DOES CORPORATE SOCIAL RESPONSIBILTY ENHANCE BUSINESS PROFITABILITY?

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Introduction

There has been much debate over the last few decades about the "social responsibilities" of businesses. Nobel laureate Milton Friedman wrote that, in a free society, "there is one and only one social responsibility of a 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."[i]

In contrast, advocates of so-called "corporate social responsibility" (CSR) maintain that the social responsibility of a business extends beyond business' financial bottom line to broader societal issues, typically those addressed by environmental, human rights and labor activists.

A key issue in this debate is the impacts on businesses from expanding its social responsibilities to include various CSR initiatives advocated by activists and so-called "socially responsible investors." These studies generally fall into two camps. Those analyses that argue companies should pursue CSR initiatives because they are the right thing to do and those analyses that argue companies should pursue CSR initiatives because they will enhance profits.

The former are founded on the premise that without proper pressure companies will not act in a socially responsible manner. Their claim is that mangers place too high of an emphasis on the pursuit of profits. Furthermore, when the pursuit of profits conflicts with the pursuit of corporate responsibility, the pursuit of profits will win out. Thus, a profit-centric corporation will inevitably choose profits over people and act in an irresponsible manner. In a modern version of this argument, Handy (2003) argues:

> …there is, first, a clear an important need to meet the expectations of a company's theoretical owners: the shareholders. It would, however, be more accurate to call most of them investors, perhaps even gamblers….But to turn shareholder's needs into a purpose is to be guilty of a logical confusion, to mistake a necessary condition for a sufficient one. We need to eat to live; food is a necessary condition of life. But if we lived mainly to eat, making food a sufficient or sole purpose of life, we would become gross. The purpose of a business, in other words, is not to make a profit, full stop. It is to make a profit so that the business can do something more or better.[ii]

The latter studies examine the impact of CSR initiatives on profits claiming that CSR initiatives have a positive impact on business profitability.[iii] A 1997 meta-study reviewed 51 analyses that claimed to test the relationship between financial performance and adherence to CSR principles finding that a majority of these studies reported a positive relationship between CSR and profitability.[iv] In another analysis Sandra Waddock claimed, "There is significant evidence from a large and growing body of academic research that there is at minimum a neutral, and quite likely a positive relationship between responsible corporate practices and financial performance.[v] Yet another study performed by the Centre for Social Markets found

> *…there is a CSR premium (i.e. an additional benefit because of CSR earned by firms or appreciated by consumers and other stakeholders) that can be earned by firms on such items as product quality, employee productivity, consumer satisfaction. Therefore, the additional CSR costs could well be cancelled out by consumers accepting to pay for this additional premium or through prices being positively affected by the additional efficiency that CSR is likely to bring about.*
>
> *Evidence for this positive CSR premium is growing….How big this premium is likely to be is a matter for further research although, as we showed in another Monthly Feature (see J-curve), visionary CSR companies can have a premium of at least 5% over non-visionary companies.*

There are numerous grounds for questioning these claims, however. Determining the impact on profitability of a non-business-related CSR initiative is not a straightforward exercise. Analyses of the financial impacts of CSR initiatives necessarily involves multiple, significant and novel subjective judgments – especially with respect to the definition of a CSR firm and which firms have the ability to engage in CSR activities in the first place. We discuss these in more detail in the next section.

There is no reason to believe that these subjective problems are either trivial or do not have a significant statistical impact on the results. If it were true that CSR initiatives necessarily led to profitability, this would imply a widespread "market-failure" — that is, businesses without CSR initiatives fail to recognize potential financial opportunities of CSR programs.

Finally, and from a broader market perspective, those who invest exclusively in companies deemed to be "socially responsible, do not appear to receive financial returns that are better than those of conventional investors.[vi]

Given that businesses are increasingly being pressured by social activists to undertake CSR initiatives in part based on a claim that CSR initiatives enhance business profitability, we set out to determine whether that claim is supported by empirical data, with specific attention to the aforementioned data biases.

