capture is that of normative ethics. Since 1970s, there has been a fast expanding discourse on the ethical self-sufficiency of the markets. In other words, the markets are claimed to reflect the firm's ethical behavior in its long term financial performance. Through different socialization processes such as business and economics education (Davis and Welton 1991), this viewpoint has been fast growing; and currently both in the socially responsible investment community (Jeroen 2008) and the academia; there is an endemic belief that markets compensate social responsibility and that investment portfolios built around social responsibility can achieve higher returns (Sparkes and Cowton 2004).

Following the emergence of activist investors and increasing separation of ownerships from management, under the fast expanding shareholder capitalism model, especially in the Anglo-Saxon world (Dore 2002), the managers had little leeway to adopt normative ethical agenda because it conflicted with their fiduciary role. Consequently while before 1980, the references of the firm executives to the social responsibilities of the firms were based on normative principles, in-line with the growing dominance of shareholder capitalism (against the backdrop of managerial capitalism), in the more recent corporate communications, the firms mostly refer to their positive social behavior as a way of achieving long term financial sustainability (O'Dwyer 2003).

The same dichotomy is also applicable to the investment community. Originally, ethical funds were funds which were managed incorporating a set of ethical principles in the investment process. However, since the 1990s, in the process of 'mainstreaming' socially responsible investments, investors are increasingly seeking higher returns (in many cases combined with 'social good')¹ from their 'responsible' investments; but as will be discussed, this trend has been facing 'empirical difficulties' given the inconclusiveness of results of the studies which attempt to prove the superior returns of such 'socially responsible' funds.

In the process of institutionalization and translation of the instrumental ethics, business education has played a significant role. While the original business ethics education was of a normative nature, since early 1990s, increasingly, terms such as social responsibility and ethics are being replaced by 'social performance' and sustainable development (Elias 2004); i.e. a dramatic shift toward instrumentalist ethics of the firm. In such a scenario students perceive ethics relevant because of its 'business case' and importance for the survival of the firm.

In the academia, empirical exploration of the social-financial performance link has been a major preoccupation of management scholars during the past two decades; however the results have been highly variable and in many cases inconclusive (Orlitzky, Schmidt et al. 2003; Margolis, Elfenbein et al. 2007). To address the variability of the results obtained from such studies, most of the academic focus has been on improving quantitative research methodology and social performance indicators (Stanwick and Stanwick 1998; Verschoor 1998). What is unique about most such studies is that, all companies are treated alike and contextual parameters such as market concentration, firm business model and risk levels are rarely taken into consideration. This paper will attempt to respond to the following two questions:

- What contextual variables mediate the social/financial performance link?
- Is instrumental business ethics sufficient to guarantee socially responsible company performance – in any context?

To respond to these two questions based on the existing literature, a conceptual model for the financial-social performance link mechanism and the underlying assumptions for its viability are provided. In addition, several scenarios are described where the social – financial performance link does not seem to be functional. Finally based on the frailties of the links between ethical behavior and financial performance, suggestions are made for a research focus orientation towards more context sensitive research on the social and financial performance link and also research into other forms of integration of deontological ethical principles into the firms' operations to increase the probability of firm commitment to social responsibility.

Theoretical Background

¹ J.P. Morgan – Focus on Socially Responsible Investing
http://www.jpmorgan.com/tss/General/Focus_on_Socially_Responsible_Investing/1159370330464

In the below section a review of the literature related to corporate ethics and the social – financial performance link is provided. It should be noted that given the breadth of literature related to corporate ethics only a selective coverage of the literature in this area is included.

Flavors of Corporate Ethics

Business ethics has gone through an interesting evolutionary path during the past few decades. The key conceptual difference between the different viewpoints on the firm's social responsibilities is rooted in whether the firm is perceived as a purely economic or a socially embedded entity (Driver 2006). While business ethics theories rooted in the human sciences are more of a normative nature, the recent flavors of business ethics which have emerged in the management research have dominantly instrumental viewpoints on the firm's social responsibility. The normative corporate ethics theories can be broken down into two broad categories of economic or social theories.

Under the social normative corporate ethics the common feature of the different theories is that, they all find the firm responsible towards the society and all the different firm 'stakeholders' on a normative basis (Hasnas 1998). Several such normative theories have emerged such as social contract theory and normative stakeholder theory.

With regards to the stakeholder theory (Cornell and Shapiro 1987) it should be pointed out that it has been used both as a normative theory and an instrumental theory (Hasnas 1998). The normative version considers managers responsible and accountable towards all the stakeholders rather than only shareholders (as a purely normative expectation), while the instrumental version claims that attending to the concerns and well-being of all the stakeholders is in the best commercial interests of the company – consequently the demand for responsible behavior towards the stakeholders is instrumental to firm's success rather than being an absolute demand (Jones 1995).

Social contract theory is another theory which attempts to establish normative social principles for the firms. The approach of this theory is similar to the social contract approach of Rousseau (Rousseau 1968) and Hobbes (Hampton 1986) for defining the principles that have to be respected by the governments to have legitimacy among their people. This approach is based on defining the terms of a contract in an imaginary society where an institution type (such as the commercial firm) does not exist, based on which the society will accept the emergence of the new institution (Keeley 1980).

