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## CSR and Value Creation

### WHAT DO WE WANT?

As a society, what, exactly, do we want from our economic system? Because CSR is generally defined in terms that link the behavior of individual businesses to macroeconomic outcomes (see Chapter 1), this question anchors CSR in much the same way that vision or mission statements anchor the strategies of individual firms. The first step in making CSR relevant for individual firms, therefore, is to make these objectives explicit.

In his 1953 book, *Social Responsibilities of the Businessman*, Bowen lists eleven macroeconomic objectives: high standard of living, economic progress, economic stability, personal security, order, justice, freedom, development of the individual person, community improvement, national security, and personal integrity.<sup>i</sup>

In their 1966 textbook on the relationship between business and society, Keith Davis and Robert Blomstrom list the following areas of potential social involvement: ecology and environmental quality, consumerism, community needs, governmental relations, business giving, minorities and disadvantaged persons, labor relations, stockholder relations, and economic activities.<sup>ii</sup>

These lists remain relevant more than fifty years later. For example, during the 2012 U.S. presidential debates between Barack

Obama, the incumbent and Democratic nominee, and Mitt Romney, the Republican nominee, nearly every item on these lists was addressed as each candidate attempted to communicate his respective aspirations for the U.S. economy. Although there may be disagreement regarding specific items, these objectives nevertheless serve to anchor the concept of CSR. As observed in Chapter 1, at the heart of CSR is the notion that individual firms have a responsibility to behave in a manner that contributes to the realization of desired economic outcomes. These lists represent a laudable attempt to make these outcomes explicit.

## **HOW DO WE GET THERE?**

Even though there may be general consensus about what we want from our economic system, there is still significant debate over the means of getting there. This is because it is often difficult to determine what participants in our economic system should do in order to produce the outcomes we want. The following scenario illustrates why making this determination can often be difficult.

Imagine that fire has just erupted in a crowded theater with only one narrow exit. Furthermore, assume that everyone in the crowd is able to immediately assess the situation; if the crowd exits as quickly as possible, seventy-five percent of those in the theater will survive. Assuming everyone is committed to the best outcome for the group—a seventy-five percent survival rate—what should each individual do? Because the exit is narrow, movement of the crowd will resemble the movement of sand through an hourglass. Like the sand at the top of the hourglass, at the back of the crowd, movement will be almost indiscernible. As individuals in the crowd move forward, however, the width of the group will narrow and movement toward the door will accelerate. Even though the group objective is to exit as quickly as possible, the most effective way for the individuals in the back to contribute to a rapid exit is to move slowly towards the exit, being careful to avoid jostling or pushing individuals in front of them.

For those in the back of the crowd, moving slowly towards the exit may seem like a counterintuitive way to increase the speed at which the group is able to exit. If those in the back attempt to move

more quickly, however, individuals will fall down (or be pushed to the ground), and chaos will ensue. This will slow the group down and fewer people will escape. For those in the back of the theater, however, because not everyone will be able to exit, contributing to an orderly exit by moving slowly reduces the odds of their survival to zero. This creates a critical divergence between what is in the best interests of those individuals in the back of the theater, and what is in the best interest of the group. They can improve their individual odds by attempting to move more quickly, but by doing so they will induce panic and thereby reduce the group's overall rate of exit. We will revisit the issue of divergent incentives later in this chapter.

The same counterintuitive relationship between individual behavior and group or collective outcomes exists in economic markets. In properly functioning markets, it is assumed that self-interested behavior by participants will produce optimal macroeconomic outcomes. As Adam Smith observed of a representative market participant, "by pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it."<sup>iii</sup> John Maynard Keynes is reported to have stated the same idea this way: "Capitalism is the astounding belief that the most wickedest of men will do the most wickedest of things for the greatest good of everyone."<sup>iv</sup> Just as moving slowly in the fire scenario described earlier counterintuitively contributes to the speed at which the group is able to exit, in the case of economic markets, working to promote one's own interests is often the most effective way to contribute to collective or societal interests. It is important to note, however, that although the links between individual behavior and group or system outcomes are counterintuitive in both instances, in the case of economic markets, there is an alignment of individual and group interests (i.e., what is in the best interest of the individual is also in the best interest of the group). In the fire scenario, in contrast, there is a divergence between individual and group interests.

As these examples illustrate, the link between participant behavior and system outcomes is often difficult to predict. In early research on crowd behavior, it was often mistakenly assumed that the characteristics of aggregate behavior were indicative of the character of the behavior of individual participants. If observed

crowd behavior was erratic, emotional or irrational, for example, then it was assumed that the behavior of individuals in the crowd was also erratic, emotional or irrational. Subsequent analysis revealed that these early assumptions were mistaken. Rational individual behavior can produce collectively irrational behavior—a situation often referred to as “collective irrationality.”<sup>v</sup> This can be seen clearly in the theater fire example. Rational behavior by individuals in the back of the crowd—attempting to move more quickly to the exit, and thereby increasing their own odds of survival—would produce a collectively irrational outcome (i.e., a suboptimal exit rate for the group).

From a CSR perspective, establishing a clear link between individual behavior and group or system outcomes is essential. In contrast to the invisible hand of economic markets, CSR asks businesses to explicitly consider societal expectations with regard to specific macroeconomic outcomes, and to then regulate their behavior in order to satisfy these expectations. Unless businesses are able to establish a reliable link between their behavior and these outcomes, businesses cannot be expected to effectively contribute to their realization.

Market theory is often the default method of linking business behavior to macroeconomic outcomes. It is unfortunate that CSR is often viewed as separate from—or in some cases, antagonistic towards—traditional market-based activities. This is understandable, however, given that CSR efforts are often motivated by a desire to mitigate market deficiencies. On the other hand, establishing links between business behavior and macroeconomic outcomes is critical to CSR, and market theory represents a well-developed and empirically-tested framework for reliably establishing these links. In situations in which markets are dysfunctional or absent, other methods are needed. One of the potential contributions of scholarly CSR dialogue is the development of alternative frameworks that can be applied in these situations.