CSR Data and Benchmarking

The first task was to identify appropriate businesses for the analysis. We started with the businesses identified by Business Ethics magazine as the "100 Best Corporate Citizens" in each of the years 2000-2004.[vii] Though this ranking is highly subjective, in the view of Business Ethics magazine, at least, these companies are the most socially responsible.

This field was then narrowed to the 29 businesses that had been on the "100 Best Corporate Citizens" list each year over the past five years (See Table 1). We omitted Fannie Mae from the analysis because it is a government-sponsored enterprise, leaving 28 companies for the analysis.

The second task involved designing the appropriate benchmark to test the impact of CSR on corporate profitability. Most studies test CSR's impact on profitability by comparing the performance of CSR companies to overall returns in a broad market index such as the S&P 500. Although the S&P 500 is one of the most common financial benchmarks, we believe that this is inappropriate for testing the efficacy of CSR. This arises from two inherent biases that plague the CSR literature.

The first bias stems from the definition of a CSR-firm. CSR proponents define a company as socially responsible if it maximizes its triple bottom line. The triple bottom line encourages companies to maximize their economic, social and environmental impacts. Typically, the economic impact revolves around profitability – often measured as total share price appreciation as in the Business Ethics survey. In other words, a company is often defined as being socially responsible, in part, if they are profitable.[viii] Because of the inter-relationship between profitability and being defined as a socially responsible company, it should be expected that the companies that are empirically defined as being socially responsible have above market returns.

The second bias arises because, to a certain extent, only profitable companies can engage in CSR. For instance, Southwest Airlines has consistently scored as one of the top 100 socially responsible companies in the Business Ethics survey over the past 5 years. It is hard to imagine USAir or United Airlines earning the same distinction if only because they do not have the resources (human or financial) to engage in any CSR programs. As such, any company whose profitability falls below a certain threshold cannot be socially responsible if only because their revenues and energies must be focused on survival.

These two biases cast doubt on the validity of testing corporate social responsibility as it has been defined against profitability in general, not to mention comparing the returns of CSR companies to the returns of the S&P 500 in particular.

In the next section we examine the differences between the 28 CSR companies to their competitors and industry averages, even though the aforementioned biases alone discount the validity of this type of analyses. We engage in

this exercise because of the large amount of research that has been devoted to the issue and because by utilizing a "top competitor" benchmark we have attempted to compensate for these biases.

Table 1: 29 CSR-leading Companies	
Company	**2004 Rank**
Fannie Mae	1
Procter & Gamble	2
Intel Corporation	3
St. Paul Companies	4
Deere & Company	6
Avon Products, Inc.	7
Hewlett-Packard Company	8
Ecolab Inc.	10
IBM	12
Herman Miller, Inc.	14
The Timberland Company	17
Cisco Systems, Inc.	19
Southwest Airlines Company	22
Motorola, Inc.	24
Cummins Inc.	27
Adolph Coors Company	31
Modine Manufacturing Company	32
Clorox Company	33
AT&T	43
Pitney Bowes Inc.	44
Starbucks Coffee Company	45
Merck & Co., Inc.	48
Graco Inc.	49
Brady Corporation	53
Medtronic, Inc.	57
The New York Times Company	63
Golden West Financial Corp.	74
Sonoco	89
Whirlpool Corporation	98

Performance Comparison with Competitors.

To begin our understanding of the relative performance of the CSR companies compared to their peers we examined the relative 1999-2003 financial performance of the 28 CSR companies compared to their competitors. We defined the competitors as those companies listed as "top 3 competitors" by Hoover's Online Business Information Service. The financial performance measures we examined were compound annual net income growth, average net profit margin over this period, and stock price appreciation. Data were collected from Hoover's Online Business Information Service.[ix]

We found that, most of the time, during 1999-2003 the 28 CSR companies did not necessarily outperform their primary competitors in any of the profitability measures we examined. Specifically, only 8 of the 28 CSR companies had a higher compound annual net income growth than their competitors. With respect to the average net profit margin, only 11 of the 28 CSR companies outperformed their competitors; and only 9 of the 28 CSR companies outperformed their competitors in terms of stock price appreciation. As such, on a visual basis, there does not appear to be any special "profitability" earned by those firms anointed with the CSR designation. A separate Appendix contains detailed charts illustrating this data.