There are differences between the normative demands of each of such theories from the firm; however, what they have in common is that in all these theories the firm is treated as a social entity (rather than purely economic). Consequently they impose social responsibilities on the firm, beyond its economic fiduciary duty towards the shareholders. To avoid delving into the differences of such normative theories which is out of the scope of this area, they are collectively referred to as social responsibility which is further defined in terms of minimizing negative social externalities and generating positive social externalities with the aim of achieving surplus in the firm interaction with all the stakeholders rather than only the shareholders.

Contrary to the social normative corporate ethics, economic normative ethics (or shareholder focused normative corporate ethics) which are rooted in neoliberal economics claim that given its fiduciary duty; the only ethical responsibility of the capital dominated firm is to maximize shareholder value (Hasnas 1998). In other words, the firm and its managers are economic instruments and agents of the shareholders and all their responsibilities are towards the shareholders. The normative basis for this claim is the agency contract between the managers and the owners. The major endorser of this viewpoint regarding the role of the firm was Milton Friedman and his school of economic thought. Milton Friedman summarizes this 'shareholder focused' viewpoint on corporate ethics in his following statement (Friedman 1970): 'There is one and only one social responsibility of business-to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud.'"

To address the inherent conflicts between the economic and social tracks of normative corporate ethics a third track of corporate social responsibility theories has emerged. This category of theories of corporate social responsibility theories which has attempted to reconcile these two viewpoints is usually referred to as instrumental or utilitarian corporate ethics (Quinn and Jones 1995; Mason and Mudrack 1997). The claim of these mostly management and economics scholars is that the pure economic and normative social demands on the firm can be reconciled. In other words, they claim that responsible behavior of the firm towards the society is a precondition for its long term financial survival and success (Aguilera, Rupp et al. 2004). This viewpoint on corporate ethics resembles utilitarian branches of religious ethics. For example in Buddhism, based on the concept of Karma there is a causality relationship between the human actions and the nature's reactions. In other words, based on Karma, the result of the human behavior is reflected back to the individual. Thus, acting ethically is not a purely normative demand; rather it results in utilitarian gains from the reactions (de Cea 1998).

In-line with the instrumental viewpoint on corporate ethics, a wide range of empirical quantitative research has been published studying the relationship between social and economic performance of the firm. Some of such studies have found a negative correlation between social and economic performance of the firms. In such cases the normative social ethical principles are considered as a cost to the firm which results in the worse economic performance for the responsible firms (Shane and Spicer 1983; Bromiley and Marcus 1989; Wright and Ferris 1997). Conversely other studies have found a positive relationship which supports the claims of the instrumental corporate ethics (Posnikoff 1997; Waddock and Graves 1997). Finally some studies have not found any relationship (Aupperle, Carroll et al. 1985; Teoh, Pin et al. 1998). A wide range of meta-analyses have also been carried out to explore the social financial performance link. In 2003 Orlitzky et al (2003) analyzed 52 studies which was followed by Allouche and Laroche (2005) 82 studies, Wu (2006) 121 studies and finally Margolis (2007) 167 studies. The results of these meta-analyses have also been variable with some claiming positive social-financial link (Orlitzky, Schmidt et al. 2003), some no relationship and some have claimed the discovery of reverse causality between social and financial performance of the firm (Margolis, Elfenbein et al. 2007) .

To address the inconclusiveness of the empirical studies in this area, some papers have attempted to improve the quantitative models by controlling for a wide range of variables such as size, R&D

expenditure, advertising expenses, etc. (McWilliams and Siegel 2000). Other papers have focused on the operationalization issues for corporate social performance (Griffin 2000). Finally some papers question the direction of the causality link between social responsibility and financial performance. In other words, such scholars argue that firms with more retained earnings have more resources to manage their social externalities (Hillman and Keim 2001).

With regards to the debate on the validity of instrumental corporate ethics several different studies from different disciplines have been published during the past few years. One example of such studies are the ones focusing on definition of firm identity and self as a social being (Driver 2006). Another category of such papers, raise a philosophical issue and the practical dangers with regards to the subordination of ethics to economics (Paine 2000). Several other studies analyze the cases where the social and financial relationship is a 'zero-sum game'. An example is the Jones (2006) paper, which explores scenarios where the social-financial link is dysfunctional due to special contextual situations. However, all these papers fall short of providing a conceptual framework for the social responsibility business cases and exposing its inherence conditionality and weaknesses.

Theoretical Contributions

While as mentioned, there is a wide body of research exploring the social-financial performance link through empirical inquiries, there have not been many studies that attempt to document the mechanisms which are claimed to underlie the link between financial and social performance and the assumptions based on which the mechanisms operate. Several papers have conceptualized one of the mechanisms involved (Moskowitz 1975; Turban and Greening 1997; Paine 2000) but none has provided a conceptual framework which integrates all the mechanisms used to explain this relationship. In this paper, an overall conceptual framework is provided which captures the different mechanisms claimed to help translate social performance to financial performance. In addition, an analysis of the assumptions underlying the different social-financial performance link mechanisms is provided. This is followed by an explanation of the market failures in the corporate social responsibility business case where one or several of the mentioned assumptions do not hold true.

