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CSR and corporate sustainability. Theory and policy implications

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CSR and corporate sustainability. Theory and policy implications

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Abstract:

The increasing globalisation of economic activity has jeopardized CSR and its sustainability in the long run, weakening the ability of stakeholders to monitor the CSR standards of a corporation. This has eroded the incentives of the top management to adopt satisfactory and homogeneous global CSR standards, and has induced the temptation of exploiting the economic opportunities offered by shortcomings in local market regulations and in their enforcement.

The paper analyses the features of a sustainable corporation in the framework of the stakeholder theory and business ethics, focusing on the debate between legal regulation and self-regulation.

Key words: Corporate Social Responsibility, Sustainable corporation, Financialization, Self-regulation, Regulation.

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1. Introduction

The process of financialization has enhanced the tendency through short-term behavior both among investors and non financial companies.

At firm level, such a myopic focus has implications for cost-of-capital issues in terms of corporate incentive for the development of management policies and attitudes aimed at procuring greater near-future financial returns at the expense of even better long-term results. In aggregate, such behavior would lead to a sub-optimal level of long-term real investment in the national economy.

While the debate concerning the relationship between investor behavior and investment horizon is not new and it is recognized that short-term investors play an important role in capital markets by providing liquidity and ensuring short-term accountability, recent studies suggest that there is a growing global need for long-term capital in both private and public markets. Estimates of global infrastructure needs are about 3 trillion of USD per annum, with public finances increasingly unable to meet these needs (World Economic Forum, 2010) and an average annual investment in clean energy of 500 billion of USD is required by 2020 (World Economic Forum, 2009). Moreover, the financial crisis has highlighted the important role that long-term investors can potentially play in stabilizing the markets at a time of distress and enabling corporations to focus on long-term strategic decisions: long-term investors can not only improve long term value of individual companies, but also provide a social good by helping global financial markets to function more efficiently and promoting sustainable global economic growth and creating wider social benefits.

Contrary to short-term investors, long-term investors may seek to add value to their holdings in ways which are not only related to price. In this framework, an important role is played by sustainable investing, an investment approach aiming at integrating long-term Environment, Social and Governance (ESG) criteria in combination with the traditional financial ones (such as expected cash flow and price-to-earnings ratios) into investment and ownership decision-making.

From the investors' perspective, integrating ESG factors or corporate performance into investment decision is not in line with the conventional paradigm of many mainstream investors, which often confuse the ESG integration approach with the negatively screened ethical investments (World Economic Forum, 2011). On the other hand, it is recognized that corporations do not integrate sufficiently socially responsible targets into strategic decisions related to their core business. This tendency doesn't support the implementation of sustainable corporate efforts on environmental and social benefits because management doesn't often consider ESG goals as opportunities of value creation.

Nevertheless, the growing awareness within the investment community that global mega trends, such as climate change and natural resource scarcity (and their related externalities), are becoming increasingly financially relevant has become an important support to the process of transition towards a financial system able to incorporate the issue of sustainable development. Within this process, investors and corporations are, therefore, the two key players and Corporate Social Responsibility (CSR) might be considered the linkage between them.

In this framework, the analysis of the features and behavior of socially responsible companies in the light of financialization, together with the understanding of investors' attitude in selecting stocks with high CSR standards, has become essential.

Indeed, a positive relation between CSR and corporate financial performance, together with a business model characterized by a lower level of financialization, can represent a vehicle to increase the demand of a stock characterized by excellent CSR standard, which, in turns, would sustain its value, therefore providing incentives to managers to further strengthen socially responsible behavior of corporations, inducing a virtuous circle which may have a growingly positive effect on the sustainability of firms and of the economy as a whole.

In this paper we discuss the features of a sustainable corporation

2. The sustainable corporation and its social responsibility

We define a corporation as sustainable when its activity is compatible with the requirements of sustainable development. Otherwise, it runs the risk of compromising its own sustainability contributing to deteriorate that of macroeconomic development. To be more precise, we define a corporation as sustainable when it creates durable value for all its *stakeholders*. This definition is characterised by two specifications that we deem strictly connected but not redundant in that they illuminate independent, albeit correlated, aspects of corporate sustainability.

