INVESTING IN SUSTAINABILITY: DELUSIONS AND POTENTIAL BENEFITS OF SOCIALLY RESPONSIBLE INVESTING

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ABSTRACT:

Socially Responsible Investment (SRI) aims at offering investments in companies that take care of their impact on society at large. It should result, if the financial flows become sufficiently large, in a change of behaviour of companies, when those companies want to attract investors concerned by SRI.

This paper tries to sum up the matters covered by the impact of socially responsible investments on the financial flows, and their possible impact on companies. It also explores the potential and shortcomings of this approach as it is practiced today, and suggests that an emphasis on the social responsibility of professional investors is a very important element in this respect, since they can play a considerable role in bringing about the expected changes in behaviour of companies. This means those investors should not so much concentrate on the selection of stocks, but on the reporting they get from companies, and the positive influence they can have on their objectives and strategies by appropriate votes at annual general meetings of shareholders, in order to be themselves *"socially responsible investors"*.

Key Words:

Socially responsible investment; financial products; ethical financing; professional social responsibility.

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1. INTRODUCTION:

The debate about the ethical aspect of economic activity is very old. Theologians were discussing it in the middle ages, when trading activities and profits were seen with an utmost suspicion. The Reformation offered a quantum leap by removing the *"sinful"* qualification of trading profit. The Scottish Enlightment –most eloquently Adam Smith– explored its subtleties and offered a new vision: self interest, working in a transparent and free market, can lead to public good; competition ensures that profit is a reward for efficiency, and thus ethically good.

There is wide debate since the earlier part of the 20th century between those who claim that the sole purpose of a company, and its main social responsibility, is to look after its shareholders' interest and to make profits[1], and those who claim that it has other, wider responsibilities, towards its employees, customers, the environment, etc.[2]. Both sides regularly call on Adam Smith to justify their opinions (mostly Smith, 1776 and 1790). A few of his famous quotations can thus be reminded here:

"... Every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it [...;] *he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good ..."*.

"... It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages ...".

"... People of the same trade seldom meet together, even for merriment or diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices ...".

In fact Smith would have said that the social responsibility of a company is to pursue and even maximise *"decent"* profits, i.e., the type of profits made in a competitive market, and in full respect of the laws and rules that protect the interest of customers and the community. The butcher and the baker of Smith were individuals living in a community, and the quality of their products was regulated by corporations; he was critical of profits made in an uncompetitive market; he pleaded that some moral restraint should be put on the pursuit of profit and that *"self love"* or *self interest* was not to be confused with greed.

This also means that even though making profits in transparent markets maybe the prime social responsibility of companies, the level of profits is not the way to measure their real added value, nor their level of social responsibility. This is not only because profits can

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[1] Opinion often associated with Milton Friedman (1970), but exposed before him by many others, not least Berle and Means (1932), von Hayek (1969), etc.

[2] In the early 1930's already a hot debate opposed Berle and Means (1932) on the one hand, and Dodd (1932) on the other, the latter arguing that companies have various social responsibilities.

come from a windfall, with little or no merit, but also because profits can be anti-economic, like the *“rent”* of the monopolist; or unsustainable, because they originate from activities harmful for the environment, the customers, the workers and create threats to the economy in the future (not mentioning of course the profits stemming from fraud or corruption). One could say that presenting profits like the true measure of economic success forgets some of fundaments of capitalism.

Thus, there is nothing very new in endeavouring to assess the ethical aspect of making profits, and also nothing *“anti-capitalist”* –and even less *“anti-market”*– in it.

2. THE STANDARDS:

Various standards are used to assess the way in which companies fulfil their social responsibilities. At this purpose, they use to follow various normative approaches.

The beginning of qualitative classifications (exclusion):

Some investment funds and pension funds have been under pressure since the early 20th century from their investors to be *“ethical”* in their investments. The first generation of standardized criteria that appeared in the 1970’s and 1980’s was based on the *exclusion* –on moral grounds– of investments in companies that were engaged in some activities (e.g., production of tobacco or alcohol, or products tested on animals, etc.); trade or investment in some countries (South-Africa in the 80’s, Burma today...); production or financing of weapons; production harmful to the environment; use of child labour, sweatshops... ; and disregard for employees, massive layoffs, etc.

The standards met the demand of the 80’s and were a first step towards *“ethics”*, by defining *“bad”* business practices: there was no predominant concern about sustainable development at that time, but these standards are still used and useful, with the limitations of exclusion standards (e.g., it is not because a bank happens not to finance land mine producers that they behave ethically).

Positive definitions:

As investor’s demands evolved, the standards also evolved to permit a qualitative definition of companies that aimed at a global *“social responsibility”* of corporations (Jones, 1980). The notion of *“social responsibility”* of companies is often associated with the notion of *“sustainable development”* of the economy; they both promote constructive labour relations, respect of the environment, and respect of the various partners or *“stakeholders”* of the company. Some concepts can be outlined, as follows:

Corporate Social Responsibility (CSR):

The concept of *“Corporate Social Responsibility”* (*CSR*) broadly includes the numerous ways in which corporations can be made more conscious of their impact on society. The debate about company prime responsibility is pretty old (Dodd, 1932; von Hayek, 1969; Friedman, 1970; Blair, 1995; de Woot, 2005) and it still opposes those who claim its sole responsibility is to make profits and those who say it is wider. The latter promote the corporate social responsibility approach, which itself can be either restricted to the immediate stakeholders (employees, customers, suppliers...) or broadened to community at large.