Through exploring such assumptions and market failures, several major breakthroughs can occur in the corporate social responsibility and socially responsible investment research areas such as:

- Research on corporate ethics can move towards exploring ways to address the market failures in the different corporate social responsibility business cases in different contexts
- Where there is a market failure in the social responsibility's business case, research can explore other ways of integrating normative social responsibility demands in the firm operations to assure responsible firm behavior
- Empirical research exploring the social-financial performance link and socially responsible investments can focus on specific business cases and their failures instead of making broad financial-social link claims

Finally through analyzing the normative basis of instrumental ethics, this paper conceptualizes the link between instrumental ethics and other important areas such as self regulation, business ethics education and the dominant language games of corporate ethics.

The Social-Financial Performance Link and its Assumptions

Different economic ‘feedback mechanisms’ have been described to explain the relationship between ethical behavior and the financial performance of the firms. Some of such theories focus on the symbolic aspects of social responsibility and its importance for the legitimacy of the firm. A dominant theory used in this area is the neo-institutional theory (Meyer and Rowan 1977; DiMaggio and Powell 1983), through which social responsibility can be regarded as an institutional requirement that the firm has to comply with, to maintain its legitimacy and to survive (Campbell 2007). In some other research studies, the focus is on the resource dependency between the firm and the stakeholders which necessitates good relationship with the stakeholders. Two examples of such theories are the instrumental iteration of stakeholder theory (Jones 1995) and the resource dependency theory (Moir 2001). Interestingly, in some cases, no detailed explanation is attempted and social responsibility of the firm has been interpreted simply as a sign of ‘good quality of the firm’s management’, which is suggested to be conducive to the firm’s superior financial performance (Bowman and Haire 1975; Akpınar, Jiang et al. 2008). A third category of such theories emphasize externalities which are transformed to explicit financial claims true the institutions representing the stakeholders (McGuire, Sundgren et al. 1988). One category of such cases is marketized externalities such as carbon emissions. Another category of such explicit costs are fines, remediation costs resulting from regulatory breaches and litigations. The above mechanisms are graphically illustrated in figure 1.

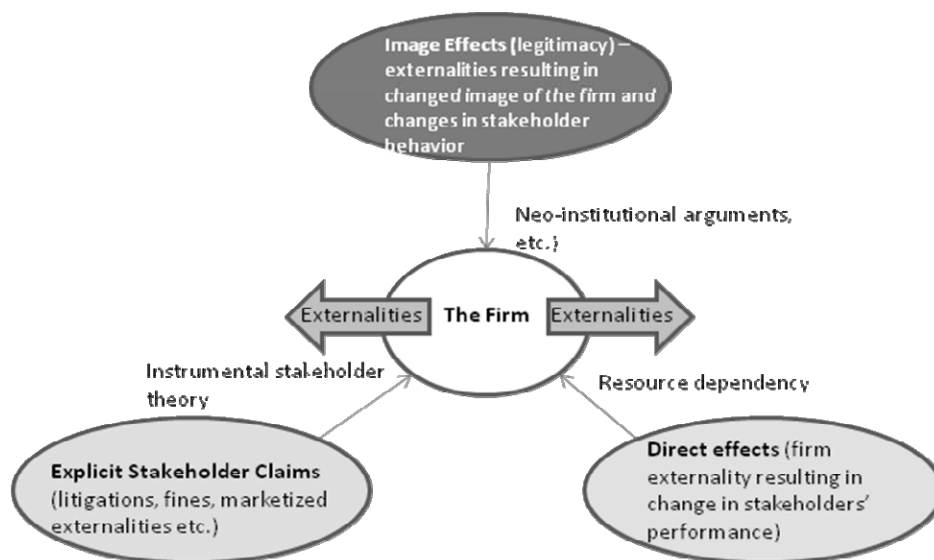


Figure 1. Claimed Social – Financial Link Mechanisms

To better understand the potential failures in these mechanisms it is important to study the underlying mechanisms and assumptions for each mechanism claimed to underlie the social-financial link. The three major social-financial linkage mechanisms detailed in the below section are:

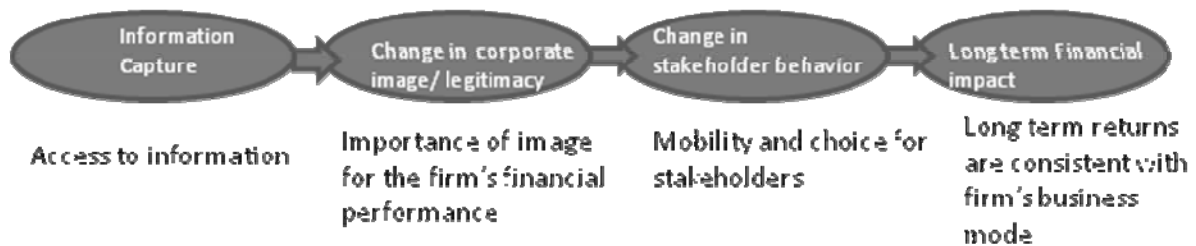
- Image effects (legitimacy)
- Direct effects
- Explicit Stakeholder Claims

Under each mechanism the assumptions and scenarios where the mechanism is dysfunctional are provided.

