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Organization Studies 2006 27: 1533

DOI: 10.1177/017084060606068255

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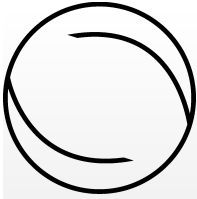
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Peripheral Vision

Modelling the Firm in its Market and Organizational Environment: Methodologies for Studying Corporate Social Responsibility

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Abstract

The study of corporate social responsibility (CSR) can best be mainstreamed within the wider social science literature if it is defined as firms voluntarily assuming responsibility for their externalities, thereby setting the puzzle of how this can be reconciled with the maximization of shareholder value as the central challenge of the subject. Means of resolving the puzzle require modelling the firm interacting with its environment as both a market actor and as an organization, and in particular through the interaction between these two. Such an approach has no need of a separate concept of 'stakeholders'. The analysis develops through the firm's relations with actual and potential political action (raising the separate issue of corporate citizenship), and the tastes of consumers, investors and employees—the last raising interesting implications for principal-agent theory.

Keywords: corporate social responsibility, corporate citizenship, governance

There is no such thing as global society; almost no such thing as global polity; there is considerable global economy. Very little exists to require transnational enterprises to come to terms with the externalities of their activities either at the global level itself or within parts of the world where national and other political structures are weak and local social structures unable to cope with large western corporations. This institutional weakness extends to markets themselves, which are frequently highly imperfect. The organizational hierarchy of the firms is often the only source of their governance, not only internally but also externally. The literature on corporate social responsibility (CSR), corporate citizenship and similar terms constitutes an attempt to provide frameworks for that governance. It is a distinctive literature. Part of it comprises boasting of their social achievements by firms and their academic supporters; another part comprises pleas addressed to firms to behave responsibly. But some writers see a need for the study of these phenomena to be incorporated within the normal scientific literature on the firm in its environment. In turn, trying to come to terms with CSR in this way assists in the general development of a multidisciplinary approach to the study of the firm in its wider context.

In the following pages the issues normally considered within discussions of CSR will be addressed via the following:

Organization
Studies
27(10): 1533–1551
ISSN 0170–8406
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SAGE Publications
(London,
Thousand Oaks,
CA & New Delhi)

- Externalities, which will be seen as coterminous with the potential field of CSR;
- Governance—defined in its political science sense, not as corporate governance—as the means by which externalities are generally managed in society;
- The firm *qua* organization, or corporate hierarchy, as the principal form of governance normally denoted by CSR;
- The problematic relationship between this and government and law, the main general means through which externalities are managed in modern societies, raising the issue of corporate citizenship;
- The relationship between the firm *qua* organization and the firm *qua* nexus of markets, particularly as seen in three areas: (1) a distinction between immediate and long-term interests, especially in relation to the issue of trust; (2) the formation of tastes; (3) the relationship between the form *qua* organization and the issue of a possible employee preference for CSR;
- The operation of this analytical frame in the firm's relations with key groups with whom it has market relations (customers, investors, employees), and with those to whom it relates solely through externalities.

Because the argument is developed in terms of CSR, it concentrates on the impact of the firm on its environment. A full study of what is often termed 'business in society', sometimes wrongly treated as a synonym for CSR, also requires considering the firm as a recipient of externalities from that environment.

Corporate Social Responsibility as 'Corporate Externality Recognition'

There is dissatisfaction even among CSR specialists with the strong normative overtones of the phrase 'corporate social responsibility', and there are frequent searches for alternatives (Waddock n.d.). The basic idea can be best reconciled to social science theory by defining it as behaviour by firms that voluntarily takes account of the externalities produced by their market behaviour, externalities being defined as results of market transactions that are not themselves embodied in such transactions. CSR is essentially 'corporate externality recognition'.

Identification of externalities is not in itself a normative exercise. Normative judgement enters when one distinguishes between negative externalities, the kind most often discussed, and positive ones. For example, imagine a western multinational arriving in a traditional Islamic society. Local women who work for the firm, and their wider circles of friends and relations, may start to be affected by western ways and stop wearing head scarves. This is an externality: it is an impact of the firm's activities not captured by its market transactions. From some normative standpoints it bears a positive sign: it constitutes women's liberation; from the perspective of many in the local community it is a moral degradation, and evaluated negatively. It does not have to be decided *ex ante* whether a given externality is positive or negative.

For a firm to reduce production of a negative externality—or to increase production of a positive one—requires it to take action that will cost it something, but for which it will not, *ceteris paribus*, receive payment. This is the central puzzle of CSR: how can a profit-maximizing firm be expected to take action of such a kind? This gives a cutting edge and a *problématique* to the subject, and explains my preference for treating it always in terms of 'externality recognition'.