The question “How do we get there?” was posed at the start of this section. Stated more formally: Assuming we know what we want from our economic system, what should system participants do to contribute to the outcomes we want? The remainder of this chapter focuses on different ways of linking business behavior to macroeconomic outcomes. Even though there may be broad

consensus regarding the macroeconomic outcomes we want, there is still likely to be considerable debate about the most effective means of realizing these outcomes. As you read the remainder of the chapter, consider why this is the case.

## **THE PERFECT COMPETITION MARKET MODEL**

As one prominent author asserts, “the ideal of a free, self-regulating market is newly triumphant . . . unfettered markets are deemed both the essence of human liberty, and the most expedient route to prosperity.”<sup>vi</sup> Popular understanding of how markets function is captured in the perfect competition market model (PCMM). The PCMM is a simplified model of economic markets that satisfies a number of important conditions, including a large number of buyers and sellers, fully-informed participants, and the free movement of productive resources. The PCMM is the quintessential economic market—decentralized, self-regulating, and fiercely competitive.

The logic of the PCMM is straightforward. There must be a large number of independent buyers and sellers. No market participants can have the ability to affect market prices, and products must be interchangeable (i.e., homogenous). There can be no barriers to entry or exit, no artificial restraints on prices, and all participants must be fully informed.<sup>vii</sup> If these conditions are met, then the profit motive ensures that firms that supply goods and/or services will closely monitor their costs and will do everything within their power to increase efficiency and minimize waste. In addition, firms will also strive to accurately determine their optimal level of output, based on the prices of inputs, their own production function, and the market price of the good or service in question. If they produce too little, they surrender potential profit. If they produce too much, the firm is responsible for the associated losses. The process of determining how much of a particular good or service to supply makes companies sensitive to price fluctuations. For example, an increase in market price may induce a company to significantly increase production. In contrast, an increase in the price of a key input may induce a company to significantly reduce production. Competitive pressure, therefore, creates powerful incentive for

companies to not only produce goods and services efficiently, but to also produce them in the right quantities.

Because products in a particular market are interchangeable, intense competition forces companies to strive to offer consumers a superior value proposition. Competitive jockeying results in the lowest possible market price, and this ensures that the largest possible quantity is demanded and exchanged. This, in turn, results in the greatest amount of subjective economic well-being. In the precise language of economists, efficient markets lead to productive and allocative efficiency (i.e., goods and services will be produced efficiently, and in the appropriate quantities), and to the maximization of social surplus (i.e., economic well-being will be maximized).<sup>viii</sup>

It is important to recognize that the PCMM explicitly links individual behavior and macroeconomic outcomes. It is assumed that if businesses are motivated by a desire to maximize profit, their behavior will lead to productive and allocative efficiency, and the maximization of social surplus. In the context of the PCMM, therefore, it follows that if businesses want to contribute to the realization of these outcomes—as CSR suggests they should—then businesses should seek to maximize profit.

## The Friedman Doctrine

In 1970, Milton Friedman, an economist and recipient of the Nobel Prize in Economics, authored a short article in the *New York Times* in which he articulated a view of CSR that has become known as the “Friedman Doctrine.”<sup>ix</sup> This doctrine asserts that the primary social responsibility of a business is to increase its profits. The following paragraphs are excerpted from Friedman’s *New York Times* article:

What does it mean to say that the corporate executive has a “social responsibility” in his capacity as businessman? If this statement is not pure rhetoric, it must mean that he is to act in some way that is not in the interest of his employers. For example, that he is to refrain from increasing the price of the product in order to contribute to the social objective of preventing inflation, even though a price increase

would be in the best interests of the corporation. Or that he is to make expenditures on reducing pollution beyond the amount that is in the best interests of the corporation or that is required by law in order to contribute to the social objective of improving the environment. Or that, at the expense of corporate profits, he is to hire “hardcore” unemployed instead of better qualified available workmen to contribute to the social objective of reducing poverty. In each of these cases, the corporate executive would be spending someone else’s money for a general social interest. Insofar as his actions in accord with his “social responsibility” reduce returns to stockholders, he is spending their money. Insofar as his actions raise the price to customers, he is spending the customers’ money. Insofar as his actions lower the wages of some employees, he is spending their money.

....

But the doctrine of “social responsibility” taken seriously would extend the scope of the political mechanism to every human activity. It does not differ in philosophy from the most explicitly collective doctrine. It differs only by professing to believe that collectivist ends can be attained without collectivist means. That is why, in my book *Capitalism and Freedom*, I have called it a “fundamentally subversive doctrine” in a free society, and have said that in such a society, “there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.”<sup>x</sup>

Friedman’s assertion that “there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits” is often cited by CSR critics to justify a focus on profit maximization based exclusively on financial accounting.

For Friedman, the primary manifestation of CSR during the time he wrote this article was what he perceived as growing pressure to obligate businesses to engage in charitable efforts to solve persistent social problems, such as underemployment or poverty. Friedman viewed this pressure as an attempt to appropriate private property (i.e., business assets) for public purposes. Friedman viewed this as an alarming erosion of private property rights and therefore asserted that CSR was a “fundamentally subversive doctrine” (Friedman, 1970: 2)<sup>xi</sup>

It is important to recognize that Friedman’s concept of CSR as a kind of obligatory philanthropy is different in a number of significant respects than a view of CSR that emphasizes the link between the actions of individual businesses and outcomes for which they—considered as a group—are directly responsible. Friedman may have been correct to assert that obligating businesses to address enduring social ills for which they have no direct responsibility would fundamentally alter the DNA of market-based economies. This position, however, is only tangentially related to the assertion of contemporary CSR advocates that businesses have a responsibility to consider the link between their individual actions and associated group or system outcomes that satisfy societal expectations. If Friedman’s assertion that businesses should stay within the “rules of the game” is interpreted as an admonition for businesses to conform to societal expectations in this respect, then Friedman’s position is more supportive of a contemporary understanding of CSR than critics generally acknowledge.