Image Effects (legitimacy)

The effect of social performance of the firm on its image is one of the most cited mechanisms for financial instrumentality of ethics from the firm (Bowman and Haire 1975; McGuire, Sundgren et al. 1988; McWilliams and Siegel 2000; Hillman and Keim 2001; Campbell 2007). A change in the perceived image of the firm is claimed to affect the stakeholder behavior and hence the firm's access to the resources provided by the stakeholder be it capital (Turban and Greening 1997), market demand and consumer goodwill (Turban and Greening 1997), talented work force (Moskowitz 1975; Turban and Greening 1997), etc.

For the image related social-financial performance link to be functional and for no market failures to exist, the following preconditions should be in place and the below underlying assumptions should hold true. The details of the process are also demonstrated in Figure 2:



Assumptions

Figure 2: The process and assumptions for the image based social-financial performance link

- I. **Information capture about firm externalities:** One of the challenges with regard to reflection of the firm's social performance in its financial performance is that the prerequisite is that information about the externality should be captured and subsequently reach the stakeholders (Shane and Spicer 1983; Deegan and Rankin 1996). Information capture can occur either through the firm's official disclosure and reporting mechanisms or by third party capture of the information through regulatory bodies, non-governmental organizations, news agencies, etc. (Shane and Spicer 1983) . However, in jurisdictions where the regulatory platform is weak and

other possible providers of information such as NGOs and news agencies have no presence or legal right to access information about the firm's externality; inferior social performance will have minimal effects on the firm's financial performance. An example is the labor issues in China and Vietnam (Winstanley, Clark et al. 2002) or waste dumping issues in Africa (Schmidt 2006) which in many cases remain unexposed for a long period of time.

As a side effect of globalization there is increasing separation between the supply and demand markets. Compared to the demand side, the production process is more social cost intensive meaning that most of the labor issues and environmental risks are on the production side (Midttun, Dirdal et al. 2007). Procurement of raw material and production in most of the multinational firms occur in different countries from where their primary markets area. This means, in the case, when the firm imposes significant social costs on the production markets, the image of the firm and its community relationships on the demand side are not directly affected. For the company's demand side image to be affected by its supply side social behavior, information about firm's behavior has to be captured and communicated to the demand side markets. Assuming that the capture, transmission and outreach of this information are perfect in such cases (which are far from reality in most of the cases due to lack of sufficient information infrastructure, access and journalism in the production country), another precondition remains to be fulfilled before a social externality translates to financial performance impact.

In the case of traditional local firms, social cost of production and demand are in the same society. However, in the modern MNC for the consumer behavior to change, a consumer should be expected to change his/her behavior based on a sense of solidarity with individuals thousands of kilometers away. Consequently, we can argue that in the multinational firms, the process for translation of social externalities to financial impact is more complex and multi-factorial. In other words, such a process is dependent on several highly volatile parameters such as information capture in the production markets and consumer behavior change based on social costs borne by relatively remote and disconnected societies.

Based on this discussion, we argue that the increasing separation of production and consumption markets weakens the relationship between social and financial performance in the multinational firms.

Factors such as reinforced regulatory platforms, better firm reporting (Roberts 1992) and also more activity by relevant third party information capture entities such as NGOs can help resolve the weaknesses in information capture and subsequently the market failures in this area. Other classes of information mediators have been emerging with the goal of better information capture regarding firm performance in respect to different stakeholders. One fast growing area is auditing for the firms' social performance (such as environmental audits, labor audits etc) (Power 1999). All such players play a significant role in resolving the market failure in the social responsibly business case related to insufficient data capture about firms' externalities.

- II. **Changes in the firm image:** Following access to information about the firm's externalities by the stakeholders, the stakeholder's perceived image of the firm should change as a result. This argument is based on a few assumptions. First that the business model of the firm is highly dependent on image. Second that the stakeholders' perceived image of the firm is driven by the firm's social performance.

With regards to the assumption of the importance of image to the firm, in many scenarios this assumption does not hold true. The importance of image to the firm can be partially judged by how much the firm spends on marketing out of its revenues. Consequently this parameter is of vital importance when using the image argument for the social-financial performance link. For example, vertical disintegration has been one of the pervasive trends in the capitalist world during the past three decades in many sectors (Herrigel and Wittke 2005). As a result, instead of one entity which employs all the capital needed to produce, distribute and sell, increasingly, these functions are carried out in different companies. Consequently, there is increasingly more number of business-to-business (B to B) firms compared to business-to-customer (B to C) type of companies. The marketing efforts of a business to business firm is typically on a one-on-one basis and public image plays a less important role in the company's financial performance than in a business to customer type of company (Coviello and Brodie 2001). This is supported by the finding that the average marketing expense in a B to B company adjusted for company size is significantly lower compared to a B to C firm. As an example, currently in the pharmaceutical sector, at least three firm types are involved in drug production which include: chemical components supplier, bulk generics manufacturer and pharmaceutical company; only 15 years ago all the mentioned three processes dominantly occurred inside the pharmaceutical company (Dixon, Lawton et al. 2009). In some sectors such as automotive industry the number of the companies vertically aligned in the production and distribution is as high as six (Fine, Clausing et al. 1998). As a result, increasingly the customer facing companies comprise a smaller percentage of the global capital markets. This implies that as a result of vertical disintegration, the number of firms that are customer image conscious is decreasing. The logical consequence is that the image argument used pervasively as a link between social and financial performance is less functional in an expanding part of the global capital markets which are the B-to-B firms. It might be argued that, the customer-facing company has a commercial interest in keeping the social behavior of the suppliers in check (Carter 2000). However this argument can be challenged because, such supplier checks get significantly diluted in longer vertical B to B company chains. In other words the social controls imposed by the customer facing automobile manufacturer on its suppliers is hardly expected to affect all the multiple levels of suppliers involved in the production of its products.