This approach excludes from consideration cases of firms claiming to be pursuing CSR simply by doing their ordinary business, nothing at all to do with externalities. For example, an information technology firm might claim that, by producing the best possible computer software and marketing it efficiently at competitive prices, it is adding value to the world. If this is simply saying that by its normal commercial activities it is creating value, adding the idea of CSR contributes nothing to a normal economic analysis. If it is saying that it produces a sum of good in the world that goes beyond what is represented in the prices of its products, it is still posing no explanatory challenge if these externalities are costless by-products. A case of CSR arises where producing positive externalities does cost something—as with the ease by which software can be pirated, reducing producers' potential sales. It would constitute CSR for software firms to decide that, in specified circumstances, they will do nothing to prevent this.

Many writers (e.g. Fraser 2005) see CSR not so much in terms of externalities as the recognition by public companies that they need to heed not only shareholders but all the multiple stakeholders impacted by their behaviour. The concept of 'stakeholder' is suspect, unless it refers to the possessors of legally or substantively guaranteed rights within a corporation, rights that can neither be reduced to market transactions nor removed at will by a firm (e.g. rights to codetermination enjoyed by employees and embedded in either legislation or guaranteed by collective agreements). If a right derives directly from a market contract (as with customers), the concept of stakeholder is redundant, as one needs nothing beyond the market contract to describe the relationship. If it depends on a firm voluntarily deciding to offer it, it does not comprise a stake, as it can be withdrawn. Finally, the term is often used in an exhortatory sense, interests being defined as stakeholders because the authors believe that they ought to be treated as though they had a recognized stake (as in communities affected by a firm's operations but having no market relations with it). Exhortatory concepts do not have a place in scientific analysis. The correct contrast with a simple shareholder maximization model of the firm is one that requires recognition of externalities; the idea of stakeholders adds little to this. As will be seen, most arguments about CSR concern ways in which this potential conflict of interests is reconciled by the latter becoming part of the former.

Governance

A key concept for the study of the management of externalities is governance. That term is here understood not as corporate governance, but as the general political science and sociology concept. This refers to the mechanisms by which the behavioural regularities that constitute institutions are maintained and enforced; institutions in turn being patterns of human action and relationships that persist and reproduce themselves over time, independently of the biological individuals performing within them (Crouch 2005: 10, 20). Governance is not concerned solely with externalities; and, as we shall see, different forms of governance show very different capacities to deal with them. However, externalities can be managed only if there is some institutional capacity to address

them and an appropriate governance mechanism in place to monitor and guarantee their performance.

This approach to governance has been developed through a series of contributions to self-styled neo-institutional analysis (Campbell et al. 1991; Crouch 2005: ch 5; Hollingsworth and Boyer 1997; Hollingsworth et al. 1994, 2002). It identifies a number of governance mechanisms, the main ones of which are: political (government and law); social (association, network, community); and economic (market, corporate hierarchy).

At the heart of our current concerns is economic governance. Here there is a striking difference between the two mechanisms: the market is by definition incapable of dealing by itself with externalities, unless they are converted into internalities through consumers' or investors' tastes, as will be considered below. The corporate hierarchy may possibly deal with externalities, either directly or by interacting with taste formation. This is what is understood by CSR: the governance of externalities by firms themselves. Most of the rest of this paper will be concerned with this, and its relationship to market governance. First it is necessary to deal with its relationship to the two other forms of governance, social and political.

The Firm and Social Governance

In community governance the conduct of individual community members is regulated by their dependence on that membership for survival; this can be a highly effective way of dealing with what are perceived by the group in general to be externalities. Voluntary exit from community is difficult or impossible; expulsion from it has dire consequences. Enforcement of the community's rules may be delegated to particular office-holders, in which case it starts to approximate to formal government. More frequently decisions about sanctions, the means of enforcement, and indeed the content of the rules themselves are informal and non-specific.

Communities are mainly characteristic of traditional societies, but small and medium-sized enterprises (SMEs), particularly in direct services sectors, may well be required by community obligations to recognize their externalities in modern societies. Because of locational sunk costs, small firms may have far less geographical mobility than individuals, and their proprietors may be required to respect local norms of good collective behaviour, as they may lose customers if they do not conform. This can include both avoiding negative externalities (e.g. dumping refuse, producing noxious fumes) and pursuing positive ones (being 'pillars of the community', supporting local charities, and so on). The community sanction operates through the market, but in an interesting way: customers do not simply consider the products that they might buy, but take extrinsic criteria into account. In doing this they have to overcome the collective action problem, which is possible in a community context.

