THE ECONOMIC CASE FOR CSR:
WHEN PROFIT-MAXIMIZING FIRMS HAVE AN ADVANTAGE IN THE PROVISION
OF SOCIAL GOODS

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ABSTRACT

We make an economic case for CSR, arguing that profit-maximizing firms may better serve stakeholder interests than non-profits if and only if they enjoy a market advantage or can leverage their core business capabilities. Where this is not the case, profits from CSR may come at the cost of stakeholders.

INTRODUCTION

As firms increasingly invest in corporate social responsibility (hereafter CSR) activities, the study of CSR has become an important topic in the strategy literature. Scholars in this tradition have argued that paying attention to stakeholder interests has long-term benefits for shareholders, because it helps create environmental conditions, relationships and resources that lead to superior performance and sustainable competitive advantage for the firm (Freeman, 1984; Hart, 1995; Jones, 1995; Porter and Van der Linde, 1995; Godfrey, 2005; Porter and Kramer, 2006; Barnett, 2007). Consistent with this insight, a growing body of empirical work has observed a positive relationship between CSR activities and firm financial performance (e.g., Waddock and Graves, 1997; Barnett and Salomon, 2006; 2012; Margolis, Elfenbein, and Walsh, 2009; Eccles, Ioannou, and Serafeim, 2014; Flammer, 2014).

While these studies provide important insights into the benefits of CSR activities for shareholders, they tell us little about the impact of such activities for stakeholders. The fact that CSR has a positive effect on firm performance is a necessary but not a sufficient condition for the claim that the interests of shareholders and stakeholders are compatible. Only if firms undertaking CSR are able to serve stakeholder needs more efficiently or effectively than their non-profit counterparts are stakeholders made better off as a result of CSR. Using non-profit organizations as the counterfactual when thinking about the benefits of CSR is important for two reasons. First, from a stakeholder perspective, if for-profit firms are less efficient or effective at serving their interests than non-profits, then CSR activities may represent a loss of potential benefits to stakeholders, since the resources used for these activities—including additional revenues from consumers (McWilliams and Siegel, 2001; Du et al., 2011), wages foregone by employees (Turban and Greening, 1996; Edmans, 2011), or foregone shareholder returns (Mackey et al., 2007)—would be better channeled to equivalent non-profit organizations than to for-profit firms. Second, from a shareholder perspective, if it is true that the additional resources
they receive from CSR would be better spent with non-profits, then the sustainability of these resource flows must be called into question.

In this paper we seek to develop new theory to address this issue. Specifically, we seek to make, theoretically, an economic case for CSR, by defining and describing the conditions under which CSR is Pareto optimal, i.e., where for-profit firms can advance the interests of their shareholders while serving the interests of stakeholders in a way that is at least equivalent to their non-profit counterparts.

**THEORY**

We theorize two types of advantages that for-profit firms have in undertaking CSR relative to non-profits. The first type of advantage is the *market advantage*, which refers to the firm’s advantage in generating support for a cause that allows it to raise substantially more resources than the non-profit. This market advantage may arise out of the superior visibility and reputation of the firm: given the lack of clear information and the high search and monitoring costs resource providers face in evaluating non-profits (McWilliams and Siegel, 2001; Siegel and Vitaliano, 2007), they may be more apt to give resources if the non-profit activity is bundled with the supply of products and services from an established firm (Nayyar, 1990; 1993; Spiller and Zelner, 1997), effectively delegating their philanthropic activity to the firm (Bénabou and Tirole, 2010). The market advantage of for-profit firms may also be the result of positive spillovers between the cause and the firm’s products and services, resulting either from the image benefits associated with goods from a reputable for-profit (Ariely et al., 2009), or from demand complementarities between the social good and the consumer good that increase the salience of the social cause.

The second type of advantage is the *capabilities-based advantage*, where the resources and capabilities of the firm in its core business activities give it an advantage in related social activities (McWilliams and Siegel, 2001). The corporate strategy literature has long argued for the role of indivisible and firm-specific resources (Penrose, 1959; Montgomery and Wernerfelt, 1988; Barney, 1991) in enabling firms to create value through diversification, either through the realization of economies of scope related to physical resources or by leveraging scale-free knowledge and capabilities across businesses (Teece, 1982; Markides and Williamson, 1994; Levinthral and Wu, 2010). We argue that a similar logic applies to the case of CSR, with firms realizing economies of scope across their business and social activities.

Extending the corporate diversification logic to the case of CSR suggests two further points. First, for the resources and capabilities of the firm in its core business to benefit its CSR activities, these CSR activities must be closely related to its core business, since only then shall the firm’s capabilities be relevant to serving the social cause (Capron and Mitchell, 2009; Kaul and Wu, 2015). Second, given the firm-specific nature of these strategic resource and capabilities, using them to serve the social cause will require the firm to undertake CSR activities in-house, integrating them with its existing operations (Teece, 1982; Barney, 1991). Thus, the capabilities-based advantage will be limited to CSR activities that are closely related to the firm’s core business, and integrated with its core operations. This would be the case, for instance, where the supply of the social good required technological knowledge, expertise, or other specialized resources that the firm already possessed (and wanted to keep in-house to protect against appropriation), but that would be prohibitively costly for a non-profit to develop. This would also be the case for socially beneficial activities that were inherently tied to the firm’s
existing operations, such as the prevention of human trafficking or the enforcement of socially and environmentally responsible practices in its supply chain, which would be easy for the firm to coordinate and control internally at minimal additional cost, but that would be hard for an outsider to observe and monitor.