As the result of the above discussion the importance of the firm image to its financial performance is highly conditional. Consequently any study exploring the image based social-financial performance link without taking into consideration the relative importance of image and marketing in the firm's operations misses an important mediating variable.

- III. Change in the behavior of stakeholder towards the firm as a result of changes in perceived image:** For the image arguments to apply, the stakeholders (especially the consumers) should change their behavior as a result of a change of the firm's image resulting from receiving information about its social performance. The implicit assumptions underlying the change in stakeholder behavior is that between the stakeholders and the firm efficient markets exists. In other words, the stakeholder has freedom of choice and mobility.

However, where the company has significant market power in relations to its customers, suppliers, human resources, etc. the image of the firm will not have significant impact on the behavior of such stakeholders (Lyon and Maxwell 2008). For example in the case of a large retail firm and its fragmented suppliers, the dominance of the firm in the relationship with its suppliers results in low mobility of the suppliers and consequently lack of or limited choices for the suppliers hamper translation of social externalities of the firms to relationship gains or costs in regards to its suppliers. The same is true of societies at the time of economic crises and high unemployment. In such states, the choices of the potential employees are limited and consequently the image of the firm cannot significantly impact its access to human resources. The same is true of a consumer purchasing a product for which purchasing elasticity is low. In such cases, the consumer is obliged to purchase the essential good and in a monopoly situation, the consumer's purchasing behavior will not change in the face of high positive or negative social externalities of the firm and the resulting changes in the image of the firm. The increasing consolidation trends in different sectors and formation of regional, temporal or global monopolies (Beccarello 1997) can further hamper the mechanisms for translation of social externalities to financial impact for the firms.

It should be noted that depending on the level of mobility of the different stakeholders (suppliers, employees, consumers, etc.), the monopolies do not need to be international or national and they can be bound in limited time or geographical scopes. An example is the pharmaceutical company which holds monopoly over a drug through holding its patent. In such cases, given the low image elasticity of consumer behavior for drugs and the monopoly of the company over the drug; efficient markets do not operate between the consumer and the firm and the consumer is less inclined to change his/her behavior as a result of the change in the firm's perceived image. In such cases there is market failure in the social responsibility business case, and the firm has no economic incentive to improve its social performance and subsequently image; simply because there is low image elasticity of stakeholder behavior (Lee 2002).

- IV. Impact on mid to long term financial performance:** An interesting aspect of the image based social responsibility business case is the time horizon of the promised future financial improvements. It is important to take into consideration that for the social responsibility business case to be valid the financial results of the social performance change should be consistent with the firm's business model.

As discussed, different social - financial performance linkage arguments promise 'long term' superior financial performance for the socially responsible firms. While some externalities such as violation of law can result in short term image effects; most of positive externalities and a large portion of negative externalities are claimed to have long term financial consequences for the firm (McWilliams and Siegel 2000). In other word, social irresponsibility is usually seen as resulting from financial short-termism which endangers the long term financial performance of the firm. In contrast activities that cause positive externalities (such as community engagement, volunteering, charity etc.) are expected to result in a combination of short and long run (depending on the type of activity) positive financial performance through a combination of the above mechanisms such as improved image resulting in better access to resources, etc.

The question is which types of firms are interested in 'long term' financial performance. One of the typical tools that the companies use to analyze the economic viability of an investment is present value analysis (Ross 1995). The present value of the future cash flows and savings claimed to result from social responsibility are dependent on a firm's risk level. In other words, if a firm has a high risk level, the value of the long term future cash flows for it is lower and consequently it has an inherent financial interest to consider the short term more pronouncedly in its business decisions. ⁱ One of the firm attributes that has been empirically proven to decrease the firm risk level is the increased size of the firm. Several empirical studies in this area prove this relationship (Chan and Chen 1988). This is consistent with the argumentation that small firm has less capacity for diversification of access to markets, supplies and human resources which results in less resilience and higher risk levels (Errunza and Senbet 1984). Consequently for small firms, the present value of the assumed future positive cash flows resulting from social responsibility (especially the type of activities with claimed longer term benefits such as charity, high environmental standards in the emerging markets operations etc.) is lower than a larger firm. From this reasoning we can conclude that, when instrumental ethics are the key rationale for social responsibility, the small firms have less motivation to be responsible. Hence, instrumental ethics arguments cannot be a reliable driver for responsible performance for small firms. Conversely, in some recent studies the small firms have been observed to spend more in charitable activities (Madden, Scaife et al. 2006). However, it has been observed that in small firms, whose governance is more management (rather than shareholder) centric (Corbetta and Montemerlo 1999), and are more embedded in the local communities, such activities are primarily based on normative principles rather than expected long term profit maximization (Spence and Rutherford 2001).