Networks are loose communities, and are relevant to many firms, including the branches of large corporations (Cafaggi 2005). Members are free to leave them at will, but they then lose the gains they derived; this enables the collectivity to exercise some control over the conduct of network members. Imagine a law firm established in the zone of a high-tech sector, specializing in legal services to high-tech

companies, and gaining from the daily interchange of sector-relevant knowledge with the firm's companies, related university scientists, specialized accountants, trade associations, and so on (Kenney 2000). The firm could relocate, but it would at least temporarily lose the advantages of these connections. It is therefore likely to accept local obligations of good citizenship (avoiding what are perceived as negative, and pursuing positive, externalities), even though in the short term it might make more profits by ignoring these.

Associational governance can be seen as formalized networks. Individuals (or, for present purposes, firms) join an association from which they derive certain benefits as members (club goods) in a more formal and explicit way than in a network. The association may then exercise governance over members' conduct through rules that are a condition of membership. These rules may simply concern relations among members, but they may sometimes also involve wider social responsibilities or externalities. This form of governance often takes the form of neo-corporatism (Lehmbruch and Schmitter 1982; Cawson 1986; Crouch 1993: ch 2). This can, particularly where it is formally established through systems of chambers, come close to a legal concept of collective corporate citizenship, extending to labour as well as business organizations. Within neo-corporatist arrangements, an interest association undertakes, in exchange for certain privileges in representing its members' interests, also to discipline or restrain them in relation to some wider general goals.

Associations are likely to engage larger firms as well as the SMEs that are involved in communities and networks. It is however increasingly difficult to hold multinationals within the grasp of associational governance. Associations are usually operative at national level, and one of the services that they offer members is access to and responsiveness to national government and other nationally organized structures (such as trade unions). Associational governance, and in particular governance that tries to make firms cognizant of externalities, is weakening as a result of globalization.

Government, Law and Corporate Hierarchy

The most obvious means available to societies for dealing with externalities is to have government and law responsible for them—whether through regulation, taxation or other means. The state is charged with responsibility for the public realm, in particular those goods that are held in common as collective goods by a defined community. This introduces the main debate in the CSR literature: should firms define a CSR role for themselves, or should they concentrate on profit maximization, leaving it to government to pursue public goals—both the creation of positive externalities and the suppression of negative ones? This is closely related to a further question: should a firm's maximand be limited to shareholder value, or extended to embrace wider criteria of value? One position was famously articulated by Milton Friedman (1970), who argued, not just that firms had no duties beyond shareholder value maximization, but that they had no mandate to go beyond that and decide wider social goals. There are two parts to this. The first maintains that, if firms pursue goals other than strict profit

maximization, they will become inefficient. The implications of this for CSR will be considered later. Here we are concerned with the second part, the relationship between CSR and the polity: that firms have no right to second-guess government's responsibility to determine the extra-economic criteria that should govern their behaviour. This raises two problems: does government have the capacity to enforce its regulation on global firms? And what are the implications of Friedman's argument for firms' rights to engage in political action?

The first issue has been tackled with reference to CSR by Ruggie (2004a, b). He argued that nation states no longer constitute the whole of the public domain. Instead, the very system of states is becoming embedded in a broader and deepening international arena concerned with the production of global goods, in which corporations are major players (see also Carroll 1979; Julius 1997; Leisinger 2005; Mintzberg 1983; Nelson 2004). Global firms have become so powerful that they cannot avoid political attention (Valor 2005; Warhurst 2005), even if political actors can exercise little direct leverage on them. In such a context governments and international agencies seek the support of firms to do their work, a major example being the Global Compact that the United Nations reached with a large number of global corporations (UNIDO 2002; Enright 2005; Ruggie 2004a). In a study of CSR practices in seven Asian countries, Chapple and Moon (2005) conclude that multinationals are more likely than national enterprises to develop CSR strategies. The conclusion is not surprising as CSR, as it has come to be understood, primarily addresses the situation of these corporations. This does not mean that SMEs, or business associations, or legislation, do nothing to address the externalities of corporate activity. It means that the debate is shaped by, for and around global firms because of the challenges that they pose to governance. Relations between business and society are being recalibrated.

Second, it is necessary to consider firms in their own political activities. Being organizations and not just nexuses of markets, they can 'talk back' to governments. They lobby them, fund political causes, and try to influence public opinion so that it in turn influences government. They can justify these actions in terms of shareholder value maximization and therefore as compatible with their market-defined goals: if the firm can secure a regulatory environment that suits what it wants to do, it will be better able to maximize its profits. But, in intervening in politics and society in this way, the firm is stepping outside the frame of straightforward market exchanges. In effect, it is producing political and public-opinion externalities in the process of maximizing its profits, as it is changing the general political environment around it. As a result of the firm's actions, the views of legislators and officials are changed, or the ability of a particular party to succeed electorally is changed, or large numbers of people have changed their minds over an issue. Whether these are negative or positive externalities will be a matter of normative judgement.