Balanced score card; multiple stakeholder indicators:

This is the oldest comprehensive approach in this matter, useful and constantly improving. To measure the performance of companies with respect to their impact on their stakeholders, one uses a set of standards that complement traditional accounting standards, measuring the quality of labour relations, the environmental impact, the relations with customers, subcontractors and suppliers at large, etc. (Clarkson, 1995; Carroll, 1999; Davenport, 2000; Steg *et al.*, 2003).

Such standards are a step towards defining sustainable development at the micro level, since they consider the sustainable aspect of what corporations do, in a positive sense, and increasingly include behavioural elements like how companies go about defining their setting of objectives, etc. The latest standards include the way in which companies consult, and report to, their various stakeholders; these are also sometimes called *"fourth generation"* standards.

More virtuous companies through their product:

Some products can be considered in essence rather favourable for sustainable development, such as renewable energy, education, health, etc.

This approach is tricky: does a heavy polluter become *"socially responsible"* because they make some reusable products or use recycled paper? It is a helpful approach, but should concern companies as a whole or at least the vast majority of their activities, not a limited part.

Fair trade:

Some companies specialize in the promotion of products that come out of fair trade. The main feature of fair trade is the remuneration of producers and middlemen; this remuneration is then supposed to be higher for local producers and middlemen in the developing countries to the detriment of the remuneration of *"multinationals"*. Products from fair trade are in principle not significantly more respectful of the environment (unless they carry an organic label), but fair trade excludes products when harvesting them would be harmful to the environment, such as protected species or protected sites.

Good and better standards?:

One cannot say that some standards are better than others; their quality and effectiveness depends on the context for which they are used, and on the quality of the data used to produce them. They are often used in combination.

3. THE INVESTORS AND SUSTAINABLE DEVELOPMENT:

There are several ways to allow the investors to send messages to companies about their approach to sustainable development; financial intermediaries (Zuinen, 2004) offer several ways to engage in what is globally referred to as Socially Responsible Investment (SRI).

Savings accounts, and deposit schemes in general, promoting solidarity:

Various banks and financial institutions offer deposit schemes in which some of the remuneration (one tenth to one quarter, typically) is paid not to the saver but to certain investment projects that promote solidarity and sustainable development. The number of

these accounts and funds is relatively low (reaching in Belgium less than 400 million euros as of the end of 2004, which is a fraction of a percent of Belgian bank deposits), and the amounts thereby directed to *"good causes"* are limited. This mainly funds some *"good causes"*, and the financial flows in themselves are not meant to influence corporate behaviour; the allocation of savings collected in this way is difficult to identify, as they enter into the financial flows of the financial institutions that collect them. Companies (and pop stars) other than banks do this as well (as, e.g.: *"if you buy my product, some money will go to tsunami victims or poor children…"*).

Some investment funds engaging in ethical, or socially responsible investing, as described hereafter, combine it with such a solidarity scheme. They are then called *"ethical and solidarity investments"*; they have accounted for a substantial part (20 %) of the total SRI in Belgium, but their share is decreasing, and is not significant in other countries.

Savings accounts with banks that practice *"ethical"* financings or *"sustainable development"* financings:

"Ethical" or *"sustainable development"* financings refer to deposits with banks that lend their money only to projects selected according to certain ethical standards or sustainable development standards.

There are few such specialized ethical banks. The main one in Benelux (*Triodos*) practices very strict standards and seems today to consider that it has no shortage of money to finance the projects it selects. Good projects seem to be less abundant. These banks may have only limited influence on the behaviour of companies at large, but they help the creation and the development of companies that foster sustainable development, the much needed *"pioneers"* in the market.

Moreover, banks in general are becoming more concerned about the environmental and social impact of projects they finance (Scott, 2004). However, they mostly have neither the same objective nor the same rigour as ethical banks about it, and they often are rather concerned to avoid embarrassing situations.

The amounts going through solidarity investment and ethical banks are limited; more money goes through financial markets and they probably offer the most potential to influence the behaviour of companies at large.

Financial markets:

Pension funds, universities, etc., as well as a large number of individuals are investing in ethical financial market instruments. These investors can identify on their own the type of stocks they want to own or avoid; they can also identify them through labels or ratings that follow the above mentioned standards. These labels and ratings are issued by specialized agencies (*Ethibel* in Belgium; *SAM* and *Vigeo* in France; *Avenzi* in Italy…). They can be of the different types mentioned: *"exclusion ratings"*, that are sometimes called *"first generation"*, and/or more behavioural ratings. Some indexes of listed companies also exist, selected by index managers such as *Dow Jones*, *Financial Times*, etc.; they provide a kind of implicit label as well.