Another class of firms with proven high levels of risk and beta are firms in financial distress (Andrade and Kaplan 1998). In other words, firms with a high default risk value long term cash flows less than firms in a stable financial condition. This means, a firm with high default risk has little motivation to take socially responsible actions for the purpose of achieving long term financial returns. In contrast, the preoccupation of such firms is short term survival.

One interesting manifestation of the effect of financial distress or difficulty on social responsibility was observed when at the peak of the current credit crisis, in some large financial institutions such as Citibank and many other investment firms, one of the first cost cutting activities was firing the sustainable investment teams.ⁱⁱ

The financial distress and company size examples are provided to demonstrate that social responsibility initiatives which are claimed to achieve long term returns are not financially viable in high risk firms. Beyond firm size and financial distress, several business environment variables can be thought of which systematically increase firm risk levels. Of course at the time of crises such as the current credit crisis, the higher levels of risk have the potential to affect the companies' level of interest in social responsibility; especially when ethics are primarily of an instrumental nature.

In the past section a detailed analysis of the process and the underlying assumptions of the image and legitimacy argument used to claim a social-financial performance link were provided. As discussed the underlying assumptions do not hold true in many difference context which means that any image based social responsibility business case is conditional and the typical empirical study of the social-financial performance link should be informed of the contextual prerequisites for this business case to hold true. In the following section an analysis of the second social responsibility business case is provided which is the direct performance effect of social externalities on stakeholder performance.

Direct Effect of Social Externalities on Stakeholder Performance

The second class of social-financial link arguments mentions the direct effect of social externalities on the stakeholder performance (Russo and Fouts 1997). For example, overworked and less motivated employees will have lower performance which can subsequently affect the firm performance (Bowen and Ostroff 2004). Another example is when the firm invests in a community, because the social health of community guarantees the long term consumption of the firm's products in that community. The same arguments apply to global issues such as global warming which can affect the viability of communities in the mid to long run which can in turn affect the firm's operations in those communities (Freedman and Jaggi 2005). The following section details the mechanism underlying this process and the underlying assumptions. Figure 3 provides a summary of the process and the related assumptions for the 'direct effect' social-financial performance links.

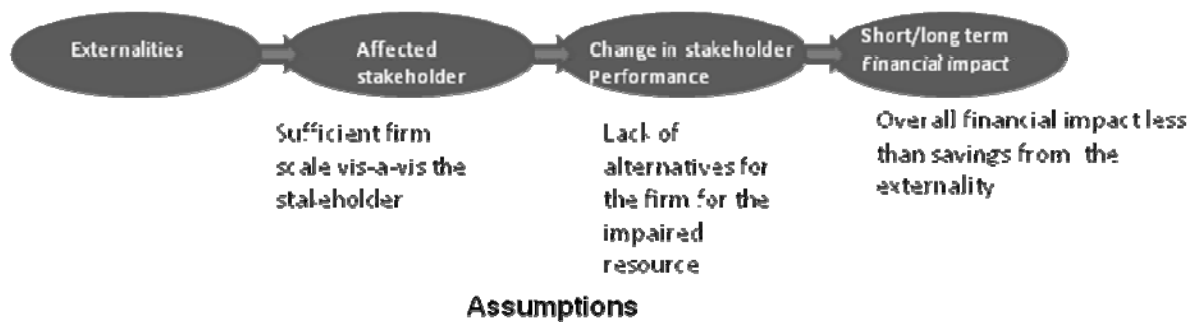


Figure 3: The process and assumptions for the direct effect based social-financial performance link

- **Impact of firm externalities on stakeholder performance:** For the firm to be able to affect the performance of a stakeholder, the firm’s externalities need to have sufficient scale compared to the size of the stakeholder. For example the firm’s behavior can directly affect the performance of its employees because it is a one-to-one relationship between the firm and its workforce. Conversely, with regards to externalities which affect the community or the society, the firm – society relationship is one-to-many meaning that the firm’s externalities play a relatively small role compared to many other variables affecting the viability of a community of a society. In such cases the larger the firm is the more important role its externalities will have in affecting the community and social conditions and consequently the stronger this business case will be (Ezeoha and Abakaliki). With regards to global issues such as global warming, the firm should be a large multinational or it should work on collective action along with the other firms to get sufficient return on managing its externality to have a viable business case. To sum up, the assumptions underlying this argument hold true only when the firm is large enough or when firm’s management of its externalities is part of a regional, societal or global collective action. Otherwise, when the size of the firm’s externalities is small compared to the factors defining the performance of the stakeholder, the firm has not instrumental financial interest in attending to its externalities.
- **Compromised firm performance resulting from compromised stakeholder performance**

For the firm to be affected by the change in the stakeholder’s performance resulting from its externalities; the following assumptions should be true:

- **High level of dependence on the stakeholder:** For example, in sector highly depend on human capital and access to talented workforce (such as most service firms), low levels of motivation resulting from firm’s mismanagement of its human capital can have significant firm performance effects (Moskowitz 1975). However, in manufacturing firms, the human capital is not a key source of competitive advantage and the dominant forms of firm’s human capital are replaceable at a low cost and consequently high employee turnover and other

side effects of human resource related externalities might not come at a big cost to the firm. Consequently, for the business case to work, the firm should have a high level of dependency on the affected stakeholder.