## **ALTERNATIVE FRAMEWORKS**

Although the PCMM reflects common understanding of economic markets, it is not the only method of connecting individual behavior to group or system outcomes. Markets require a number of supporting institutions and must satisfy a number of conditions if they are to deliver optimal outcomes. The term “market failure” is used to describe situations in which markets fail to function properly.<sup>xii</sup> As demonstrated by the financial crisis of 2007–2008—the worst economic crisis in the U.S. since the Great Depression in the 1930s—in some cases, market failure can be catastrophic.<sup>xiii</sup> In

situations in which market failure is likely, government or social action can often produce superior outcomes.

From a CSR perspective, it is important that businesses understand when the pursuit of profit is likely to contribute to the social good, and when it is unlikely to do so. Market failure explanations are similar to the PCMM in the sense that they link individual behavior to specific group or system outcomes. In contrast to the PCMM, however, a market failure approach connects individual behavior to inefficient or undesirable outcomes.

Social dilemmas, defined as “interaction situations in which rational individual behavior produces irrational group or collective outcomes” represent another method of connecting individual behavior and group or system outcomes.<sup>xiv</sup> Social dilemmas, in contrast to both the PCMM and market failure, focuses on situations in which the incentives or payoff for each individual are dependent on the actions of other participants. In these situations, the link between participant behavior and system outcomes is often counterintuitive (e.g., the fire scenario used earlier in the chapter), and self-interested behavior (i.e., “profit maximizing” behavior) will often lead negative group outcomes.

## **Market Failure**

Market failure, as defined by one of the first economists to use the term, is “the failure of a more or less idealized system of price-market institutions to sustain ‘desirable’ activities or to estop ‘undesirable’ activities.”<sup>xv</sup> Stated simply, market failure occurs when markets fail to deliver efficient outcomes. Market failure is likely when there are 1) externalities or spillover effects, 2) public goods, or 3) monopolies or oligopolies, natural monopolies, network externalities, information problems, or other structural idiosyncrasies that impede competition or create other incentive problems (see Table 3.1).

An *externality*, or *transaction spillover*, is a cost or a benefit that is not reflected in the price of a product that affects an unrelated third party. Environmental pollution is an example of a negative externality. If the manufacturing process associated with a particular product or service, for example, were to result in a significant amount of pollution, but the cost of this pollution were not

**TABLE 3.1** Types of Market Failure

<i>Causes</i>	<i>Problem Description</i>	<i>Example(s)</i>
Externalities	Costs or benefits that are not reflected in the price of a product that affect unrelated third parties lead to over-supply or undersupply.	pollution (negative); LoJack (positive)
Production of Public Goods	Free-rider problems created by goods that are non-rivalrous (consumption does not decrease their availability) and non-excludable (benefits are difficult to restrict to those who contribute to their production) lead to undersupply.	national defense
Monopolies & Oligopolies	Insufficient competitive pressure results in insufficient efficiency incentives and prices that are too high to maximize overall economic value.	any market controlled by one or a small number of companies (movie studios, cell phone service providers, beer industry)
Natural Monopolies	Economies of scale over the entire demand range lead to higher prices because dividing up demand among competitors results in higher production costs for individual firms.	cable TV service
Network Externalities	When a significant portion of the value of a product is determined by the number of other users, competition will lead to market dominance by a single firm (see monopoly). The same dynamics can lead to the “lock-in” of inefficient standards.	telephone service; eBay; Facebook; the QWERTY keyboard (standard)

**TABLE 3.1** Continued

<i>Causes</i>	<i>Problem Description</i>	<i>Example(s)</i>
Information Problems	Information asymmetries create adverse selection problems that make it difficult for parties to engage in mutually beneficial exchange.	health insurance
Structural Idiosyncrasies	Idiosyncratic features of particular markets complicate or prevent competition or insulate companies from competitive pressure, and this leads to insufficient efficiency incentives and prices that are too high to maximize overall economic value.	college textbooks, credit cards

reflected in the price of the product, then the price of this product would not accurately represent the value of the resources required to produce it. As a consequence, the product would be priced too low, and more than the optimal amount of the product would be demanded. On the other hand, if there were positive externalities associated with a particular product, but the price buyers were willing to pay for it failed to reflect the value of these benefits, then the market price would be too low, and too little of the product would be supplied.

The LoJack Stolen Vehicle Recovery System is an interesting example of a product with positive externalities. Installation of the LoJack security system involves hiding a small radio transceiver in a vehicle. If the vehicle is stolen, this transceiver can be activated, and police can use the signal to locate it. LoJack acts as a general deterrent to auto thieves because it enables police to locate chop shops and significantly increases the likelihood of arrest and prosecution. Because there is no obvious indication that a Lojack transceiver has been installed in a vehicle, the security system does little to prevent theft, and only a small portion of these benefits, therefore, are captured by individual LoJack customers. Because there is no ready

buyer for the positive externalities generated by the device, less than the optimal level of LoJack systems are demanded. Researchers have estimated that for every \$100 spent on LoJack security systems as much as \$1500 of social benefits are generated, primarily in the form of reduced auto thefts. Because these benefits are “socialized” in a sense (i.e., they are spread indiscriminately across a community), these benefits are not reflected in private demand for the product, and these potential benefits are forfeited. The underprovision of goods and services with positive externalities by the market is a predictable and well-understood phenomenon.<sup>xvi</sup>

The significance of externalities, or transaction spillovers, has been debated by economists for more than a century. Arthur Cecil Pigou, in a book published in 1920 entitled *The Economics of Welfare*, argued that the presence of spillovers justified societal intervention in economic markets. Pigou’s logic was persuasive. Economic markets, because they involve private transactions based on private costs and benefits, are unable to account for third party effects or spillovers (either positive or negative). Neither social costs nor social benefits will be represented in the calculus of the market, and this deficiency, if left uncorrected, will lead to the overproduction of goods associated with negative spillovers, and the underproduction of goods associated with positive spillovers.