Testing the hypothesis

To formally test whether CSR firms are associated with higher profitability we ran two separate examinations. The first test directly examined the internal consistency of the Business Ethics rankings. The second test conducted a dummy variable regression analysis on the competitor data set gathered from Hoovers. A "dummy variable" tests whether the existence of some attribute (in this case whether the firm has been deemed to be socially responsible) is related to another attribute (in this case profitability). Here, if a firm has been deemed socially responsible, the dummy variable is given a value of 1. If it has not been deemed socially responsible, the dummy variable is given a value of 0. In this way, the analysis tests whether being a CSR company has a positive, negative, or no impact on profitability as measured by the compound annual net income growth, average net profit margin and stock price appreciation.

Business Ethics Top 100 ranking underlying correlations. The Business Ethics survey screens companies against a set of criteria that have evolved to include companies' actions with respect to their Community Relations, Minorities & Women, Employees, Environment, Non-U.S. Stakeholders, Customers, and Financial Performance. According to the 2004 survey:

> *In each category, KLD notes where companies have "strengths" and "concerns." For example, in the employee category, a firm might get three strengths for profit sharing, retirement benefits, and employee involvement, while it gets two concerns for union relations and workforce reductions. To arrive at a net score in this category, we take three*

strengths and subtract two concerns. The same is done in each category. Environmental strengths, for example, might include beneficial products, pollution prevention, and recycling, while concerns would include emissions, climate change, and regulatory problems.

Since all seven variables have different scales, we standardize them to determine a standard deviation from the mean -- which indicates performance relative to peers. The scores shown in the chart represent the number of standard deviations a firm fell above or below the mean. For the shareholder performance measure, we use one-year total return to shareholders (stock appreciation plus dividends), standardized in the same way.

Next we take an unweighted average of all seven stakeholder measures, to arrive at a single score per company. The fact that the scale is unweighted means that all stakeholders are accorded equal status.

We conducted an analysis to see how the categories that comprise the rankings were correlated. We divided these categories into two groups: the first group contains the Financial Performance and Customers categories as these metrics are associated with *traditional business factors*; the second group is those categories commonly associated with *social responsibility* and include the Environment, Community Relations, Employee Relations, Diversity, and Non-U.S. Stakeholders categories.

Following the Business Ethics methodology, we calculated the average score for each group by averaging each company's category score in the Business Ethics top 100 list. Thus, the traditional business factor group scores were obtained by calculating the average score for the Financial Performance and Customers category, while the Social Responsibility factor group scores were obtained by calculating the average score for the Environment, Community Relations, Employee Relations, Diversity, and Non-U.S. Stakeholders categories.

Table 2 summarizes the correlation coefficients between the group and overall scores for all of the companies in the Business Ethics Top 100 rankings for 2003 and 2004. Correlation coefficients examine how two different data series are related. The value of the coefficient can range from -1 to 1. A score of -1 indicates that the two series always move in opposite directions (they are negatively correlated). A score of 0 indicates that the two series are unrelated; while a score of 1 indicates that the two series always move in the same direction (they are positively correlated).

Table 2 clearly illustrates that the overall scores (a higher score indicating a more socially responsible company) are heavily correlated with the scores for the social responsibility group; however they are not correlated with the scores for the traditional business factors. This provides evidence that the firms on the top of the Business Ethics Top 100 list perform more what is commonly perceived to be "social" programs than the firms at the bottom end of the Top 100.

This is not the case for the traditional business factors group. Based on the overall score, there is no correlation between how well a firm performs its traditional business roles and where it is ranked in the Business Ethics survey. Furthermore, if just the Financial Performance category (or stock price appreciation) is examined, there was no relationship between how socially responsible a firm is and how well its share price appreciates during 2003 and a mild negative relationship during 2004.