Balanced against these advantages that a firm may possess is its profit-seeking nature, which means that the firm will choose the level of the social good where the marginal resources raised equal the marginal cost of providing the social good (McWilliams and Siegel, 2001), rather than the level of the social good where the average resources raised equal the average cost. Thus, other things being equal, for-profit firms will systematically provide less of the social good than a non-profit, the intuition being that while non-profits will spend all the resources they raise to advance stakeholder welfare, for-profit firms will divert some of the resources raised for the social causes to their shareholders in the form of additional profit. We call this the dead weight loss of CSR, i.e., the loss of potential value to stakeholders resulting from the suppression of the supply of social goods by profit-maximizing firms. Only if the market and capabilities-based advantages of the for-profit firm offset this deadweight loss will CSR be Pareto optimal.

Figure 1 summarizes these ideas, plotting the combinations of market advantage (ϕ) and capabilities-based advantage (reflected in the relatedness between CSR and business activities, r) that are just sufficient to offset the deadweight loss caused by the profit seeking nature of the firm, i.e. the points at which the for-profit firm provides the same quantity of social goods as a non-profit. Specifically, we define ϕ* as the level of market advantage above which the firm will provide a greater quantity of the social good than an equivalent non-profit, and plot values of ϕ* as a function of relatedness (r). We further define r*, the level of relatedness above which the for-profit firm should always integrate its CSR activities, and r* as the level of relatedness above which the for-profit’s cost advantage is high enough to offset the dead weight loss on its own.

The figure highlights three distinct regions of CSR activities, each with its own rationale for the optimality of CSR. To begin with, the region above ϕ*, and to the left of r*, represents the case of market-based CSR. In this region, the value of the firm undertaking the supply of the social good (rather than leaving it to a non-profit) comes from the firm’s relative market advantage, i.e., its superior ability to raise resources for the social cause in question, which is sufficient to overcome dead weight loss. At the other extreme, points to the right of r* and above the ϕ* line in Figure 1 represent the case of capabilities-based CSR. For this region, the optimality of CSR rests squarely on the for-profit firm’s superior efficiency in providing the social good—the for-profit firm is so much better at producing the social good than a non-profit, that it is better for stakeholders if the firm undertakes the provision of the social good, even if it maximizes its own profit while doing so. Between these two extremes, Figure 1 shows a zone of mixed CSR. This represents a set of activities where neither the additional resources raised by the firm, nor its superior efficiency, is sufficient to justify the firm undertaking CSR by itself, but the combination of the two makes CSR socially worthwhile. The existence of this region suggests that even though we have described two distinct types of (Pareto optimal) CSR above—market-based and capabilities-based—these may best be thought of as pure types, with a continuum of cases that combine the two benefits of CSR between them.

***Insert Figure 1 about here***

Figure 1 also points to a substantial region where CSR may not be Pareto optimal, i.e., the entire region below and to the left of the ϕ*. Note that in this region the firm still makes
additional profit for its shareholders by undertaking CSR, but it does so at the cost of reduced supply of social goods to stakeholders. Specifically, Figure 1 suggests two cases of suboptimal CSR. The first is when resource providers are willing to contribute more generously to the cause as a result of the firm’s involvement, but these contributions (either in the form of premium prices, increased demand, or foregone payments), are primarily helping to raise shareholder returns; stakeholder interests would have been better served if the non-profit had provided the social good on its own, rather than having the for-profit act as its intermediary. The second case of suboptimal CSR takes place when the for-profit firm is substantially more efficient at producing the social good than the non-profit, and could enhance stakeholder welfare while making a profit for its shareholders, even if it received the same resources as the non-profit. But because resource providers are suspicious of the firm’s motive, seeing it as driven purely by profit, the firm is unable to raise the same level of resources as a (substantially less efficient) non-profit.