Corporate Citizenship

The significance of corporate political action is highly subject to scale effects. There is a continuum from the individual acting in a democratic context, trying to influence political events, all the way up to large firms and other organizations. At

what point does it cease to be realistic or accurate to regard corporate political actions as a sum of individual citizens using their democratic rights?

It is at this point that the concept of corporate citizenship becomes relevant. Corporate citizenship is not a synonym for CSR. The latter is mainly concerned with the perspective of firms themselves, whereas the citizenship idea places the firms in their wider context. Matten and Crane (2005) have tried to impart analytical rigour to this, often loosely used, concept by treating it seriously in terms of the rights and obligations of individual citizenship. In another contribution (Moon et al. 2005), these authors make it clear that they are not referring to formal legal concepts, but to more participatory (i.e. sociological or political theory) approaches to the subject, based on de facto engagement in and receipt of rights from a political system. In an even more important step (Matten and Crane 2005), they also discuss the role of large corporations replacing or sharing with the state in the task of the administration of individual citizens' rights. They have been criticized by Van Oosterhout (2005), on the grounds that organizations should not be entrusted with citizenship rights unless these rights serve the purposes of human persons (see also Klonoski (1991) for the problem of treating firms as moral persons). But, as Crane and Matten (2005) reply effectively, they are not advocating such rights but exploring their implications.

They are surely right in applying this wider concept of citizenship to firms, as they intervene in politics and receive privileges from it. Solomon and Collins (1987) developed a similar and elegant argument concerning what they called a 'concession theory' of corporate law. Enjoyment of corporate status is a legal privilege, conferring rights to operate in ways not accessible to non-corporate actors. It would therefore seem reasonable for legislatures and courts to demand a social quid pro quo for these privileges.

Particular use has been made of the extended idea of corporations as administrators of citizens' rights alongside (or instead of) states, primarily in relation to Africa. This refers partly to the emergence of South Africa from *apartheid*, within which employers were implicated, and the subsequent role of firms in establishing civil society institutions; and partly from their engagement in the struggle against HIV/AIDS (Middleton 2005; Ruggie 2004a; Visser 2005). Fourie and Eloff (2005) point to the collective nature of much of this activity; it has not just been activity by individual firms, but a generalized business commitment to pursue goals of democracy, peace and sustainable development. It has even been argued (Egels 2005; Hamann et al. 2005b) that in some African contexts multinational firms have wanted to shape their own political and so-called stakeholder environment, *in order to have a responsible local context with which to deal*.

The relationship between corporate hierarchies, CSR and the state and law, squaring corporate political influence through lobbying with corporate social and environmental responsibility, is therefore highly complex. It is difficult to maintain that, particularly where global firms are concerned, a clear distinction can be drawn between the arena of profit-making activity and that of external governmental regulation.

Further, a major force leading firms to adopt CSR strategies is pre-emptive action to ward off the introduction of such regulation (Amnesty International 1998;

Mirvis and Googins 2004), sometimes as early responses to criticism from social movements (Falkner 2003; Schnietz and Epstein 2005). Verschoor (2005a, b) has even suggested that government pressure on firms to behave ethically gave stock market advantages to firms already pursuing such practices, because they were considered less likely to have to change their practices in response to any new legislation. Schnietz and Epstein (2005) report similar findings following crises such as the demonstrations against the World Trade Organization in Seattle; firms with good CSR records were protected from a general stock market decline, because they were seen as less vulnerable to government intervention responding to the social concern. Similarly, the weakness of political threats can explain weak CSR. Thompson and Zakaria (2004) scrutinized the annual reports of the 250 largest companies operating in Malaysia. They found very little reference to social and environmental questions, and note the lack of government and public pressure, as well as the low level of firms' perceived benefits from showing such concerns, and the widely held view that firms do not have a significant impact of the environment, as explanations of this.

Organization and Market in Large Enterprises

Zenisek (1979) discovered that developing what he called 'a fit between the business ethic and social expectations of the private sector' required turning to the wider literature on organizations. The concepts of supply and demand must be enlarged to the ideas of inflow and outflow. Supply is that subset of all inflows into a firm that are traded, and demand is that subset of all outflows from a firm that are traded. That leaves untraded inflows as those inflows into a firm that cannot be analysed as market supply, and untraded outflows as those outflows from a firm that cannot be analysed as market demand.

The traded and untraded then interact, both production processes and products, in relationships with raw materials, suppliers, potential labour pools and workforces, customer firms and ultimate consumers. The market enables those operating within it to express their preferences, their tastes, but it cannot tell us how they derive those tastes. To some extent the market itself shapes tastes, as our levels of wealth and income and the products that the market makes accessible to us will tend to affect what we choose: it is difficult to develop a taste for something of which we have no experience. However, in general for economics, taste is exogenously determined. But firms can access and shape tastes in ways that go beyond the market. This is the activity known as marketing, which is far more extensive than 'selling'. Through it firms try to push their reach into parts of the society not yet accessible to them, attempting to create tastes and construct markets.