- **Irreplacibility of the Stakeholder's Resource Input to the Firm:** In some cases, if the firm's externality results in compromised performance of a stakeholder, the firm can switch to another provider of the same resource that the original stakeholder provided. For example a large retail firm has a multitude of choices with regards to suppliers for different products. Consequently, if price pressures of the retail firm result in financial unsustainability of a supplier, in the case of many products the firm can switch to another society in the same or different geographies to procure the same product. Consequently the stakeholder's resources provided to the firm should not be replaceable at low cost for this business case of social responsibility to be viable.

- **Impact on short to mid-term financial performance**

The financial returns of managing externalities which affect the resource supply from a stakeholder through affecting stakeholder performance can be from short to long term. For example mismanagement of human capital can have short to midterm financial consequences (Moskowitz 1975; Waring and Lewer 2004) while issues such as global warming and other large scale issues might take a longer period of time to affect the firm. As mentioned under the 'image effects' section, the time horizon of such financial impact should be relevant to the firm's business model and risk level. For high risk firms, the present value of the long term financial benefits in this area can be insignificant and hence the viability of this business case especially with regards to the long term benefits is highly dependent on the firm risk level.

Explicit Stakeholder Claims

A third mechanism for translation of social performance to financial performance is when the social externality is translated to explicit financial claims by the institutions representing the stakeholders. This term is borrowed from stakeholder theory (Wood and Jones 1995). Such explicit claims come in two broad categories

Marketized externalities: An example of such externalities is the carbon emissions which are marketized in several countries (Paterson 2007). Another example is when the externalities are valued by the government and reflected in the companies' financial performance through tax incentives for positive externalities and punitive taxes for negative externalities. In other words, the cost of externalities to the stakeholders is translated to a cost to the firm through market or government processes or a combination.

Fines and lawsuits: Another mechanism for translation of implicit stakeholder claims to explicit stakeholder claims is the laws, codes and regulations. All such institutional constraints on the

firm when combined with financial incentives or punishments are other mechanisms through which the firm's social externalities can be translated to financial performance effects. The effect of lawsuits and fines on the firm's financial performance has been widely researched (McGuire, Sundgren et al. 1988; Cohen, Fenn et al. 1995) with most of the studies demonstrating a short term effect and many also claiming a lagging effect.

The details of the above mechanisms related to explicit claims and the implicit assumptions behind this business case are discussed below. The process and its implicit assumptions are also detailed in Figure 4:

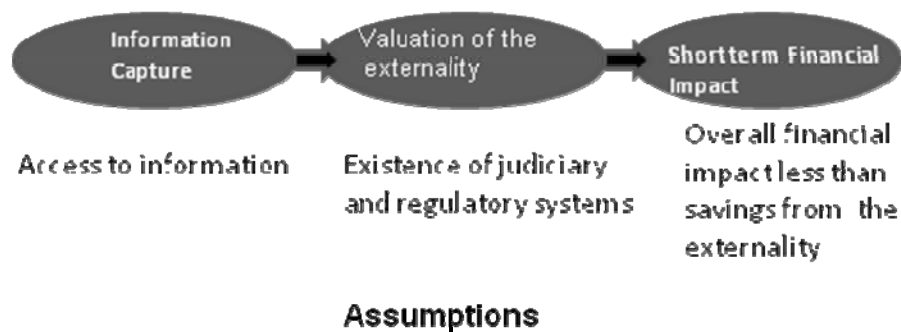


Figure 4: The process and assumptions for the explicit stakeholder claims based social-financial performance link

- I. **Information capture of firm externalities:** As the case of image – for the implicit costs to stakeholders to become explicit first the information about such externalities should be captured and then it should reach the stakeholder(s)' representative body with executive powers. As discussed under the image (legitimacy) section, information capture is imperfect in many cases.
- II. **Valuation of the externality by the institutions:** For the implicit cost to be translated to explicit costs for the firm, institutions representing the stakeholder should be in place with executive powers over the firm. In many countries the regulatory and judiciary platforms are weak; consequently, the firm's externalities might not translate to fines or litigations against the firm. One solution to this problem is to hold the in their home countries for their externalities overseas. This approach has been proven to be effective in the case of controlling global child labor and its adverse effects (Winstanley, Clark et al. 2002).

However while such regulations have not become sufficiently pervasive and the institutions of the country where the externalities are generated are weak, this business case for social responsibility remain fragile. The same argument applies to societies where market mechanisms for valuating firms' externalities (such as carbon markets) are underdeveloped.

- III. **Fines and other legal claims levied against the firm:** The litigations and fines have been cited to have two types of financial impact on the firm; one is mediated by the effect on the firm's image

and the other is related to the direct cost of fines and settlements born by the firm. The image mechanisms were discussed earlier in this paper. With regards to the fines and settlement costs levied against the firm, it should be pointed out that for the business case to hold, such costs should be financially more than the savings from externalizing firm's costs. In other words, through the combined effect of image impact and direct financial effect of the explicit claims this business case for the firm's social responsibility can become viable however with the precondition that the range of assumptions discussed above come true.