CONTRIBUTIONS AND IMPLICATIONS

We believe our paper makes an important contribution to the theory on CSR. While recent work in this area has focused on the benefits of CSR for shareholders, highlighting the role of CSR as a source of sustainable competitive advantage (e.g., Hart, 1995; Porter and Van der Linde, 1995; Porter and Kramer, 2006, 2011), of long-term relationships with key stakeholders (e.g., Jones, 1995; Henderson and Isaacs, 2013), and of utility derived by socially concerned shareholders (Mackey et al., 2007), the effect of CSR on other stakeholders remains understudied (McWilliams et al., 2006; McWilliams and Siegel, 2011). Our paper addresses this gap, going beyond other recent studies that have considered the creation of joint value for both shareholders and stakeholders (Porter and Kramer, 2006, 2011; Tantalo and Priem, 2014) in two key ways. First, we highlight the supply of a social good by a non-profit organization as the appropriate counterfactual for CSR, arguing that the benefits to stakeholders from CSR need to be judged by the more stringent criterion of whether these benefits are greater than those that would result were the social good supplied by a non-profit. In doing so, our approach on the broadest level answers the call for strategy to consider how firms add value to global welfare (Oberholzer-Gee and Yao, 2010). Second, we rigorously define and describe the specific mechanisms by which CSR advances stakeholder interest. In doing so, our work also complements models that study the effect of CSR on the competitiveness of firms in markets for consumer goods (McWilliams and Siegel, 2001), by studying the competitiveness of CSR relative to non-profits in the provision of social goods.

By comparing the provision of social goods by for-profit and non-profit organizations, we are able to show that there are conditions under which CSR is Pareto optimal, i.e., where for-profit firms may be more efficient and effective at serving stakeholder interests than non-profit organizations, even as they make additional profits for their shareholders. This result is important because it moves the discussion of CSR beyond ethical debates about the relative primacy of shareholder or stakeholder interests to offer a strictly economic case for CSR—one in which both shareholders and stakeholders are better off with CSR than they would be under any other alternative. This Pareto optimality of CSR in turn informs the sustainability of these non-market practices: pragmatically, CSR activities that benefit stakeholders while leaving shareholders worse or no better off may be hard to sustain organizationally, and CSR activities that benefit shareholders but are less efficient or effective than those provided by non-profits are likely to
lose their legitimacy over time; but CSR activities that serve stakeholders better than non-profits while making additional returns for shareholders should be easy to sustain.

Beyond making the economic case for CSR, our paper also recognizes and embraces the heterogeneity of activities that fall within the rubric of CSR. First, we offer a typology of CSR activities based on the rationale for the for-profit firm’s advantage in providing the social good, distinguishing between market-based CSR, where the firm enhances the visibility and appeal of the social cause, and capabilities-based CSR, where the firm leverages the capabilities and resources of its core business to provide the social good more efficiently. This distinction between market-based and capabilities-based CSR not only builds on prior work studying CSR as a source of competitive advantage (McWilliams and Siegel, 2001), it also links our theory to work on corporate diversification (Penrose, 1959; Teece, 1982; Levinthal and Wu, 2010), suggesting that we can think of entry into CSR as a special case of diversification into non-market areas, with the benefit from such entry coming from the synergies between the firm’s market and non-market activities. The drivers of the firm’s advantage in undertaking CSR are also linked to the organization of these activities (Boddewyn and Doh, 2011), with firms outsourcing the provision of the social goods to non-profits if their advantage is market-based, but integrating CSR with their business activities when their advantage is capabilities-based.

Second, by highlighting conditions under which CSR is Pareto optimal, we also describe the conditions under which it is not so, i.e., conditions under which the firm may realize additional profits from undertaking CSR, but only at the cost of lost opportunities for stakeholders, who would have been better served by non-profits. In particular, our formal model suggests that firms that seek to enhance their own reputation by making donations to large, well-established non-profits may, in fact, reduce the potential welfare of the focal stakeholders. On the flip side, it also suggests that skepticism about a firm’s motives in undertaking CSR on the part of consumers may, in fact, be harmful to stakeholder interests, since in cases where the social cause is closely related to the firm’s core business, the firm may be able to do more for stakeholders than a non-profit, even if its motive in doing so is purely to maximize profit. These arguments also highlight the relative benefits of for-profit and non-profit organizations in serving stakeholder interests, and provide a theoretical rationale for the co-existence of both forms of social activity.

In addition to advancing CSR theory, our paper also has several practical implications. For managers of firms, it highlights the need to think not only about how CSR can benefit shareholders, but also about its efficacy in serving stakeholders, and suggests that they may want to pick causes to address based not on their own preferences (Chin, Hambrick and Trevino, 2013), or on the general popularity of the cause, but based on whether they can serve stakeholders better than existing non-profits. For resource providers, it suggests that they may want to consider the best way to express their support for a cause, carefully considering whether their additional expenditures or foregone payments are not better channeled to a non-profit, or their donations not better used to support a for-profit’s CSR efforts. For public policy, our paper stresses the efficacy of ‘markets for virtue’ (Vogel, 2006), suggesting that in some cases, governments or other social actors may be better off paying for-profit firms to act in socially responsible ways, rather than trying to serve stakeholder needs themselves.

CONCLUSION
In conclusion, our study considers the provision of social goods by a for-profit firm and a non-profit organization, arguing that CSR is only economically optimal if the for-profit firm provides a greater quantity of the social good to stakeholders, even as it maximizes profits for shareholders, and showing that there are conditions where this is indeed the case. As such, our study offers a stronger and more complete case for CSR, while highlighting the need to subject such activities to a more stringent counterfactual criterion, and to carefully consider the heterogeneity of CSR efforts.

REFERENCES AVAILABLE FROM THE AUTHORS

FIGURE 1