The first specification concerns the traditional aim of firms, namely creation of value for shareholders or -in economic terms- profit maximisation, pointing out that in order to attain corporate sustainability the firm's decision makers (DMs) have to focus on its long-term average performance. In this light, exceptional short-term results, much appreciated by stock markets and most shareholders, are not desirable if they are reaped, as often occurs, at the expense of future performance. In recent years, accounting practices have become increasingly common, whereby corporate results are, by legal means or otherwise, inflated to the detriment of future returns. Some of these accounting practices use derivatives to include in the current financial year expected future returns or postpone inclusion of losses by valuing securities at the purchase price instead of at the market price. Particularly risky is the use of the *over the counter* (OTC) derivatives that are not subject to regulation and now constitute more than 90% of derivatives in circulation. The "creative" accounting practices have been fuelled by excessively optimistic expectations and incentives given to managers, sometimes also to directors, based on short-term results. A significant case in point is the recent diffusion of stock options given to managers and directors as variable compensation in order to strengthen their commitment to produce shareholder value[1]. This has led to conscious or unconscious manipulations of the share prices and a narrowing of the time horizon of economic decisions to the time when the options mature, to the detriment of corporate sustainability (see, e.g., Bebchuk, 1989; Bebchuk, Fried, and Walker, 2002).

Finally, the growing financialization of the economy which has proceeded in parallel to the growing importance of stock markets, has made the financial side of balance sheets increasingly important while short-term *trading* has gained greater weight[2]. As has been recently emphasised, "[...] *the ratio of financial wealth to real wealth, Goldsmith's Financial Intensity Ratio (FIR), doubled between 1980 and the second half of the 1990s in the US, UK and France (where the FIR is between 2.1 and 2.9); it increased by over 50% in Italy and Germany (FIR between 1.3 and 1.4)* [...]" (Nardozzi, 2002, p. 15). Early on, Keynes (1936) observed that: "[...] *as the organisation of investment markets improves, the risk of the predominance of speculation [over enterprise] increases... Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done* [...]" (Keynes, 1936, p.158-9).

In general, an excessive focus on short-term performance is fuelled by a situation of potential conflict of interest involving a firm's *top managers* and directors on one side and stakeholders on the other side in that the reappointment, career and remuneration of the former crucially depend on their short-term results. According to some qualified observers the conflict of interests, which has always been *endemic* in a market economy, has recently become *epidemic* (Rossi, 2003).

The second crucial specification of the definition of sustainable firm concerns the key-recipients of value creation on the part of a company. According to the traditional concept,

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[1] As is well known *stock options are* option rights over the company's shares that may be exercised on maturity.

[2] A significant, albeit extreme, example is that of Enron. As explained by Frank Partnoy, professor of commercial law at the University of San Diego in his hearing at the US Senate, "Enron may have been just an energy company when it was created in 1985, but by the end it had become a full-blown OTC derivatives trading firm. Its OTC derivatives-related assets and liabilities increased more than five-fold during 2000 alone" (Partnoy, 2002). On the Enron case, see also Salter (2008).

embedded in the civil code of industrialised countries, the sole concern of a corporation should be that of increasing its profits so as to create the maximum possible value for shareholders[3]. This point of view has been stated in a particularly rigid and monist way since the 1970s under the name of "*Shareholder Value Theory*" (SVT). As is well known, an alternative view -often called "*Stakeholder Theory*"- has taken root in the last decades as a reaction to the perceived dogmatism of the recent versions of the SVT. According to this view, a firm should seek to create value not only for its *shareholder*s but also for all the other subjects, called *stakeholders,* who have a legitimate interest in its performance. The extension of the set of stakeholders varies according to the definition suggested. We include in the set of legitimate stakeholders only those who may claim a specific investment in the firm. On the basis of this criterion the list of legitimate stakeholders of a corporation is rather short: its employees who have invested in specific human capital, creditors (including shareholders) who invested in financial capital, suppliers who invested in specific productive capital, customers who invested in trust, and the local communities that invested in specific infrastructures and facilities. A debate is under way whether or not it is appropriate to explicitly include *stakeholder* interests different from those of the shareholders in the objective function of a corporation. Some experts note that the mono-stakeholder point of view prevailing in the legislation of industrialised economies has been superseded by events and should be updated by taking the other legitimate *stakeholders* interests explicitly into account[4].

A broad consensus is coalescing among scholars and experts on the need to take shareholder objectives into account *within a long term approach* (Jensen, 2001). Official

[3] This position has been confirmed by law. In 1919 the sentence Dodge vs. Ford Motor Co. of the Michigan Supreme Court maintained that Ford had to build automobiles in the exclusive interest of its shareholders, without letting itself be "distracted" by concerns for the interests of others, including consumers. Indeed, the sentence declared that the corporation exists for the benefit of the shareholders; therefore all the powers of those who manage it should be used for this purpose (see Rossi, 2003, p.123). This line of reasoning has subsequently been reaffirmed not only by law, but also by authoritative experts and scholars (Cary, 1969).