Investors can also invest indirectly, through specialized investment funds that invest according to some standards (Social Investment Forum 2001; Avanzi SRI Research and SiRi Company, 2002). As previously stated, they are often called *"Socially Responsible Investment"* (*SRI*) funds.

Table 1. Some facts and figures on European investors taking an interest in SRI.

- *CSR Europe* and *Euronext* conducted an European-wide survey on *"SRI and the Financial Community"* in 2001 amongst 197 fund managers and 105 financial analysts.
- 44 % of interviewed investors perceived a specific demand for SRI products.
- Within the financial sector 33 % of respondents stated that their company already offered SRI products.
- 15 % said that their companies were planning to develop and introduce SRI products in the future.
- 15 % systematically offered SRI to all customers.
- There was being strong growth, but from a very low base.

Source: Corporate Social Responsibility Europe, Deloitte and Euronext (2003).

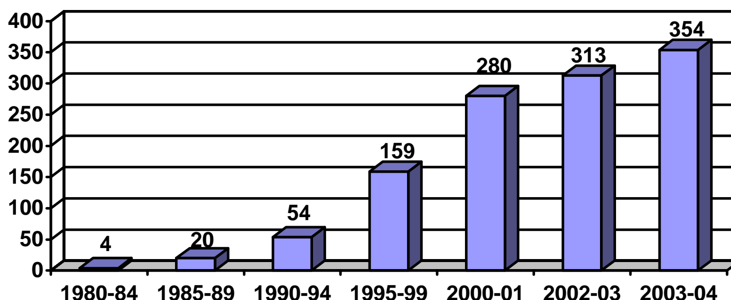
Some of these SRI funds are large enough, so that they do not rely on published labels and rating only, and select themselves the stocks in which they invest. This is the case of some specialized funds in Great Britain and the United States.

The units of these investment funds can then be bought by all kind of investors either individuals or institutional.

How important is it anyway?:

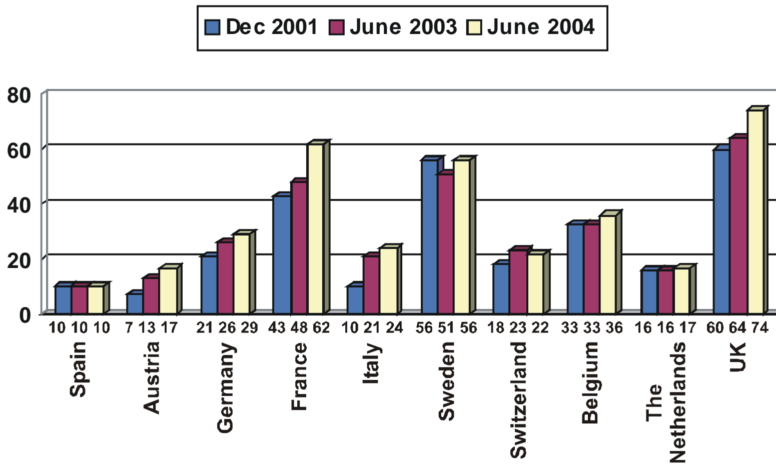
The influence of ethical investment on the markets has until now been bigger through example setting and through reporting, and more modest on the tracking of social responsibility, or the valuation of stocks in the market (Davenport, 2000; Cerin and Dobers, 2001; The Economist, 2004c; Donaldson, 2005; Keck, 2005). Table 1 shows that many companies and investors say they are concerned about responsible investment, but there is so far a gap between these good intentions and reality (as is often the case in matters related to *"good behaviour"*).

Figure 1. Number of SRI funds, cumulated, in the period 1980 to 2004 (situation on June 30th, 2004).



Source: Avanzi SRI Research and SiRi Company (2004).

Figure 2. Number of SRI funds domiciled in each country (situation on June 30th, 2004).



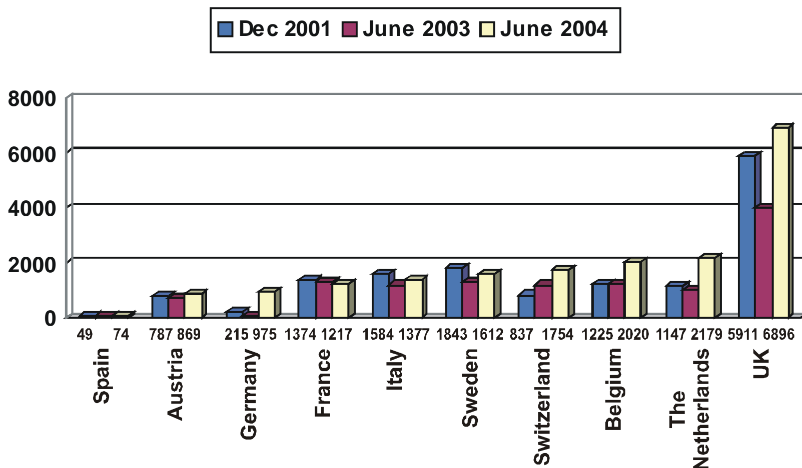
Source: Avanzi SRI Research and SiRi Company (2004).