These activities create externalities, leading groups in the society and polity to try to change the behaviour of firms in order to reduce (increase) those that they regard as negative (positive). They may seek government action through the regulation of products and/or production processes. They may seek to act directly on firms through publicity campaigns, affecting their reputations and therefore the taste for their products. Firms may in turn seek to take pre-emptive action to avoid problems in both the political and market arenas. To do this requires having an

organizational capacity to intervene against short-term market advantage and short-term shareholder interests, but the response is always triggered by either political or market challenge. This is where active CSR strategies come into play. The main arenas of action concern: long-term interests, including those relating to trust and consumers' own long-term interests; tastes and fashions; and the tastes or value preferences of those working within corporations.

The Role of Long-Term Self-Interest

It is very common for CSR studies to distinguish between short-term profit maximization likely to be pursued by shareholder interests (particularly those embodied in stock markets) and a longer-term interest that these interests are in danger of neglecting. They may be cared for by institutional shareholders, venture capitalists or senior management. The spot market as such cannot easily cope with the long term. Normally, long-term actions require a capacity of the firm *qua* organization temporarily (but only temporarily) to second-guess the market, or rather to combine market and organizational action. The firm receives messages from certain points in its environment that it will need to incur certain short-term costs in order to respond to an externality if it is to pursue its own long-term interests. The interesting issue is then: what points?

Kytle and John (2005) give a good account by arguing that CSR constitutes good risk management. By being alert to social issues that are not only current but might be developing in future, or social groups that are weak today but might acquire power tomorrow, firms will be able to anticipate change and disturbance. Engagement in CSR activities provides them additional intelligence and sensitivity. Zadek (2005) similarly describes firms that engage in what he terms 'collaborative governance'—becoming involved as partners with public authorities in the production of public goods—as being more forward oriented and likely to be innovative than those that remain defensive. In a study of governance systems of major corporations, Ricart et al. (2005) found that leading firms were more likely than other firms to give an important place to sustainability issues. These contributions all suggest that issues that are currently externalities will in time bear upon the firm's market transactions, and that a forward-looking firm will benefit from early perception of this. This is also what is implied by the findings of Verschoor (2005a, b) and Schnietz and Epstein (2005) cited above.

These arguments seem to resolve the Friedman problem and also the basic CSR dilemma. However, they beg the question of how, from among the mass of events that take place, firms are to select those that give a sure guide to future market opportunities. Ostlund (1977) perceived that, in the last analysis, interpretation of a corporation's response to a social issue would be in the hands of individual executives and their personal judgements, because these social goals could not be interpreted in a straightforward way in terms of profit maximization. He considered that this would be the case whether taking cognizance of social responsibilities was imposed on firms by government or pursued by firms themselves. Ostlund here anticipated some recent debates that consider CSR in terms of the principal-agent problem: in present terms, when the firm acting

qua organization intervenes in the immediate signals given by the market and uses its organizational intelligence, management is trying to act autonomously.

Jensen (2001), in a widely noted contribution, takes an extreme view of the moral hazard involved here. He sees CSR and stakeholder theory as precisely the kind of issue on which managers will seize in order to acquire autonomy to pursue their private ends at the expense of their principals. Agents are a priori suspected of systematically trying to deceive their principals. Since the efficient functioning of the capitalist economy depends on the profit maximization goal, any attempt by managers to pursue other goals will lead to inefficient resource allocation. (Jensen's argument explicitly excludes the existence of externalities.) As soon as there is a plurality of measures of corporate performance rather than the simple bottom line, managers will either be confused, or will have an incentive to do as they like, using the ambiguity of priority among the measures to go their own way and deceive their principals. Jensen (2001: 17–19) criticizes in particular the concept of a 'balanced scorecard', pointing out that it is precisely not 'balanced'. There is no way of loading the choice between its various, to some extent competing, components, which grants the much-feared freedom to managerial discretion.

Principal–agent theory requires the assumption that the signals conveyed in share prices are always superior to managerial assessments of a firm's prospects, because the former is a neutral market mechanism, while the human judgement of managers and other professionals will be swayed by personal concerns. This rests on the assumption that share prices embody perfect knowledge and perfect rational expectations. In practice this will not always be the case; in conditions of uncertainty, share prices may sometimes reflect mutually reinforced erroneous perceptions, while managers may have sound professional knowledge. An example would be the final stages of the dot.com bubble, when ignorance was driving share prices. Neoclassical theory can reply that these are only empirical occurrences that may be exceptions; theory is on safer ground making its a priori assumptions. However, in practice doubt may sometimes legitimately exist about the quality of the knowledge governing spot markets; this provides continuing scope for managers to seek some autonomy from them.

