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Research Report

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Columbia FDI Perspectives, No. 207

Provided in Cooperation with:
Columbia Center on Sustainable Investment (CCSI) - A joint center of Columbia Law School and the Earth Institute, Columbia University

Suggested Citation: Nachum, Lilac (2017) : How much social responsibility should firms assume and of which kind? Firms, governments and NGOs as alternative providers of social services, Columbia FDI Perspectives, No. 207, Columbia University, Columbia Center on Sustainable Investment (CCSI), New York, NY

This Version is available at:
https://hdl.handle.net/10419/254041

Columbia Center on Sustainable Investment
A JOINT CENTER OF COLUMBIA LAW SCHOOL AND THE EARTH INSTITUTE, COLUMBIA UNIVERSITY

Columbia FDI Perspectives

Perspectives on topical foreign direct investment issues
No. 207 August 28, 2017
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How much social responsibility should firms assume and of which kind? Firms, governments and NGOs as alternative providers of social services*

by
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Contemporary public expectations that firms assume responsibility for societal deficiencies are inconsistent with the demand of long-term survival and profit maximization, representing a fundamental shift in the view of firms and their role in society. The economic power and visibility of multinational enterprises (MNEs), combined with their global scope and exposure to multiple and diverse stakeholders, have made them the major targets of these expectations.

Is this state of affairs, whereby firms are treated as social institutions expected to assume responsibilities traditionally held by governments, desirable? Does the creation of public goods by profit-maximizing firms generate the greatest societal return? In the contemporary enthusiasm for the engagement of firms with social causes, these questions are seldom asked.

Beyond adherence to the law, refraining from taking advantage of gaps in the law and abuses of failure to enforce the law, including attempts to influence the law to their benefits, and being accountable for their own externalities, firms have societal responsibility. Within this domain, they should confine their engagement to activities that generate proprietary benefits and improve long-term competitive advantage. These activities include the creation of public goods that generate proprietary value in excess of public value, and social activities for which stakeholders are willing to pay a premium.

Governments and non-governmental organizations (NGOs) are alternative providers of social services, with respective strengths and weaknesses. They should provide those services whose production is based on assets that are not core to firms, and whose externalities cannot become proprietary to firms, e.g., clean environment. These include services for which markets do not exist or are dysfunctional, either because self-coordination via price mechanisms is not feasible, or due to market failure. High-risk investments whose returns are uncertain or very small, such as pharmaceutical orphan drugs, are cases in point.

Firms' investment in such causes puts them at a competitive disadvantage and harms their performance. Examples include UBS's tree planting and recycling programs, Wipro's program in Indian schools and colleges aimed at improving sustainability, and Indian Oil's investment in drinking water and rainwater harvesting, as well as Coca-Cola's investment toward cleaning China's Yangtze River.

Engagement in such activities not only harms firms; it is also unwarranted for society. Firms are not democratically elected, and there are no formal institutions dictating the social causes they choose to address, undermining their legitimacy in this role. Firms' dependency on profits implies that business considerations influence their social engagement in ways that may not be aligned with societal benefits. Furthermore, addressing societal causes divert resources away from firms' core business, decreasing societal value.

Society has the power to shape firms' social agenda and, in the contemporary world, uses this power to push firms into social engagement as an imperative for protecting reputation and brand name. These attitudes often originate in disregard of the societal value and positive externalities that firms generate, in the form of innovations and their commercialization, job creation, tax payment, and returns to shareholders.

The widely repeated and highly influential claim that firms should create "shared value" as a condition of legitimacy and credibility is similarly driven by a misconception of the relationship between firms and society. This claim is being met by default, in that firms' success and survival are dependent on the strength and sustainability of their stakeholders. There is also a need to change the view of firms as the agents for compensating government shortcomings. What is needed instead is pressure on governments to perform their duties effectively. NGOs may be called upon to fill some of the gaps left by governments.

National governments and international organizations have put considerable pressure on firms to assume many social causes. These efforts should be informed by the opportunity cost of treating firms as a social institution and enticing them to engage in activities that bear no relation to their core assets and mandate to maximize profits. Instead, governments—on their own or in collaboration with firms—should provide these social services. Collaborative efforts between governments and firms could be appealing when governments offer firms proprietary gains but guard against social losses.

Firms, governments and NGOs have a shared responsibility for meeting societal demands, but are suited to different respects. Under certain conditions, investment by firms can cause a more efficient utilization of resources and generate societal value. Absent these conditions, social engagement by firms has debilitating consequences. The framework introduced in this *Perspective* should be employed by policy-makers to identify the types of social causes that should be addressed by firms, and distinguish these from other causes that are the realm of governments and NGOs (or could be addressed through collaboration between governments and firms). Policy-makers ought to use their legislative authority and soft power to instill this division of responsibilities and to champion the societal benefits it generates.

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