The amounts are growing, but limited:

The number of ethical or socially responsible investment funds is constantly on the rise, as Figures 1 and 2 show. The size of these SRI funds, however, continues to be very small, as Figure 3 shows.

The total amount of funds managed in Europe is several trillion euros, and the amounts collected by socially responsible funds in Europe are about 1% of the total. This is much lower than in the United States where they amount up to 12 to 15% of professionally managed funds.

Figure 3. SR funds assets per country (million Euro, situation on June 30th, 2004).



Source: Avanzi SRI Research and SiRi Company (2004).

However, this needs to be seen in relative terms, because in the United States screening standards seem to be rather concentrated on exclusion (*"first generation"*) criteria. If one excludes the crude version of exclusion criteria (the *"sin-stocks"*, like tobacco and weapons), it is likely that the imbalance between Europe and the United States is not nearly as great.

The impact these investments have on the financial markets is limited. It is unlikely that these financial flows substantially affect the valuation of companies (Bauer, Koedijk and Otten, 2002; Zuinen, 2004). It is mainly first generation criteria that could have had a concrete impact, given the amounts involved through US investors, and many companies potentially affected (tobacco, oil, defence) are subject to some specific influences which can weigh on their valuation; during some periods these *"nasty"* companies have underperformed, during some others they have outperformed (the last few years they have done very well in the markets).

It is important also to stress that managers' surveys indicate a large and growing pressure put on them to report on Social Responsibility issues, and some willingness to do so, despite a good deal of scepticism (The Economist, 2004c). The number of companies reporting on CSR is increasing in most industrial countries in 2005 (Buck, 2005).

4. FUNDAMENTAL QUESTIONS REMAIN:

Are criteria and measurement of socially responsible investments reliable?:

Generally speaking, and as for the effectiveness of the standards, they are widely discussed. A survey by *The Economist* at early 2005 (Keck, 2005) about the reliability of socially responsible measurement discards them as ineffective: *"one problem with the triple bottom line is quickly apparent. Measuring profits is fairly straightforward; measuring environmental protection and social justice is not* [...]*"*. Other studies would agree or disagree (Berman *et al.*, 1999; Ranganathan, 1999; Margolis and Walsh, 2003), but they rather indicate some link, rather positive, between CSR and some financial performance, than the way to measure the impact of CSR on companies' behaviour and on society.

There remains an ambiguity about what social responsibility has to be measured, which stems partly from an ambiguity about CSR itself; should the non-financial performance be concerned with inner circle stakeholders (like shareholders employees, suppliers, natural resources, customers, creditors...), or with the community at large, the well being of people and the environment?

The socially responsible *"performance"* of companies is difficult to measure, and in many cases one has to rely on what is said by companies. Of course, information can be useful, and can lead to better definition of what has to be measured, but story telling alone will not get us very far, and can even be dangerous.

On the other hand, in practical terms, Table 2 is cause for some concern. It shows the companies whose stocks are most often found in European ethical funds according to the situation on June 30th, 2005. It is, of course, a snapshot, but an interesting one. It is worrying to realize that, in the 20 most favoured stocks, there are various companies that had, or have since then, shown less than *"socially responsible"* or ethical characteristics.

Table 2. The 20 companies most often found in European ethics funds (situation on June 30th, 2005).

Rank	Company	Rank	Company
01.	*Vodafone*	11.	*ING*
02.	*GlaxoSmithKline*	12.	*Svenska Handelsbanken*
03.	*Astrazeneca*	13.	*Sanofi-Synthelabo*
04.	*Johnson & Johnson*	14.	*Royal Bank of Scotland*
05.	*BP*	15.	*TeliaSonera AB*
06.	*Hennes & Mauritz*	16.	*Telefónica*
07.	*Ericsson AB*	17.	*Intel*
08.	*HSBC Holdings*	18.	*Förenings Sparbanken*
09.	*Nordea Bank*	19.	*Pfizer*
10.	*Citigroup*	20.	*Royal Dutch Petroleum*

Source: Avanzi SRI Research and SiRi Company (2005).

So, some of these pharmaceutical companies have been quite unethical in their behaviour *vis-à-vis* the regulators or tax authorities, their retention of information concerning the side effect of their products, or the way in which they conduct their research (*Pfizer* facing some well publicised –but not isolated– cases).

There is also in the list one bank that has been charged for unfair behaviour toward investors in the US in 2002-2003 (*Citigroup*), and since then has been known for various other misbehaviours in Europe and Japan (Wighton, 2005). There is an oil company (*Royal Dutch*) that has admitted to have been providing false statements on its reserves for several years. Another oil company (*BP*) has been accused of negligence that resulted in various accidents and casualties in Alaska and Texas.

Telecom companies are well represented in the list because they do not produce visible pollution, yet the way in which they use (and *abuse*) dominant positions, and market their products towards teenagers is not always *"socially responsible"*.

At least two of these companies (*GlaxoSmithKline* and *Citigroup*) have been attacked by some large shareholders for allegedly overpaying their CEO's.

Most of these companies were then –and they are– included in some *"good company"* indices.