In a further widely noted and controversial contribution, Ghoshal (2005) tackled this question in a quite different way, enabling us to take the question in a further direction. He argued that the ideology of profit maximization as the sole goal for managers had created an amoral managerial cadre which in turn made possible the Enron, Worldcom and other major scandals. If managers were trained and rewarded for paying attention to the bottom line at all costs, they had no incentives to obey principles of probity or even the law (other than the risk of being found out). This leads us to examine the idea of a long-term corporate interest in trust.

Long-Term Interests, Trust and Reputation for Trust

Cases of corporate deception are contrary to the efficiency of the market, as they give false signals that distort rational decision-making. If it must be assumed that managers will have no inhibitions about behaving in a corrupt way in order to meet their bottom-line obligations, other than the fear of being discovered to

have committed a legal offence and to run the risk of punishment, investors and customers become reluctant to come to market. In a world where risk-taking is rewarded, there must be a strong presumption that managers will take a calculated risk view of whether deception is likely to be discovered. Regulatory law has to be extremely detailed and intrusive in order to curtail loopholes; and inspection and policing have to be intensive to ensure a risk of detection high enough to act as a deterrent. These activities constitute a cost burden on business and on the wider society. Sound principal-agent relationships will not avoid the problem, partly because shareholders themselves need monitoring to protect them from cynical managers, and partly because dominant investors may themselves practise deceptions on customers and small investors.

Regulation and policing constitute institutional trust (Farrell 2000; Hardin 2002; Levi 1998), which is needed where there can be no personal trust. With institutional trust, A does not have to trust B personally in order to make deals. All A needs to know is that B is a member of class X that is dependent for certain important resources on an agency C which has a strong incentive to guarantee the behaviour of all members of class X. The cost of maintaining agency C constitutes the cost of an inability to sustain personal trust. There may therefore be efficiency and market gains for firms with managers who could be personally trusted, and therefore subjected to lighter regulatory regimes. Jensen does not actually dissent from this view, arguing precisely that 'we cannot maximize the long-term market value of an organization if we ignore or mistreat any important constituency' (Jensen 2001: 16). For him the essential thing is that the definition of this wider goal, the organization of the firm's day-to-day activities in relationship to it, and, one can conclude, the cultivation of trust, must be the responsibility of the principals, not managers.

It is difficult for customers, small investors and others to determine whether or not firms are honest, but firms can take a number of steps to acquire a reputation for probity, and adopting prominent CSR strategies can be a means of doing this. Wilson (2005) describes the rationales offered by retail firms who pursue CSR strategies in order to overcome low opinions of corporations 'in today's climate of corporate mistrust and scandal' (see also De Man (2005) with reference to Wal-Mart). Starck and Kruckeberg (2003) discuss the contribution that public relations practitioners can make to further CSR. Customers may believe that a firm that engages in good works in the community has a kind of corporate conscience, and would not engage in dishonest practices. Investors may do the same: Verschoor (2005a, b) presents evidence that 'good corporate citizenship does well and will continue to result in superior financial returns', again citing reaction against the Enron scandals and the response to the dot.com collapse, as motives for this. In other words, firms may find it rational to accept the short-term costs of reducing negative (increasing positive) externalities flowing from their activities in order to realize long-term trust gains. To do this, they must deploy their organizational resources.

However, it should be noted that what firms need is a *reputation* for trust (Fombrun 1996). This can mean using claims and self-advertisement without changing their behaviour. Since the actual pursuit of CSR also requires expenditure on its advertisement if it is to be known by customers, investors and others, it will always be cheaper to pursue reputation alone. This further trust problem has led

to the growth of a specialized set of institutional trust mechanisms for monitoring CSR practices, with various firms and voluntary bodies developing benchmarks and scorecards (AccountAbility 2005; Crawford and Scaletta 2005; Grossman 2004; Martin and Lohin 2005). Sometimes firms resist these attempts at external validation. In case studies in South Africa, for example, Hamann et al. (2005a) showed that there are tensions between the attempts of the ISO (International Organization for Standardization) to develop global standards for CSR and local norms, or individual firms' practices. At the same time, the growth of these activities does serve as a testimony to the growing prevalence of a CSR agenda in contemporary business life. As some authors have argued (Elkins 1977; more reluctantly, Ostlund 1977), whatever might be argued over whether firms ought to adopt social responsibilities, in practice many of them do so; their actions and their reasons for them should therefore be studied objectively.

Consumers' and Investors' Long-Term Interests

So far we have assumed that consumers, investors and others care for CSR only indirectly, as an indicator of a firm's probity, and that firms may have a long-term interest in performing well on CSR in order to satisfy that indicator. Consumers and investors may also have long-term interests that lead them to pursue CSR products in their normal market exchanges with firms. If so, there will be market niches for firms able to supply such products. An important example would be anxieties about environmental damage and sustainability.