The influence of Pigou’s arguments were eventually muted by Ronald Coase, who argued in a 1960 paper entitled “The Problem of Social Cost,” that spillovers could be resolved through the judicious assignment of property rights. For example, if a property owner were negatively affected by waste from a nearby manufacturing plant, assuming property rights were sufficiently defined and enforceable, this owner would be able to demand payment from the plant. The plant, because it would be forced to deal with the land owner, would then be forced to include the costs of disposing of its waste in the price of its products. In practice, however, difficulties assessing spillovers, the complex nature of property rights, and the costs of negotiation often make property rights solutions to spillovers impractical. Coase, in his 1991 Nobel Prize lecture, acknowledged that the costs of spillover detection, assessment, and then subsequent negotiation—costs that economists refer to as transaction costs—might make a collective (or government) solution more efficient:

Of course, it does not imply, when transaction costs are positive, that government actions (such as government operation, regulation or taxation, including subsidies) could not produce a better result than relying on negotiations between individuals in the market. Whether this would be so could be discovered not by studying imaginary governments but what real governments actually do. My conclusion; let us study the world of positive transaction costs.<sup>xvii</sup>

A *public good* is defined by two important characteristics: a) consumption does not decrease its availability to others, and b) benefits are difficult to restrict to those who contributed to its production. A common example of a public good is the safety and security afforded to a country by its military. Once resources are dedicated to a nation's defense, the enjoyment of that defense by one citizen does not decrease its availability to other citizens. Likewise, it is difficult to restrict the benefits of safety and security to contributing citizens. In economic terms, national defense is a good that is both non-rival (individual consumptions doesn't diminish its availability) and non-excludable (once produced, it is difficult to limit its consumption to just those that contributed to its production).

Public goods are likely to be chronically undersupplied by economic markets. Because public goods are non-rival and non-excludable, and non-contributors will derive as much benefit from their production as contributors, individuals have little incentive to contribute to their production. Furthermore, individuals are also likely to worry that if they do contribute, they will be taken advantage of by others who refuse to do so, intending to subsequently "free-ride" on their contributions. The temptation to free-ride, and wariness of the possibility that others will succumb to the temptation to do so, creates an incentive to refrain from contributing. In situations in which public goods are involved, even though significant economic value might be created by their production, they may fail to be produced.

When there is only one supplier of a particular good or service (*monopoly*), or a small number of suppliers (*oligopoly*), firms will face little competitive pressure, and will therefore have little incentive to focus on efficient production, optimal allocation, or to price

their goods competitively in order to maximize overall economic value.<sup>xviii</sup> Examples of oligopolies in the U.S. include movie studios (the “big six,” Columbia Pictures, Warner Bros., Walt Disney, Universal Picture, 20th Century Fox and Paramount Pictures, control approximately 90% of the motion picture market), the cellular service providers (AT&T Mobility, Verizon, T-Mobile and Sprint control approximately 90% of the cell phone service market), and the beer industry (Anheuser-Busch and MillerCoors have a combined industry market share of approximately 80%).

In some situations, however, it may not make sense to have more than one firm supply a given product or service. If, for example, there are significant economies of scale over the entire range of total demand for a product, then dividing up demand among a number of firms may result in significantly higher prices than if a single firm controlled the entire market. These situations are referred to as *natural monopolies*. The provision of cable TV service in a particular geographic area often exhibits the characteristics of a natural monopoly. The cost of providing this service may be \$150/month if a firm services 10,000 households, but this cost may drop to \$50/month if the number of subscribers is increased to 50,000. In a town in which there may be a total of 50,000 potential subscribers, dividing up this potential demand equally among five different companies, in order to insure some level of competition, may result in cable prices that are significantly higher than if just one cable company were allowed to operate in the market.

*Network externalities* (or *network effects*) are present when a significant portion of the value of a product or service to an individual is determined by the number of other users. The value of telephone service, for example, increases in lock-step with the number of telephone users. Other products characterized by strong network effects include computer operating systems, online auction sites, like eBay, or social media sites, like Twitter or Facebook. In the case of eBay, a significant portion of the value of its service to vendors is derived from the level of buyer traffic on its site. eBay is able to sustain this level of buyer traffic because its large number of vendors make it a convenient place to shop. This kind of positive feedback loop—an increase in the number of vendors leads to more buyers, and more buyers, in turn, leads to more vendors—often leads to market dominance by a single firm.

In situations in which a technological standard exhibits network effects, the result may be a situation in which an inefficient standard becomes impossible to dislodge, even in situations in which new products are clearly more efficient. The QWERTY keyboard is a classic example of this kind of technological “lock-in.” The QWERTY keyboard was originally designed to optimize the mechanical functioning of early typewriters. Because individual letters were linked to metal arms or typebars, the letters commonly used in combination, like “st” or “th” were intentionally separated in order to prevent jams. Given that these mechanical constraints are no longer a concern, more efficient layouts are possible. One such layout, the Dvorak keyboard, requires less finger motion, and is therefore associated with fewer errors and higher typing speeds. If this keyboard were to become the standard, the efficiency gains from increased levels of keyboard productivity would be substantial. However, given that a significant portion of the value of the QWERTY keyboard lies in the fact that other individuals use it, there is insufficient incentive for individuals to switch to the new standard. Even though everyone would benefit from a move to a more efficient standard, because of the incentives created by existing network effects, the only way to make the move would be for individuals to band together and decide to do so en masse. The organizing costs associated with this kind of collective action are substantial, and have to date prevented such a move.<sup>xix</sup>

There are situations in which parties to a potential transaction have different information, and this asymmetry may prevent proper market functioning.<sup>xx</sup> For example, *information asymmetries* in the health insurance market complicate the sale of healthcare plans to individuals. If an insurance company were to actively market a healthcare plan for \$500/month to the general public, individuals that anticipate medical expenses of more than \$500/month would be the most likely to purchase it. This would result in a pool of insured individuals that would likely cost more than \$500/month to insure, and the company would be forced to raise the price of its plan. This would cause plan participants to reevaluate whether or not the plan were still a “good deal” by comparing the new price of the plan to their expected medical expenses. This would likely result in the healthiest individuals in the pool dropping the plan, given that these individual would be the most likely

to conclude that the new price exceeded expected expenses. This process would produce a smaller, but equally unprofitable, pool of insured individuals. This would again force the insurance company to raise the price of its plan, and the cycle would continue. This process—known as adverse selection—is one of the primary reasons that health insurance is generally sold to groups of individuals rather than directly to individuals.