Some obvious holes in the definitions?:

The *"social responsibility"* has thus far been defined mostly in terms of environmental and labour relations, sometimes also in terms of global stakeholder relations, but the problem of defining social responsibility exists, even in this limited definition (some companies claim a project that is devastating for the environment is socially responsible because it creates jobs).

Moreover, in the future, *"social responsibility"* should increasingly address problems like the attitude of companies' *vis-à-vis* their clients, including the way in which they design and market their products. Products can be dangerous or lethal to consumers, particularly in case of over-consumption, which some marketing strategies encourage. Many pharmaceutical companies are suspected to overspend on marketing and promotion, inducing over-consumption detrimental to patient's health and the finances of health care systems alike (Bowe, 2004; The Economist, 2004c; Cookson, 2005). The behaviour of drug companies towards research seems at times less than ethical (Horton, 2004). Food companies are also accused of inducing their clients to over-consume products detrimental to their health by over-promoting their product, and hiding their less attractive sides. Both food and drug companies are running the risk of the same type of litigations that have plagued tobacco companies for years (The Economist, 2004e; Grant, 2005).

The attitude of companies *vis-à-vis* markets and competition is also important; profits made in competitive markets are a good and reliable indication of wealth creation. In case of a monopoly or oligopoly, the profits do not have that quality, because the monopolist (oligopolist) can overcharge with little or no challenge, and thus make profits that cause prejudice to clients rather than indicate value creation for the economy; this remains the core principle of the market economy. Many mergers and acquisitions are therefore a problem: the majority of these transactions are economic failures, value destructing (Jensen and Meckling, 1976; Ravenscraft and Scherer, 1987; Franks and Harris, 1989; Hart and More, 1995[3]); they happen nevertheless if only, because they reduce competition and because investment banks and other advisors promote them actively so as to earn lucrative fees on them. Anyway, companies that are condemned by competition authorities could hardly be considered socially responsible, at least for a while, until they show more respect for markets.

The remuneration discrepancies within companies is an issue, mainly CEO compensation (Bertrand and Mullainathan, 2001; Michaels, 2004); the excessive use of stock option could be considered contrary to social responsibility, because they can antagonise shareholders, workers, and the community. Since there does not seem to be much link between pay and performance, many remuneration packages –with or without stock options– encourage greed rather than performance, and greed is not the type of decent pursuit of self interest which the market economy is based upon and which encourages sustainable development.

Many companies provide lengthy reports on their social responsibilities, and ethical behaviour. The problem with the reporting freely provided by companies is that, for instance, a tobacco company can report on its CO^2 emissions (The Economist, 2004b), a bank about the safety of its products for its customer's health, and a hedge fund about the quality of its labour relations; none is relevant for the core of their activity.

The debate about the right criteria and the assessment process will continue, but it is difficult, to say the least, to determine that a company is *"ethical"* or *"socially responsible"*. In the very least, it should not be judged on the basis of what the company says about itself, without commitment or control.

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[3] See also Henry and Jespersen (2002), and The Economist (2005).

Do *"socially responsible"* investments perform better?:

This matter has been widely debated and studied (Hutton, D'Antonio and Johnsen, 1998; Loiselet, 2000; Bauer, Koedijk and Otten, 2002). There is no evidence that ethical or socially responsible investments perform better or worse as investments than others, except for sector-related divergences during limited periods (Statman, 2000), or a bias for investing in smaller companies (Zuinen, 2004).

It is legitimate to ask the question, but it should not by any means be the only way to judge SRI, specially since many investors are interested in it for moral and ethical reasons.

Some promoters of SRI are a bit ambiguous about this question, because on the one hand they expect people to invest in SRI to be motivated, not by greed, but by ideals like they themselves are. On the other hand, they (want to) believe that by being socially responsible, companies will reduce risks, improve goodwill... and that it will be shown on their earnings, at least in the long term, and in valuation by the markets, thus making SRI financially rewarding. There does seem to be some positive relation between CSR and financial performance of companies (Ditz and Ranganathan, 1997; Margolis and Walsh, 2003), but a lot of scepticism as well (Keck, 2005), and anyway no long term out-performance of socially responsible investment so far.

There are also promoters of SRI who do it as business, and do not shy away from proposing SRI as an investment with a better potential than others, because those companies, being more symbiotic with sustainable development, will have more sustainable long term profitability.

Do ethics and social responsibility pay anyway?:

Let us not be *naïve* about the matter. A part of neoclassical economy has been based since Adam Smith on the assumption that it pays to be honest in trade, but the world may have changed.

Some people and companies who used to consider honesty and ethics as their main asset seem to have decided that ethics do not pay, and that a non ethical approach can be very profitable. Investment bankers have made fortunes since the 1980's by deceiving their clients, and when they were caught in 2003, fines were a fraction of the booty. Some of their practices amounted to no less than cartel, blackmail, bribery and corruption[4]. This is particularly dangerous when they push companies in doing mergers and acquisitions that are bad for them and detrimental to the market, just because of the (absurdly high) fees investment banks earn on them. It is equally dangerous when they convince fund managers to neglect their investor's interest in exchange for some kickbacks, soft commissions, etc. Likewise, auditors bargained their *"professional"* advice against consulting fees, lawyers often seem more interested in making a deal than advising a client...