It is easy to model situations where consumers might trade immediate market gratification for protection against a negative externality. For example, it is not irrational to prefer to patronize the more expensive of two shops selling identical products if one can access the cheaper one only by crossing a road with a very high pedestrian accident rate. Knowledge of the price difference that the consumer would be willing to accept before preferring to cross the road, discounted for the risk of death or serious injury in crossing it, enables us to estimate the value that she places on her life. Allowing one's consumer and lifestyle preferences to be affected by concerns for the global environment can be seen as an extension of this logic, but with considerable difficulties. The discount rate of the expected environmental damage will be very high, because the expected time interval before the damage arrives is very long. There may also need to be assumptions that individuals do not distinguish much between their own interests and those of their descendants—and again this must be expected to be subject to heavy discount rates. There is also the collective action problem (Olson 1966). When I take action to avoid the risk of a road accident, I am able to achieve my goal as a direct result of my own actions. When I take action to avoid the risk of global warming, I am not only dependent on the actions of millions of other people to achieve my goal, but my own contribution to the outcome is infinitesimally small. It is therefore irrational to take the action. Even (perhaps especially) if I have knowledge that everyone else will behave in an environmentally friendly way, I have no incentive to do so, as my contribution will be so small.

However, where the difference in the costs that the consumer incurs from pursuing environmentally regarding rather than non-regarding behaviour is very

small, but the implications of the environmental damage are extremely large, it may still be rational to accept the costs of being an environmentally sensitive consumer, even after the environmental damage risk is discounted over time and account taken of the collective action problem. This argument does not require any departure from neoclassical analysis. If it can be assumed that consumers or investors are behaving in the way specified, the operation of the market by itself should ensure that producers will fill the market niches concerned, though that analysis would lead us to expect that these niches will be small. To go further we have to investigate something that economic analysis takes for granted: tastes.

The Formation of Tastes and Fashions

Although the satisfaction of personal tastes is normally considered as an individualistic, self-regarding exercise, it is not problematic to hypothesize that individuals might develop a taste for certain collective goals as part of their personal repertoire of preferences. This could be a result of altruism, the reality of which as a human motive is the subject of a considerable literature. For present purposes we shall investigate an alternative motivation: fashion. It is entirely feasible to imagine a fashion for CSR; it may become 'non-cool' to buy products from, or invest in, or work for firms or countries of origin that have acquired a reputation for producing externalities that the fashion defines as negative. 'Being fashionable' may be a goal that brings personal satisfaction. Its pursuit is therefore rational, and an individual pursuing a fashion for CSR will ignore the long-term nature of the substantive issues and the problems of collective action.

There is research evidence suggesting the validity of consumer preferences for what we might call 'CSR goods'. Paul et al. (1997) measured US consumers' sensitivity to what they called corporate social performance, with findings that suggested the reality of this dimension for important proportions of consumers. Meijer and Schuyt (2005) replicated the study in the Netherlands, with similar results and across a wide range of income levels. The success of the Fairtrade brand provides similar evidence (*Marketing Week* 2005). Munilla and Miles (2005) derived a CSR continuum of issues, ranging from the use of slaves and child labour to willingness to provide employee recreation programmes, and were able to detect clear sensitivity to these in surveys of customer intentions. Crawford and Scaletta (2005) similarly use the 'balanced scorecard' concept to detect a taste for CSR. (Munilla and Miles (2005) and Crawford and Scaletta (2005) relate their work to stakeholder theory, but this is not necessary to their account, which operates through market relationships alone. If the interests of a 'wider community' of affected interests are served, it is only because these interests have become indirectly reflected in the firm's normal markets through the tastes of those who trade directly with the firm in various ways.)

Similar arguments may apply to investors and employees, though fashion is a more prominent component of ultimate consumption than of investment or labour markets. On the other hand, investors may be sensitive to a taste for CSR for other reasons: they do not necessarily have to have such a taste themselves;

they only have to believe that it exists, or will soon exist, among consumers, and they will start to prefer investing in companies with CSR reputations.

Taste Formation in Interactive Markets and Market/Organization Interaction

So far the argument about taste has required only a market model of the firm, not an organizational one. However, firms engage actively and routinely in shaping consumer tastes, i.e. in the generation of fashion. They do not simply supply goods and services in response to existing demand: they try to shape that demand, appearing on both demand and supply sides of the equation; that is what 'marketing' means. Firms therefore have choices, not only over to which taste niches they wish to *respond*, but over the kinds of niches that they wish to *create*. The firm does this actively as an organization.