Table 2: Correlation Coefficients between Group and Overall Score

	2003	**2004**
Social Responsibility factors	+ 0.64	+ 0.75
Traditional Business factors	+ 0.07	- 0.03
Stock price appreciation only	+ 0.02	- 0.18

The negative relationship between financial performance and social responsibility are even starker by comparing the correlations between the Traditional Business Factors group and the Social Responsibility Factors group. Among the Top 100 companies for 2004, CSR factors were negatively correlated with the business factors: The correlation between the 5 CSR factors and the 2 business factors was -0.63. The correlation between the 5 CSR factors and stock price appreciation was -0.56. Similar results were also found during 2003, were the correlation coefficients were -0.73 and -0.62 respectively.

These results appear to indicate that within the Business Ethics Top 100 list that higher profitability is associated with less corporate social responsibility activities. This contradicts the basic premise of the studies portending that there is a positive association between CSR and corporate profitability or at bare minimum suggests that there is a maximum amount of CSR programs in which a company should engage. Furthermore, if this maximum amount of CSR programs theory is correct, then the companies on the Business Ethics survey have passed this maximum.

Turning now to the regression analysis, we examined whether or not a company was considered to be socially responsible by the Business Ethics survey against the three profit measures we have been examining (compound annual net income growth, average net profit margins, and share price appreciations).[x] These results are summarized in Table 3.

The Beta Coefficients indicate the strength and sign of the relationship between being a CSR company and each one of the three profitability measures. The P-value indicates at what level the results are statistically significant. Typically, results are considered significant if the P-value is at the 5% significance level or less. The Adjusted R-Square measures how much explanatory power the regression has. An Adjusted R-Square of 1 indicates that the independent variables (in this case CSR) explain all of the variations in the item of interest (in this case profitability). A value of 0 indicates that very little of the variation is explained by the independent variables.

Table 3: Regression Analysis Results: Dependent Variable as a function of CSR

Dependent Variable	Adjusted R-Sq	Beta Coefficient	P-Value
Stock Price Appreciation	-0.008	0.117	0.567
Compound Annual Net Income Growth	0.0412	-0.075	0.043
Average Profit Margin	-0.012	-0.005	0.753

The results indicated that there was significant and negative relationship between being one of the 28 CSR companies and compound annual net income growth over the sample period. The results for the net profit margin test were negative, but not significant (at the 5 percent level); and a non-significant (at the 5 percent level) positive relationship between being one of the 28 CSR companies and stock price appreciation. Overall, none of the equations have much explanatory power with respect to changes in corporate profitability – not surprising given that the regression does not include any other determinant of profitability.

These results support the results we found during the examination of the Business Ethics survey – there appears to be mild support that CSR programs have a negative impact on overall corporate profitability.

Discussion

In this analysis of 28 companies who were among the Business Ethics Top 100 Corporate Citizens every year from 2000-2004, we found no significant positive correlation between CSR and business profitability as determined by standard measures.

In each of the three profitability comparisons (compound annual net income growth, net profit margin and stock price appreciation) with their peers, only a minority of the 28 CSR-leading companies in each comparison outperformed their peers. Being a CSR-leading company was negatively or not correlated with compound annual net income growth, net profit margin and stock price appreciation.

No relationship between CSR and profitability was observed within the list of Business Ethics Top 100 Corporate Citizens. As might be expected, the five CSR factors were heavily correlated with ranking in the list, but the two business factors were essentially not and stock price appreciation was only weakly correlated. Moreover, the five CSR factors were strongly inversely correlated with the two traditional business factors.

A limitation of our analysis is that we only examined the businesses among the “Business Ethics Top 100 Corporate Citizen” list. We did not examine the other businesses on which Business Ethics collects data as this was not publicly available. By focusing on the “Top 100,” however, our analysis has the advantage of considering those businesses that are the most “socially responsible” according to Business Ethics.

Our results, of course, do not conclusively prove that CSR initiatives have a slight negative impact on a businesses financial performance. They are, however, strong evidence against the claim that CSR initiatives have universal or systematic positive financial impacts on businesses. Perhaps the most that can be said at this point is that research in this area should continue.