[4] See the various cases against investment banks brought by Elliot Spitzer, Attorney General of New York, and various articles on this (for instance in *The Economist* or the *Financial Times*), or books (Augar, 2000 and 2005). See also Rohatyn, a leading banker (2002a and 2002b). See also a strong article in *Fortune* (Tully, 2002), with a clear title *"Is Wall Street Good for Anything?"*: *"…Today scandals could breed no reform more important than to kill the Wall Street levy. The abuses centre on three areas: equity research, mergers and acquisition, and IPO offerings"*.

As to the environment, global warning, depletable resources, harmful products[5], companies regularly fight any restrictive measures, claiming they would harm business, which means *"reduce their profits"*. Tobacco and liquor manufacturers, but also pharmaceutical and food companies have repeatedly shown more concern for quick profits than for scientific truth, or the health of their clients. Likewise, dominating a market is very profitable for the dominator(s); free competition is good for the economy but not for individual companies. In fact this can be said of social responsibility in general: it brings advantages to companies in general and to the economy, but could be costly to individual companies. It is thus not obvious at all that companies which are really socially responsible would be more profitable.

The credo of some who claim that corporate social responsibility is profitable and that companies will engage in it without constraints is at least *naïve*.

What is the objective of a joint-stock company?:

In a market economy, every actor is supposed to pursue their interest, and an *"invisible hand"* within competitive markets ensures that this translates into optimal efficiency and wealth creation[6].

The merchants and the Temple:

The concept of company started in 13th century in Italy as an entity with a legal personality to facilitate a business project (by allowing association of various owners, limitation of liability, etc) with the same (short term) objective of enrichment in trade that motivated the merchants who owned it. When in 1602 the *"mother"* of all companies, the *Dutch East India Company* (*VOC*), was incorporated in Amsterdam to do business in the Far East, it included many features borrowed from those great religious institutions which Dutch protestants disliked but did not underestimate: the monastic and militant orders (amongst which the order of the Temple with its trading and financial network spanning the Mediterranean World had been paramount). The *VOC* was managed by a collegial board, it had long term objectives going beyond trading profits, a loyalty instead of a mercenary relation with the people it employed, and it sought what could be called an *"institutional culture"*. The concept of company has thus a double heritage: the merchants and the Temple[7].

The rise of the company, and of economic power:

Competition and darwinian selection is a powerful economic engine, and so is cooperation; companies behaving in a competitive market allow both mechanisms to develop[8].

The company is a major institution of economic development, but prone to institutional instability: its interest is usually defined in function of third parties rather than the company's; those who work for companies (including those that manage them) are not

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[5] The question of harmful chemical products (REACH) and that of the carbon taxation are interesting cases: industry federations made a lot of noise about them, despite scant evidence that they would harm the economy in general, because some vocal companies would lose some business.

[6] For various ways to look at it, see Smith (1776), Coase (1937 and 1960), and von Hayek (1969).

[7] See also De Keuleneer (1997 and 2003).

[8] Alfred Chandler (1977) said famously that the visible hand of management could be more efficient than the invisible hand of the market, justifying the rise of the company.

supposed to pursue first their self-interest, but the interest of the company. Some mechanisms try to somehow align both, but difference always remains; this is what economist call the *"agency problem"*.

The board of directors is supposed to control that the interest of the company is taken care of by the management, and various rules (the corporate governance rules) try to ensure that the interest of the company is well defined, translated into clear objectives, and that these objectives are correctly pursued.

At this point, the US type of market based company has played the leading role worldwide since 1945 because of its efficiency and the economic and political domination of the United States.

After a period of wild growth that culminated with dreadful excesses in the 1920's, the US model of company came under strong regulation in the 1930's; professional managers received the central role (hence the term *"managerial company"*), and played it efficiently until the 1970's, when excesses of the agency problem intensified and led to a wave of hostile takeovers in the 1980's.

The pursuit of profit has been used –increasingly since the 1980's– to measure the efficiency of companies and address the agency problem. It also has lead to excesses, when the motivation of CEO and management is excessively linked to short term profit. The use of stock options, which give large capital gains in the case of stock price rises, has been associated with such excesses; it brings windfall profits in many cases, and it has motivated many managers to concentrate on stock prices and the *"managed information"* (read: accounting manipulation and propaganda) that make them rise. The central characteristic of the US model remains that it is dominated by professional managers even though since the 1980's they have been put under (some) pressure by shareholders. The profit objective thus became dominant; the term *"shareholder value"* summarizes what the company's objective should be.

This has led companies to gain in efficiency, but managers had become motivated to be greedy. Some companies started to behave in ways that were detrimental to employees, the environment, their clients, etc. A very potent alliance between CEO's and investment banks, both motivated by greed, led to the massive stock market manipulation in 1995-2002.

The US company has thus been oscillating between its two heritages: the merchants until the 1920's; the Temple from the 1930's to the 1970's; the merchants since the 1980's.

