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Managerial contracting and corporate social responsibility

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Abstract

This paper presents a theory of corporate social responsibility in the form of the private provision of public goods and private redistribution by a firm. These social expenditures are determined by a manager operating under a compensation contract chosen by shareholders in a capital market that prices social expenditures. The theory incorporates three explanations for compensation systems that encompass social performance. First, consumers may reward the firm for its social expenditures; second, managers may have personal preferences for contributing to social causes; and third, the shareholder clientele a firm attracts may prefer social expenditures. Social incentives are higher powered the more consumers reward the firm and the stronger are shareholders' warm glow preferences for social expenditures. Profit incentives are higher powered the more consumers reward the firm but are independent of shareholder preferences. When consumers reward the firm for its social expenditures, firms with higher ability managers have both higher operating profits and higher social expenditures when times are good, so a positive correlation is predicted. In bad times, however, the correlation is negative, except for firms with very low ability managers in very bad times, where the correlation is zero.

Keywords: Corporate social responsibility; Incentive contracts

1. Introduction

Corporate social responsibility is much discussed by executives and often occupies a prominent position on corporate Internet sites. An increasing number of companies are publishing corporate social responsibility reports and discussing it in annual reports. Firms have also established compensation programs that include the evaluation of the social performance of managers. One form of this evaluation is the balanced scorecard advocated by Kaplan and Norton (1992, 1996), which can be extended to social performance. Cohen and Roy (2005) note an increase in the use of non-financial criteria in CEO compensation and within the balanced scorecard framework identify 12 performance factors identified in the literature. Three of the factors, ethics and values, environmental, health, and safety, and management of external relations, fall under the rubric of corporate social responsibility. In their study of board compensation committee reports of 59 industry-leader firms, Cohen and Roy found that all used financial performance in determining compensation and 14 used at least one of the three corporate social responsibility factors. Other firms have developed triple bottom line performance evaluation systems based on financial, environmental, and social measures.[2] Many firms have established environmental, health, and safety reporting systems linked to compensation

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[2] Norman and MacDonald (2004) provide a critical analysis of the triple bottom line perspective.

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systems. The incentives firms provide for social performance necessarily interact with incentives for financial performance. For example, if corporate social expenditures affect the demand for a firm's products, incentives for financial performance affect the incentives for social performance. Conversely, providing incentives for social performance can affect the incentives for financial performance and hence for the operations of the firm.

This paper provides a positive theory of corporate social responsibility in which managers instead of markets allocate resources, including social expenditures, through the corporate form. The social expenditures could constitute redistribution or public goods and are funded from the financial returns of shareholders. Although managers allocate resources, their compensation is set by shareholders. The resulting managerial compensation contacts are limited to observable measures of performance, such as profits and social expenditures, and contracting is second-best because of hidden information, hidden effort, and limited observability. The theory focuses jointly on the operational management of the firm and on its social expenditures as influenced by incentives chosen by shareholders. The theory provides an explanation for compensation systems that encompass social performance.

The theory also provides a framework for studying the private provision of local public goods by firms. These goods can include community projects and support, philanthropy, training and educational programs, workers' rights initiatives, environmental abatement and protection, and alternatives to animal testing. One form of private provision is self-regulation as manifested in environmental programs to reduce toxic emissions (Lyon and Maxwell, 2004), safety and pollution abatement in the chemical industry (King and Lenox, 2000), sustainability as in the case of participation in Forest Stewardship Council and the Sustainable Forestry Initiative programs (Cashore et al., 2005), and improvements in managerial practices relating to environmental, health, and safety (Prakash and Potoski, 2006). Firms also participate in voluntary government programs as in the case of the EPA's private–public program to reduce carbon dioxide emissions (Delmas, 2006) or industry-NGO voluntary programs such as recently announced coalition of ten U.S. companies and four NGOs to reduce greenhouse gas emissions and to work for mandatory government programs with flexibility and incentives.[3] The number of such initiatives and programs appears to have increased substantially in recent years.[4] One explanation is that citizens' support has increased for private parties to address externalities and social problems beyond the mandates of government; i.e., to privately provide public goods. This paper provides a framework for studying certain agency aspects of corporate social responsibility and the private provision of public goods as induced by citizens' preferences. That is, the citizens who own firms choose compensation systems to induce managers to serve their interests, taking into account the contracting limitations due to hidden actions, hidden information, and private observability. This requires that firms be embedded in a capital market in which citizens choose whether to hold shares in firms that provide local public goods and how to compensate the managers who operate the firms in which they become shareholders.

Graff Zivin and Small (2005) present a model in which investors have preferences for both financial and social returns and can invest in firms that engage in corporate social responsibility. They show that if citizens are indifferent between personal giving to social causes and their ownership share of corporate social expenditures, the market values of firms are independent of their social expenditures. Corporate social expenditures thus perfectly crowd out personal giving. Baron (2007a) considers a model in which shareholders are not indifferent between personal giving and corporate social expenditures, in which case corporate social expenditures are costly to shareholders. The social entrepreneurs who establish the firms that make social expenditures then bear the cost of their social expenditures. Baron (2007b) considers the motivation underlying corporate social responsibility in a setting in which firms compete directly in a market. One firm is morally motivated and voluntarily addresses a negative externality associated with its production. The other firm is self-interested and addresses the externality only if sufficiently pressured to do so. The firms segment the market with the morally-motivated firm setting a high price and attracting consumers who value mitigation of the externality and the self-interested firm setting a low price and attracting consumers who do not value those expenditures as highly. Activists funded by citizens can apply social pressure to one of the two firms, and if citizens do not distinguish between moral management and corporate social performance induced by social pressure, morally-managed firms are softer targets than self-interested firms. Social pressure then is more likely to be directed to morally-managed firms, and the demands made on those firms are higher. The present paper focuses on the role of managers in corporate social policy in the absence of social pressure.

[3] New York Times, January 19, 2007.

[4] A bibliography with over 500 recent studies on corporate social responsibility is available at http://environment.yale.edu/profile/9827/workshop_on_research_in_corporate_social.