In the above sections a detailed analyses of the social-financial business cases was provided. It should be noted that in the cases where the business case has flaws and the underlying assumptions do not hold, social responsibility can come at a cost and consequently can have negative financial consequences for the firms. In such cases it can be reasoned that:

- For those companies, instrumental ethics does not suffice to guarantee social responsibility and normative ethics and regulations should complement the role of instrumental ethics.
- If such companies invest in social responsibility it will have negative financial consequences for them which is against one of the key underlying assumptions of return driven (or hybrid SRI targeting normative missions and good returns) socially responsible investments.

Finally, an argument that is usually cited to link management of social externalities and financial performance is that, if a firm manages its social and environmental risks and opportunities well, it can be taken as a sign of high quality of the management (Akpınar, Jiang et al. 2008) and high quality of management should in turn result in improved financial performance. The fiduciary duty of the managers is to maximize shareholder value. As discussed in the above scenarios, in many contexts, focus on decreasing social externalities does not lead to improved financial performance and does not create shareholder value. Consequently, in the purely instrumental viewpoint on corporate ethics, decreasing negative externalities and increasing the positive ones in such scenarios, is against the managers' fiduciary duty and can be conversely judged as a sign of 'low quality of management'. Among the claimed links between the social and financial performance of the firm the 'management quality' argument is the vaguest, which renders a detailed critique of this argument difficult.

Discussion and Conclusion

As discussed in the past sections, there are ongoing trends in the global economic systems that distort the relationship between the social and financial performance. Examples of such fast growing trends are vertical disintegration of the product/services value chains and separation of stakeholders' social spaces (for example separation of production and consumption markets). Other arguments such as firm size and financial distress and their impact on the social performance of the firms are not necessarily growing trends but both are affected significantly by global and regional economic cycles. These arguments strongly challenge the assumed consistent relationship between the social and financial performance of the firms and highlight the importance of contextual factors in the existence and

direction of the relationship between the financial and social performance of the firm. In other words, these scenarios aim to demonstrate the effect of the context on the type of relationship between the financial and social performance of the firm.

The attempt for reconciliation of the firm's fiduciary duty of shareholder value maximization and its social role is a helpful exercise that can result in development of new business models which decrease negative social externalities and increase the positive ones while creating shareholder value (such as bottom of pyramid business models (Prahalad 2006) etc.). However, when the ethical role of the firm is seen as an economic question and ethics are purely instrumental, management of externalities becomes a purely strategic and financial question. In such an approach, as any other 'project', decisions about management of externalities are influenced by factors such as the risk level and the business model of the firm. Consequently decisions aimed at economic maximization in many cases (as described in the past section) might not coincide with minimization of negative externalities or maximization of positive externalities of the firm. Given the existence of such conditionalities and flaws in the social and financial performance link; the question that arises is whether the markets qualify to be the primary reference for the managers' ethical decisions.

Further contemplation and research about the failures in the social responsibility's business case in different contexts can affect the way self-regulation of social externalities by the firms is being recommended as the preferred mode for control of the firms' social behavior by some academics and practitioners. As mentioned the credit crisis has provided a great opportunity to expose the failings in self-regulation (Eichengreen 2008). The karma of the markets seems to be partial and the ethical judgments of the markets are highly conditional and context sensitive.

With regards to the social responsible investments space, the pervasive assumption that firms and portfolios with better management of social externalities have better financial performance does not seem to hold in the mentioned scenarios. As described in this paper, more social 'responsibility' can result in worse short or long term financial performance in many cases and such cases are becoming increasingly pervasive due to phenomena such as vertical disintegration, off-shoring and industrial consolidation. Consequently in the construction of socially responsible portfolios, if higher returns are also part of the objective, the business models of the firms, their risk levels and their external environment should be taken into consideration.

To address the gap between the firm's instrumental interest in ethics and the firm's normative social responsibilities, several paths such as regulation and socialization processes for increased attention to normative ethics by the investors and managers can be taken. In addition, I suggest that to reinforce the validity of the instrumental ethics as a means of assuring responsible firm behavior, more focus be accorded to the failure points in the corporate social responsibility business case and addressing them, where possible. Some of such market failures such as information capture about the externalities might be resolvable through better reporting and third party social footprint audits etc. However, failures in the social responsibility business case resulting from firms' inherent attributes such as high risk level or strategic unimportance of firm's image seem to be more difficult to address. In such cases, external

institutional constraints & regulations and commitment to normative business ethics by the managers and shareholders seem to be needed to guarantee socially responsible firm behavior.

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ⁱ Here we do not delve into the questions of the decision making process and relativity and boundedness of rationality. Rather we base our argument on the same assumption of rationality that is inherent in the argument of proponents of instrumental firm ethics. Such proponents demand from the managers to act in a socially responsible way to achieve long term superior financial performance; which assumes managers' rationality and strategic choice.

ⁱⁱ Responsible Investment 2008; http://www.responsible-investor.com/home/article/citi_sri/