One should thus not discard the pursuit of profit as a legitimate goal for companies that create value, but one should also remember that some profits are the result of deceit, fraud, monopoly, lobbying, abuses..., and thus anti-social as well as anti-economic. Some people would nevertheless like us to believe that making profit is almost a proof of virtue; it can also be the opposite.

For companies to pursue profit, if they do it honestly, is not anti-social and can lead to public good. A very unpleasant aspect of the profit motive is that it may become too universal, for instance when municipalities pursue it as well when evaluating urban planning, or when the intellectual property maniacs want us to believe than no creative work is motivated by anything but profit.

The economic system is based on the individual pursuit by economic agents of their self interest. Even though some economists would prefer them to be only pursuing their financial interest because that fits easier in data bases, individuals have objectives that are much wider and more subtle. Companies also should have wider objectives than just to make money, but this is much more delicate to achieve, because of the complex decision-making process and the agency problem in companies. The priority given to profit making is thus a simplification, maybe an oversimplification, but it works (and makes economists' models work better).

The alternative model:

An alternative to this *"shareholder value maximization"* has been sought (Freeman, 1984; Blair, 1995; de Woot, 2005). One such alternative is the *"stakeholder value"*, whose theoretical basis goes back at least to the 1930's as well (Dodd, 1932). It remains rather theoretical, as long as it does not offer objectives that are an efficient alternative to economic profit, but it allows a discussion on the respective merits of the two models, even though the first is overwhelmingly followed in practice.

The case for regulation:

Most economists consider that a good regulatory environment is needed to have markets functioning well, even though some members of the *"profit is all that counts"* crowd disagree, and consider that in a perfect world regulation is mostly disruptive. This may be true, but as long as the world is not perfect, regulation is necessary. Good regulation –amongst other anti-trust regulation, environmental regulation and safety regulation– can reduce profits for some, and regulation will be deemed negative by those.

Since the modern corporation far surpasses in bargaining and lobbying power the butcher and the baker of Adam Smith times, one may fear that the best interest of corporations will not necessarily mean the best interest of consumers[9], and that good regulation should be a major concern of legislators, whether it is for food, drugs, or other sectors. A prominent business paper does not hesitate to write (Arndt, Carter and Arnst, 2005)[10]: "*without stronger federal guidelines, food makers will keep pushing junk"*, even though –or because– they are strong free market advocates. The *"stronger guidelines"* are still lacking, in the US, but also in the EU. Many have advocated the same for investment banks but also with little success: the lobbying power of investment banks is so enormous that they could so far escape any meaningful reforms.

Since the economy is short of good regulation, social responsibility indicators could function as a first line regulatory mechanism, by better approaching what is a *"decent"* profit, one that benefits the economy.

The need to make SRI indicators efficient:

Social responsibility should be measured against all the activities of a corporation, in ways that enable comparisons in time and among peers (Steg *et al.*, 2003; Donaldson, 2005). SR indicators are of little use if companies report only on matters they are comfortable with.

[9] Coleman (1982 and 1990), Eraly (2003), Bakan (2004), Ostros (2005).
[10] See also Bowe (2004), The Economist (2004a) and Grant (2005).

Indicators including these elements should be reliable, and thus the information on which they are based should be audited. The information provided by subcontractors and suppliers should also be reliable. When companies or their managers are found guilty of trespassing laws and the rules (be it social rules, tax rules, accounting rules, competition rules, product safety rules), this should be highlighted and included in those indicators.

A few initiatives aim at offering the kind of framework that is needed, like that by the University of Groningen (Steg *et al.*, 2003), the GRI (*Global Reporting Indicators*) and the CSRR (*Corporate Social Responsibility Reporting*); few companies seem willing to accept constraints at the moment, but the GRI is gaining more acceptance, and SRI funds are putting more pressure on corporate governance issues (Social Investment Forum, 2005).

Effective SRI indicators would be a help to those directors and those investors that are truly concerned by the social impact of the companies they oversee and invest in (Elkington, Kuszewski and Zollinger, 2001), and wish to make the difference between a decent profit objective in the long term, and short term greed. They could also be used to determine CEO's bonuses, thereby aligning everybody's interest. In their present form, they are useful because they are forcing a debate, and they are showing the way for what has to be done. But it is premature to use them as a selection tool to determine whether a company actively cares about its social responsibility on a simple scale. Worse, as long as the social responsibility movement remains based on voluntary action and reporting by companies, there is a risk that these labels may be used as a smokescreen by companies that behave irresponsibly (Keck, 2005), a practice called *"greenwashing"*.

5. CONCLUSION:

Efficient social responsibility indicators could thus provide some help in order to better approach the problem of corporate social responsibility by boards of directors and by investors.

For companies to alter their behaviour, it will take either increased and improved regulations and/or new market mechanisms (Monks and Sykes, 2002; Stiglitz, 2002; de Woot, 2005). Regulation is not easy, the role of regulators is made ever more difficult by the power of lobbies and the complexity of the economy. It is weakened by the increasingly nationalistic concerns of public policy in the US and Europe alike. The reinforcement of international regulation is particularly important for matters concerning labour relation, the environment, or competition, but it regularly falls short of what is needed.