Finally, there are situations in which markets are structured in a way that prevents competition from having the desired effect on supplier behavior. This is the case in the college textbook market. In this market, the buying decision (the “adoption” decision) is made by one party (the institution or professor), but the cost of the product is born by the student. The decision to adopt a particular textbook, therefore, is based on the preferences of the institution or professor, and is generally based on criteria other than price, such as the availability and quality of ancillary materials, authorial reputation, convenience, and so on. Competition to enhance these features (in order to increase the likelihood of adoption) drives up the price of textbooks. In other words, competitive pressure in the college textbook market drives prices up, not down. The credit card market is another context in which structural features prevent proper market functioning. In this case, credit card companies have been able to contractually require businesses to shield customers from the actual costs of using a credit card. This prevents customers from deciding which card to use based on the associated transaction expense (and this effectually insulates credit card companies from price-based competition).<sup>xxi</sup>

## **Social Dilemmas**

Consider the scenario of a fire in a crowded theater presented earlier in this chapter. In this scenario, it is in the best interests of the group—considered collectively—to exit as quickly as possible; this implies that individuals should exit quickly, but in an orderly manner. From an individual perspective, however, pushing, shoving, and running for the exit is a superior strategy. To see this, consider the possible outcomes. If the crowd remains calm, running for the exit will increase one’s odds of survival. Likewise, if the

crowd panics, running will also increase one's odds of survival. Regardless of whether the crowd panics or not, from the perspective of an individual in the crowd, running always yields better survival odds. Unfortunately, if every individual approaches the dilemma in the same way, everyone will run towards the exit, chaos will ensue, and a much smaller proportion of the crowd will escape the fire. Put succinctly, in social dilemmas, individual rationality leads to collective irrationality.<sup>xvii</sup>

Social dilemmas have been studied extensively in a number of different fields, including economics, psychology, sociology, and political science. Three representative stories or scenarios are often used to illustrate different types of dilemmas: the prisoner's dilemma, the public good dilemma, and the tragedy of the commons. The prisoner's dilemma is discussed below. The public good dilemma, and associated free-rider problems, were introduced earlier in the context of market failure. The tragedy of the commons involves a shared resource, such as common grazing land, or the population of fish in a common fishing area. In this scenario, each individual has incentive to use as much of the resource as possible while avoiding responsibility for management or maintenance. The result is often collectively irrational neglect and depletion of the shared resource—a resource that, if better managed, would yield significantly more value for everyone.

Social dilemmas are common in developed economies. They are evident in efforts to control pollution, establish technological standards, and deal with environmental issues. An understanding of the incentives created by social dilemmas helps explain the lobbying efforts of "special interest" groups, the behavior of companies involved in format wars, and why social problems, like littering, tax avoidance, and poaching are so persistent. Resolving social dilemmas can often create significant economic value. For example, implementing an effective tax system that minimizes free-riding may make it possible to produce public goods that are many times more valuable than the inputs required to produce them (e.g., a national highway system, public parks, and libraries).

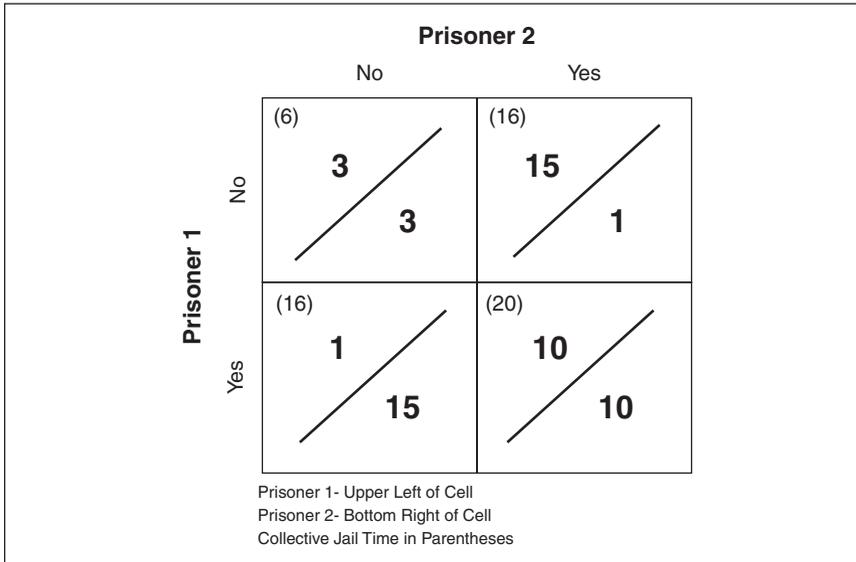
The PCMM assumes that the value buyers and sellers ascribe to a given transaction is independent of the behavior of other market participants. Several types of market failure can be linked to the

violation of this assumption (e.g., externalities, public goods, network externalities). A defining characteristic of social dilemmas, in contrast to the PCMM, is that participant behavior is *not* independent. This suggests that the incentives or payoffs to one participant are dependent on the behavior of other participants.<sup>xxiii</sup> Because the assumptions about the nature of social interaction are different in social dilemmas than in the PCMM or in a market failure approach, the incentives and dynamics of a typical prisoner's dilemma are described in greater detail in the following section.

### The Prisoner's Dilemma

The prisoner's dilemma gets its name from the original backstory created by Albert Tucker and Melvin Dresher, two scientists at RAND Corporation in Santa Monica, California, who developed the dilemma in 1950 and used it in an informal experiment.<sup>xxiv</sup> In the original scenario, a law enforcement representative offers two prisoners the opportunity to provide evidence against each other in exchange for leniency. They are each informed that if both choose to provide evidence, then the offer of leniency will be retracted and each will receive a relatively long sentence. On the other hand, if neither informs on the other, then the officer admits that each is likely to receive a relatively light sentence. The inducement, explains the officer, is that if one prisoner provides evidence and the other does not, then the cooperating prisoner will be rewarded with a particularly light sentence while the other will be punished with a particularly long sentence. In other words, there are four possible outcomes: a) both prisoners cooperate; b) the first prisoner cooperates, but the second prisoner does not; c) the first prisoner refuses to cooperate, but the second prisoner does; and, d) neither prisoner cooperates. Payoffs for each prisoner for each possible outcome are displayed in Figure 3.1.