While these are general issues, their application to externalities raises them in an extensive form, relating not just to products but to production processes, labour practices and various environmental effects. In what circumstances should it be expected that firms will actively promote market niches that associate them with positive externality creation or negative externality reduction? To what extent can campaigners argue that, given that firms try to create their markets through the encouragement of certain fashions, they have a responsibility to encourage socially responsible ones? As Liedtka (1997) has pointed out, there is an important role for constructivism in the study of CSR (see also Smith 2005).

The answer to these questions from principal-agent theory must be that constructing externality-sensitive market niches is fine provided that it works; in highly developed markets there are very many niches, and there are good profits to be made from being the first to discover them. However, managers should also be exploring the opposite hypothesis, that there might be a market for 'bad' behaviour, or that the fashion might change. This brings us again to Jensen's objections to managers having the right to deploy their own moral agendas. It has been mentioned above that a taste for CSR might exist in labour markets: people may prefer to work for firms with good reputations. If such a preference were to become so extensive that firms could not hire high-quality managers and other professionals unless they were willing to pursue CSR policies, the issue changes from being about principal-agent and becomes one about the quality of available labour supply. Managers who insist on being ethical become the same kind of problem for investors as employees who do not have adequate skills. (This is more or less literally the position of *The Economist* (2005), which contends that CSR just constitutes managerial 'woolly thinking'.) The distinction is relevant to the kind of strategy that investors adopt if they perceive a problem of 'excessive externality recognition' within the firm. If the problem is seen to be one of principal-agent, the rational strategy for investors is to tighten the rules on managerial discretion, or make increasing use of stock options to bring managers' preferences in line with those of investors. If the problem is one of quality of labour supply, the rational options include: training programmes to

reduce managers' commitment to ethical practices; moving production to locations where there are greater supplies of non-ethical managers; or accepting the situation and relying on the firm being able to succeed in CSR niches. Firms may even pursue all three in different parts of the world.

Jensen (2001), cited here as a major advocate of principal–agent theory, has a distinctive position on these issues. In no way does he want unethical business: he wants shareholders, rather than managers, to be educated to take CSR issues into account. If they as principals come to place a value on socially responsible goals, this becomes reflected in their maximization preferences rather than being set against such preferences. He therefore advocates principles for principals, and would probably have no difficulty with those firms that provide training in CSR for executives (Mirvis and Googins 2004), provided that they were not established as a personal preference of managers. A problem of his argument is the identity of this 'we' whom he frequently invokes as wanting, needing and being in a position to carry out this behaviour modification among principals. There is a curiously Platonic assumption of a guardian elite in his otherwise totally market-driven view of the world. Does this imply uneasiness with a world in which there is no economic governance outside the corporation? Or even more fundamentally, is he seeking a moral framework that stands even beyond governance, keeping profit maximization within some bounds set by a profound moral sense?

Conclusions

The above discussion has shown that in most instances where we are able to see a resolution of the potential conflict between CSR (defined as corporate externality recognition) and the maximization of shareholder value, the resolution lies in the CSR goal being marketized, and there are several ways in which this may be predicted to happen, particularly once analysis moves beyond a simple demand and supply model to take account of:

- interaction between firms' roles as market actors and as organizations, the latter giving them a capacity to perceive a long-term interest that might conflict with immediate maximization, including an interest in trust or at least reputation for trust;
- an interest on the part of consumers in their own long-term interests, albeit one that is heavily discounted over time and subject to collective action problems;
- the key role of taste, driven by either altruism or fashion, in further influencing consumers' preferences for CSR;
- a possible direct taste for CSR goals on the part of investors, provided there are niches for CSR products; and a derived demand for CSR practices among investors if they believe that such practices will be advantaged by either consumer preferences or political action;
- a taste among employees and potential employees to work in firms with CSR reputations—raising important implications for the principal–agent issue.

In all these cases so-called stakeholders (especially consumers and employees) express their demands through their normal market transactions; only the firm needs to be modelled as possessing an organizational capacity in addition to a market presence. Interests that are not linked to the firm through the market can enter the frame only if the values of consumers, employees or investors develop a taste for caring about them strong enough to generate a market niche. The only other, non-market, way that their concerns can enter is through the fact or threat of government, legal or political action. These interventions themselves stand outside the CSR frame, the CSR literature being almost solely concerned with the actions of firms. However, even in that literature the fact and the threat are seen as present in the minds of firms as they construct their approaches to their own externalities.

Note

This article originates in work carried out by the author as part of the CSR Platform Project co-ordinated by the European Academy for Business in Society as part of the Framework Six research programme in the social sciences and humanities of the European Commission. He wishes to thank Simon Smith for invaluable research assistance in the preparation of the article, and Maureen Kilgour, Peter Lacy, Gilbert Lenssen, Kevin Morrell and Simon Smith for many helpful discussions of the academic study of corporate social responsibility.

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