Corporate Social Responsibility (CSR) or Professional Social Responsibility (PSR)?

A company will be as ethical or socially responsible as the people that manage and control it are. Large, listed companies are run by CEO's and controlled by markets. To encourage the socially responsible behaviour of a company it would thus be a good thing to concentrate first on the behaviour of all the people who have professional duties *vis-à-vis* it. The notion of *Professional Social Responsibility* (*PSR*) might be a great step towards *Corporate and Social Responsibility* (*CSR*).

The PSR of CEO's should be to optimise decent profit in the long term; the PSR of internal lawyers could be the compliance of the company with legal, regulatory, and social responsibility issues in general; the PSR of directors should be to evaluate, remunerate and sanction CEO's strategic and operational performance correctly; the PSR of employees of

any company should be to follow a clear code of conduct the company has adopted; if lawyers, financial analyst, brokers, fund managers, regulators, politicians, physicians, etc. were all to pursue PSR, the world would probably be a much better place. In some professions there are codes of ethics that describe professional duties: we need them to be improved, we need more of them. They have to be more than public relation exercises, and help clients and the judiciary to distinguish between right and wrong behaviour. Initiatives are timidly being taken to introduce such codes for investment bankers (Wall Street Journal, 2005), who very much need one, but are not keen to adopt one.

The difficulty is to monitor how every one is following a decent code of professional conduct. Internal control mechanisms, workers councils, boards of directors have to monitor how employees and managers do it. Consumers can play an important role by demanding that their suppliers do it; all investors could require it from directors they elect.

Investors could require it from professional fund managers; it is central to our subject of socially responsible investing, and it is very important because it can be the starting point of a change in attitude, since so much today seems to be submitted to the pressure of investors.

Active and Responsible Investors is What We Need:

The market-based capitalism has been in turmoil since the 1980's, when it became clear that boards of directors had failed to monitor CEO's, and shareholders failed to sanction boards of directors. Shareholders have to play their role. As Monks and Sykes (2002) have said: *"capitalism without owners will fail"*. *"Responsible investors"* may be a better term than *"owners"* (a company is not an object) but, anyway, speculators are not the same thing as investors: it is from *bona fide* investors that the signals must come.

Active and responsible investors maybe the best hope for forcing boards and CEOs to take their responsibilities seriously, and stop confusing wealth creation with greed. This will not in the immediate future be achieved by labels on companies, but it can be achieved by thousands of professional investors around the world attending annual general meetings of shareholders, asking questions, challenging boards on social responsibility and ethical issues, challenging empire building, acquisition policies, the payment of excessive fees to bankers, advisors and lobbyists, and the excessive compensation of CEOs, voting against the reappointment of deficient board members and CEOs. Responsible investors should also select bankers/brokers who demonstrate they can act responsibly and avoid conflicts of interest. Thousands of active investors can bring about –for each company, taking due account of its characteristics– the kind of market based subtlety that is needed, because they can each bring their own vision of what is the right balance between short term and long term objective, between shareholders' and other stakeholders' interests. Shareholders assemblies (AGMs) and markets will work out what is best for each company.

Most individual investors have no time or resources to do that, and mutual funds and many institutional investors are today not very active shareholders for a number of reasons, like cost and conflicts of interest. They are induced to take a more active part in AGMs by some rules in the US, and now France and the UK, but they mostly practice box ticking and add little value.

In fact any professional money manager –and particularly those who want to sell *"socially responsible investments"*– should be an active and responsible investor; this, and the criteria use to select the bankers/brokers they do business with, should be the two main pillars on which to evaluate their Professional Social Responsibility (PSR); it would be very useful for end investors to get assistance in judging how the money manager they entrust their money to, behave in this matter. We know that a large number of end investors are concerned by the SR content of their investment; their prime concern is probably that socially responsible investment has an impact on the way the markets work and on the way corporations behave, rather than on the number of pages they publish with unchecked information of variable relevance. This impact depends on the good working of boards of directors, which itself depends on the good working of AGMs and the vigilance of shareholders. Investment funds, but also pension funds should be encouraged to report on these matters, and be rated as to their behaviour by specialized rating agencies. Some pension funds, mostly public employee funds (like *CalPERS* in California) have been doing this for time, with real success and, according to studies (Business for Social Responsibility, 2006), significant positive impact on valuations. Private pension funds are less active, and may have conflicts of interests (in the US, company management often appoints pension fund managers, and prefer them to be not *"too active"*), which should be dealt with: their activism should be evaluated and encouraged.

Rating agencies that specialise in social responsibility criteria are doing a useful job today in devising and refining criteria, and in encouraging an increasing number of companies to report on social responsibility issues. But their *"labels"* on companies are insufficiently reliable. It would be of great use that they use the tools they are developing to rate money managers about the way they pursue their Professional Social Responsibility; this rating should include a reliable report on the way in which they attend AGMs, ask the right questions about social responsibility issues, and vote with the shares they manage. It may well be that for a considerable time, there will not be such a thing as a social responsible investment without *"socially responsible investors"* to start with.

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