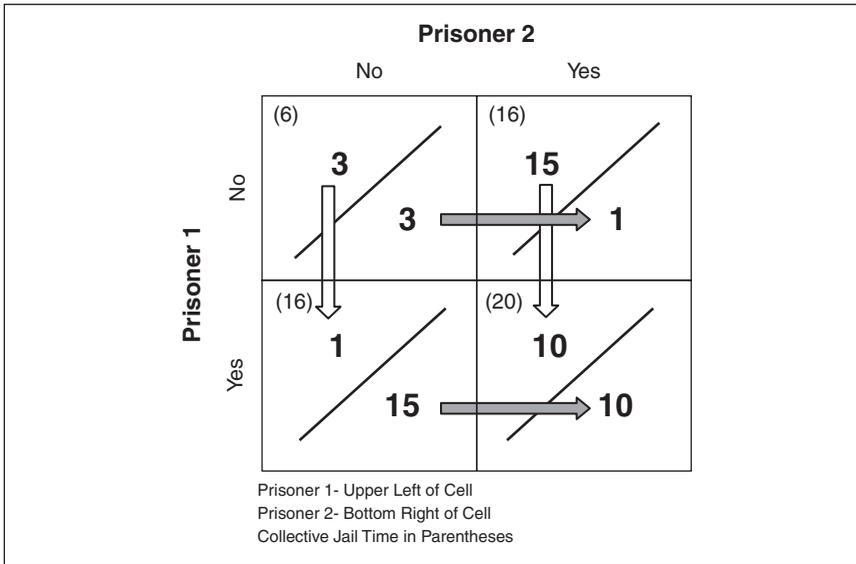
In each cell, the prison sentence for Prisoner 1 is displayed in the upper-left and the sentence for Prisoner 2 appears in the bottom-right. The sum of the two prisoners' sentences for each outcome appears in parentheses in the top-left of each cell. For example, the numbers in the top-left cell represent the outcomes for each prisoner if neither prisoner confesses. In this case, each receives a three-year sentence. The bottom-left cell indicates the sentence for



**FIGURE 3.1** Prisoner’s Dilemma Payoff Matrix

each prisoner if Prisoner 1 confesses (1 year), but Prisoner 2 does not (15 years). The top-right cell is the mirror image of the bottom-left cell: Prisoner 1 refuses to confess (and receives 15 years), while Prisoner 2 confesses (and is rewarded with a 1-year sentence). Finally, in the bottom-right cell, both prisoners confess and each receives a 10-year sentence.

The shaded arrows in Figure 3.2 represent the choices available to Prisoner 1. If he or she believes that Prisoner 2 will refuse to confess, then he or she is left to choose between a three-year sentence and a one-year sentence. This choice is represented by the shaded arrow that extends from the upper-left cell to the upper-right cell. On the other hand, if he or she believes that Prisoner 2 will confess, then he or she is left to choose between a fifteen-year sentence and a ten-year sentence (represented by the shaded arrow extending from the bottom-left cell to the bottom-right cell). Regardless of what Prisoner 2 does, Prisoner 1 is always better off confessing. Similarly, Prisoner 2 faces the same decision set (represented by the outlined arrows). Each prisoner, therefore, is always better off confessing regardless of what the other prisoner does. If each prisoner behaves rationally, each will confess, and each will receive a ten-year sentence. This outcome is represented in the bottom-right cell.



**FIGURE 3.2** Prisoner’s Dilemma Decision Arrows

Take a moment to examine Figure 3.2. Assuming both prisoners prefer to avoid jail time, the best joint outcome is for neither to confess. This outcome—represented in the top-left cell—yields a total of six years for the two prisoners. In order to realize this joint outcome, however, both prisoners must refuse to confess, thereby forgoing the possibility of being rewarded with a single year in prison, and simultaneously exposing themselves to the risk of being sentenced to fifteen years. In other words, in order to realize the best possible joint outcome, each prisoner is required to act in a manner that is inconsistent with his or her immediate self-interest.

In properly functioning economic markets, individual and collective interests are aligned. In social dilemmas, in contrast, individual interests conflict with collective interests. In Figure 3.2, for example, if both prisoners act in their own self-interest, they will both confess. The result will be a combined total of twenty years in jail—the worst possible joint outcome.

How groups of people, communities and societies resolve social dilemmas is the focus of an extensive and expanding body of research that spans a number of different social science disciplines. Different solutions have focused on the value orientations of participants, participant communication, the role of group identity,

reciprocity, social norms, social learning, and different structural changes, including altering the frequency or time horizon of interaction, and changing the payoff structure (or incentives) by introducing additional rewards and sanctions.<sup>xxv</sup> At least two factors are important in the resolution of social dilemmas. First, it is important that participants be made aware of the dilemma, so that they can factor moral, normative, and altruistic considerations into their decision making. Second, it is important that participants believe that other participants will resist the temptation to act in their own self-interest.<sup>xxvi</sup> CSR can play an important role in the resolution of social dilemmas by increasing awareness, enhancing normative constraints on self-interested behavior, and introducing other incentives for cooperative behavior.

## **VALUE CREATION**

This chapter began with a question: As a society, what, exactly, do we want from our economic system?

Both Bowen's list of eleven macroeconomic objectives and Davis and Bomstrom's list of potential areas of social involvement can be succinctly subsumed in this statement: We want our economic system to create value. In this context, value is a subjective attribution of relative worth. We want our economic system to use resources to create products and services that we value more than the resources used to produce them. As Wheeler and colleagues assert, the "creation of value is the central motive force of market economies, and by extension the primary purpose of private enterprise."<sup>xxvii</sup>

The second question that was asked at the beginning of the chapter was this: How do we get there? Stated more formally, assuming that we, as a society, know what we want from our economic system, and assuming that businesses recognize an obligation to contribute to the realization of these objectives, what does CSR suggest about how businesses should behave?