Future research, however, must be careful to avoid apples-to-oranges comparisons among businesses. It is important for researchers to keep in mind that CSR initiatives impose significant programmatic and administrative costs on businesses. It is likely, therefore, that the businesses that tend to engage in CSR initiatives tend to be businesses that are already financially successful and that can afford the added “CSR overhead.” Since, in these cases, financial success occurred before CSR initiatives were implemented, it would be obviously incorrect to conclude that CSR-related activities caused the financial success, though a positive correlation may exist.

To properly compare companies that undertake CSR initiatives with those that do not, many factors need to be controlled, including: the two CSR bias issues we have identified as well as standard financial issues such as industry sector; mature versus growth industries; operating scope (regional, national and multinational); investment risk profile (e.g., pharmaceutical versus consumer products businesses); and general economic and market conditions. Comparing financial performance across companies without considering these factors/ may produce misleading results.

Conclusion

This analysis does not support the claim that CSR is positively correlated with business profitability. Future efforts to evaluate the effect of CSR initiatives on profitability should be careful to tease out the specific financial impact of CSR initiatives rather than relying on crude analyses that, at best, may only really show that profitability leads to CSR.

ENDNOTES

* Arthur Laffer is founder and President of Laffer Associates; Andrew Coors is the Director of Research, Laffer Associates; and Wayne Winegarden is the Chief Economist, Sterling International.

i Friedman M, "The Social Responsibility of Business Is to Increase its Profits." New York Times Magazine. September 13, 1970.

ii Handy Charles, "What's A Business For?" (2003) Harvard Business Review on Corporate Social Responsibility, p. 72. (originally published by Harvard Business Review in December 2002)

iii There have been many studies purported to show this relationship. These include: Wood, D. J. &. Jones R.E., (1995) "Stakeholder Mismatching: A Theoretical Problem in Empirical Research on Corporate Social Performance" *The International Journal of Organizational Analysis*, 3 (3), July, 229-267; Tsoutsoura, Margarita (March 2004) "Corporate Social Responsibility and Financial Performance" *Working Paper: Haas School of Business*; Pava M. L. & Krausz, J., (1996) "The Association Between Corporate Social-Responsibility and Financial Performance: The Paradox of Social Cost" *Journal of Business Ethics*, 15: 321-357; Waddock, Sandra and Graves Samuel B., "The corporate social performance-financial performance link" *Strategic Management Journal*, 18 (4): 303-319; Waddock Sandra and Graves Samuel B., "Quality of Management and Quality of Stakeholder Relations: Are They Synonymous?" *Business and Society*, 36 (3), September 1997, 250-279.

iv Griffin J. J. and Mahon J.F. (1997) "The corporate social performance and corporate financial performance debate: twenty-five years of incomparable research" *Business and Society*, 36 (1): March, 5-31.

v Academy of Management Executive, May 2002, 16 (2): 132-148.

vi Munnell Alicia H. and Sunden Annika, "Social Investing: Pension Plans Should Just Say 'No'", Conference on Costs and Benefits: "Socially Responsible " Investing and Pension Funds The American Enterprise Institute Washington, DC June 7, 2004.

vii http://www.business-ethics.com.

viii Technically speaking, CSR advocates have created an implicit function. Because the definition of corporate social responsibility is dependent in part on profitability, analyses that test profitability on whether or not a firm is deemed socially responsible is implicitly testing profitability upon itself.

ix See www.hoovers.com

x Since Compound Annual Net Income Growth cannot be calculated if the net income during the final year is negative, the full data set was further narrowed to 77 companies. For consistency, this list was used for all of the regressions. The results for stock price appreciation, which could use a slightly larger valid set of 101 companies, does not change – being a CSR company has a negative but insignificant (at the standard 5% significance level) impact on share price appreciation with this larger set. This finding is important because the CSR companies were screened based on this profitability measure. Hence, the CSR selection bias should be most prominent for this measure of profitability.