If answered broadly, the answer to this question is fairly straightforward. From a CSR perspective, businesses should be committed to creating economic value, given that that is what society expects from its economic system.

What specifically, should businesses do to create economic value? Should they focus on maximizing profit? Should they focus on other economic, social, or environmental measures? Should businesses act in ways that may not be in their immediate interest, but that have the potential to lead to superior group or collective outcomes? The answer to these questions is this: It depends. It depends on the type of good or service, on the existence of market-supporting social institutions, and on whether or not basic market conditions can be satisfied. It depends on whether or not there are significant externalities, monopolistic or oligopolistic market conditions, network externalities, information problems or other problems with market structure that insulate companies from competitive pressure. And finally, it depends on whether or not there are conflicts between individual and collective interests.

When markets are properly structured and sufficiently competitive, a focus on profit maximization may be the most direct way to contribute to the social good. In the case of market failure, however, an exclusive focus on profits may lead to inefficient, suboptimal, or even catastrophic outcomes, and in these cases, profit measures will be poor indicators of whether or not businesses have created economic value. In the case of social dilemmas, CSR may require businesses to subordinate their individual interests to collective interests in order to avoid the trap of collective irrationality.

Regardless of the context, a commitment to CSR requires a commitment to value creation. The PCMM, market failure, and social dilemmas should be viewed as different frameworks for linking individual behavior to group or system outcomes. CSR requires businesses to know when each is appropriate, and to regulate their efforts to create economic value accordingly.

## **CHAPTER SUMMARY**

Societies expect certain outcomes from their economic systems. Because market participants have an obligation to contribute to outcomes that satisfy societal expectations, these expectations anchor the concept of CSR.

The perfect competition market model (or PCMM) is a good representation of commonly held beliefs about how markets work. It is often used to link business behavior to macroeconomic outcomes. In order for the PCMM to function properly, however, a number of conditions must be met, including a large number of independent buyers and sellers, no participant pricing power, product homogeneity, no barriers to entry or exit, no artificial restraints on prices, and participants must be fully informed. If these conditions are met, the most effective way for businesses to contribute to productive and allocative efficiency, and the maximization of social surplus, may be to seek to maximize profit. This approach to CSR has become known as the Friedman Doctrine.

Although the PCMM reflects a common understanding of economic markets, it is not the only way of connecting business behavior to macroeconomic outcomes. The term “market failure” describes situations in which markets fail to function properly. There are a number of different causes of market failure, including externalities, public goods, monopolies and oligopolies, natural monopolies, network externalities, information problems, and other structural idiosyncrasies. In cases of market failure, profit measures will be poor indicators of whether or not businesses have created economic value, and attempts to maximize profits can lead to inefficient, suboptimal, or even catastrophic outcomes.

Social dilemmas—defined as “interaction situations in which rational individual behavior produces irrational group or collective outcomes”—represent another approach to linking individual behavior and group or system outcomes.<sup>xxviii</sup> In social dilemmas, participant behavior is not independent, and the incentives or payoffs to participants vary based on the behavior of other participants. One of the representative stories or scenarios generally used to illustrate social dilemmas—the prisoner’s dilemma—is described in detail in order to illustrate how these dilemmas work. In contrast to properly functioning economic markets, in social dilemmas individual interests conflict with collective interests, and in order to realize the best possible outcome, participants may be required to act in a manner that is inconsistent with their immediate self-interest.

We want our economic system to create value in the sense that we want it to use resources to create products and services that we

value more than we value the resources used to produce them. CSR demands that businesses be committed to creating economic value, given that that is what society expects from its economic system. The PCMM, market failure, and social dilemmas should be viewed as different frameworks for linking individual behavior to group or system outcomes. CSR requires businesses to know when each is appropriate, and to regulate their efforts to create economic value accordingly.

## REVIEW QUESTIONS

1. What do we, as a society, want from our economic system?
2. Explain why it is difficult to link individual participants' behavior to group or system outcomes.
3. What is the perfect competition market model (PCMM)? Why is it important to a discussion of CSR?
4. What is the Friedman Doctrine? In cases of market failure, or in social dilemmas, would the application of the Friedman Doctrine produce good macroeconomic outcomes? Why or why not? Explain.
5. List and then explain the different causes of market failure.
6. What is a social dilemma? Explain the concept of collective irrationality and why it is important to a discussion of CSR.
7. Explain the prisoner's dilemma. Why is the prisoner's dilemma interesting?
8. From a CSR perspective, why is a focus on value creation important?

## ENDNOTES

<sup>i</sup>Bowen, H. R. 1953. *Social responsibilities of the businessman*. New York: Harper & Row, pgs. 8–12.

<sup>ii</sup>Davis, K. and Blomstrom, R. L. 1971. *Business, society, and environment: Social power and social response* (2nd ed.). New York: McGraw-Hill Book Company.

<sup>iii</sup>Smith, A. 1776/1976. *An inquiry into the nature and causes of the wealth of nations*. Chicago: University of Chicago Press.

<sup>iv</sup>Although this quote is frequently attributed to John Maynard Keynes, there is some doubt about whether not this attribution is correct. See <http://quoteinvestigator.com/2011/02/23/capitalism-motives/>, and also [http://www.barrypopik.com/index.php/new\\_york\\_city/entry/capitalism\\_is\\_the\\_belief\\_that\\_the\\_wickedest\\_of\\_men\\_will\\_do\\_wickedest\\_things/](http://www.barrypopik.com/index.php/new_york_city/entry/capitalism_is_the_belief_that_the_wickedest_of_men_will_do_wickedest_things/).

<sup>v</sup>See Schelling, T. C. 1978. *Micromotives and macrobehavior*. New York: W. W. Norton & Company; This concept is closely related to research on social dilemmas. For a good overview, see Kollock, P. 1998. Social dilemmas: The anatomy of cooperation. *Annual Review of Sociology*, 24: 183–214.

<sup>vi</sup>Kuttner, R. 1996. *Everything for sale: The virtues and limits of markets*. New York: Alfred A. Knopf, pg. 3.

<sup>vii</sup>For an accessible, but thorough, discussion of the perfect competition market model, see Chapter 2 of Walters, S. J. K. 1993. *Enterprise, government, and the public*. New York: McGraw-Hill. For a more advanced treatment of the same, see Bator, F. M. 1957. The simple analytics of welfare maximization. *American Economic Review*, 47(1): 22–59, and Bator, F. M. 1958. The anatomy of market failure. *The Quarterly Journal of Economics*, 72(3): 351–379.

<sup>viii</sup>See Walters, S. J. K. 1993. *Enterprise, government, and the public*. New York: McGraw-Hill, Chapter 2.

<sup>ix</sup>See Friedman, M. 1970. The social responsibility of business is to increase its profits. *New York Times Magazine*, September 13.

<sup>x</sup>These paragraphs are excerpted from Friedman, M. 1970. The social responsibility of business is to increase its profits. *New York Times Magazine*, September 13.

<sup>xi</sup>Although Milton Friedman is generally viewed as the most articulate proponent of this brand of CSR criticism, he is not alone. For additional insight into this line of CSR criticism, see Collins, D. 1996. Capitalism and sin. *Business and Society*, 35(1): 42–50; Davis, K. 1973. The case for and against business assumption of social responsibilities. *Academy of Management Journal*, 16(2): 312–322; Frederick, W. C. 1960. The growing concern over business responsibility. *California Management Review*, 2: 54–61; Jones, M. T. 1996. Missing the forest for the trees. *Business and Society*, 35(1): 7–41; Shaffer, B. D. 1977. The social responsibility of business: A dissent. *Business and Society*, 17(2): 11–18.

<sup>xii</sup>Francis M. Bator was one of the first economists to use this term: Bator, F. M. 1958. The anatomy of market failure. *The Quarterly Journal of Economics*, 72(3): 351–379.

<sup>xiii</sup>[http://en.wikipedia.org/wiki/Financial\\_crisis\\_of\\_2007-2008](http://en.wikipedia.org/wiki/Financial_crisis_of_2007-2008).

<sup>xiv</sup>Beal, B. D. 2012. Competitive markets, collective action, and the Big Box Retailer problem. *Journal of Philosophical Economics*, 6(1): 2–29, pg. 12.

<sup>xv</sup>Bator, F. M. 1958. The anatomy of market failure. *The Quarterly Journal of Economics*, 72(3): 351–379, pg. 351.

<sup>xvi</sup>Ayres, I. and Levitt, S. D. 1998. Measuring positive externalities from unobservable victim precaution: An empirical analysis of Lojack. *Quarterly Journal of Economics*, 113(1): 43–77.

<sup>xvii</sup>Nobel Prize lectures are available at <http://www.nobelprize.org>; Coase's 1991 lecture is available here: [http://www.nobelprize.org/nobel\\_prizes/economics/laureates/1991/coase-lecture.html](http://www.nobelprize.org/nobel_prizes/economics/laureates/1991/coase-lecture.html).

<sup>xviii</sup>Pepall, L., Richards, D. J., and Norman, G. 2005. *Industrial organization: Contemporary theory and practice* (3rd ed.). Mason, OH: South-Western.

<sup>xix</sup>For a good overview of network externalities or network effects, see Arthur, W. B. 1989. Competing technologies, increasing returns, and lock-in by historical events. *The Economic Journal*, 99(394): 116–131; Katz, M. and Shapiro, C. 1985. Network externalities, competition and compatibility. *American Economic Review*, 75(3): 424–440; Katz, M. L. and Shapiro, C. 1986. Technology adoption in the presence of network externalities. *Journal of Political Economy*, 94(4): 822–841; Liebowitz, S. J. and Margolis, S. E. 1994. Network externality: An uncommon tragedy. *Journal of Economic Perspectives*, 8(2): 133–150.

<sup>xx</sup>The classic paper on information problems is Akerlof's The Market for Lemons: Akerlof, G. A. 1970. The market for "lemons": Quality uncertainty and the market mechanism. *Quarterly Journal of Economics*, 84(3): 488–500; Also see Stigler, G. J. 1961. The Economics of Information. *Journal of Political Economy*, 69(3): 213–225.

<sup>xxi</sup>Levitin, A. J. 2008. Priceless? The economic costs of credit card merchant restraints. *UCLA Law Review*, 55(5): 1321–1405.

<sup>xxii</sup>For an overview of social dilemmas, see Dawes, R. M. 1980. Social dilemmas. *Annual Review of Psychology*, 31(1): 169–193; Heckathorn, D. D. 1996. The dynamics and dilemmas of collective action. *American Sociological Review*, 61: 250–277; Kollock, P. 1998. Social dilemmas: The anatomy of cooperation. *Annual Review of Sociology*, 24: 183–214; and Schelling, T. C. 1978. *Micromotives and macrobehavior*. New York: W. W. Norton & Company.

<sup>xxiii</sup>See Dawes, R. M. 1980. Social dilemmas. *Annual Review of Psychology*, 31(1): 169–193; Heckathorn, D. D. 1996. The dynamics and dilemmas of collective action. *American Sociological Review*, 61: 250–277.

<sup>xxiv</sup>Kollock, P. 1998. Social dilemmas: The anatomy of cooperation. *Annual Review of Sociology*, 24: 183–214, pg. 185.

<sup>xxv</sup>For a good overview of different approaches to resolving social dilemmas, see Kollock, P. 1998. Social dilemmas: The anatomy of cooperation. *Annual Review of Sociology*, 24: 183–214.

<sup>xxvi</sup>Dawes, R. M. 1980. Social dilemmas. *Annual Review of Psychology*, 31(1): 169–193.

<sup>xxvii</sup>Wheeler, D., Colbert, B., and Freeman, R. E. 2003. Focusing on value: Reconciling corporate social responsibility, sustainability and a stakeholder approach in a network world. *Journal of General Management*, 28(3): 1–28, pg. 2.

<sup>xxviii</sup>Beal, B. D. 2012. Competitive markets, collective action, and the Big Box Retailer problem. *Journal of Philosophical Economics*, 6(1): 2–29, pg. 12.