[4] The formulation of tasks and responsibilities of the directors of a public company as acknowledged in the relevant codes in the USA is still based on the codes drawn up at the beginning of the 19th century on the basis of Massachusetts court law (Longstreth, 1986). A broader point of view has been received also in recent official documents. For example in the *Principles of corporate governance* issued by the OECD a whole section (III in the first part) is devoted to the role of the *stakeholder* encouraging active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

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documents are beginning to record this need. For example, the self-regulation code of companies listed in the Italian Stock Exchange explicitly states that shareholder interests should be evaluated in a "non-short" time horizon (Committee for the self-regulation of corporations quoted in the Italian Stock Exchange, 1999, p.19). This implies more attention for all the stakeholders since "[...] *to manage the corporation in the long-term interest of the stockholders, management and the board of directors must take into account the interests of the corporation's other stakeholders* [...]" (*American Business Roundtable Report*, 1997). The latter statement is crucial and well grounded. It may be argued that in the long term there is no irreconcilable conflict between the specific aims of a company (business and profit sustainability) on one side and *stakeholders* welfare on the other side. This is confirmed by a vast and growing number of studies that have applied the most diverse methods (historical, statistical, econometric)[5]. The results mostly confirm that companies which have survived longer and have attained higher average profitability are precisely those that have attached greater importance to the interests of all *stakeholders* within a far-sighted framework (see Schmidheiny-Zorraquin, 1996).

We may thus conclude that the two specifications of the definition of sustainable corporation that we have suggested above are correlated in that the *stakeholders* are often bearers of long-term interests. Employees are mainly interested in the company survival and in its good economic and financial health so that they are guaranteed a job, opportunities of career and a remuneration no lower than that prevailing in the market. The suppliers are interested in the persistence of the opportunities offered by the survival of the firm. Customers are interested in maintaining a lasting fiduciary relationship with the company; the latter may consolidate this by focusing on customer needs, and even forgoing to this end a share of short-run profits. Finally, the local community is interested especially in the firm's survival so as to protect jobs and wealth over time in the area and ensure lasting social benefits, as

[5] We just mention here an econometric study which demonstrates the existence of a positive correlation between attention to the environment shown by a firm and its medium-long term returns: see Butz and Plattner, *Sustainable investment: an analysis of returns in relation to environmental and social criteria*, Sarasin Basic Report, Basle, August 1999. See also Consolandi, Jaiswal-Dale, Poggiani, and Vercelli (2009).

well as in the firm's attention to the environment and local social needs.

By the same token, it is in the long term interest of the company to devote as much attention as possible to the *stakeholders'* expectations. As regards workers, it is well known that continuous attention to their needs is fundamental to stimulate commitment and raise their productivity as well as to attract and keep employees with the best professional potential. It is moreover in the interest of the firm to have a set of reliable suppliers. In the case of customers, an orientation towards their needs so as to maximise their satisfaction is obviously fundamental to gain their loyalty and attract new clients. Lastly, the relationship with civil society is of crucial importance to obtain orders, reasonable taxation and structural facilities from the local communities.

The long-term orientation of entrepreneurial choices is a fundamental criterion for guaranteeing a firm's social responsibility. Yet it is not *per se* sufficient. Indeed, there is no objective criterion for determining a clear-cut threshold between short and long period. The precise choice of the time horizon for decisions has different effects on different stakeholders. This assertion holds even if we restrict our attention only to shareholders since they are motivated by objectives set in different time horizons. The same shareholders who participate in a controlling syndicate do not always have long-term objectives. This also applies to other stakeholders. The employees may exploit their training received or position reached in the firm so as to find a better position in another company. The customer who entertains an impersonal relationship with the usual supplier does not hesitate to change supplier once he finds an albeit marginal improvement in price/quality ratio. The local community may yield to the temptation of squeezing money out of a firm by applying a heavy tax burden without bothering to create the necessary infrastructures and facilities. The orientation of corporate choices towards value creation for all stakeholders is no guarantee of sufficient long-term attention. It is thus inevitable that there will be negotiations between the company's DMs and stakeholders to agree on an appropriate *reference time horizon,* that is the longest time horizon within which corporate strategic choices must be made. Obviously, this time horizon must then be segmented into shorter horizons within which the decisions take account of unexpected contingencies. There are company decisions, for example as regards cash management, which have to be taken at short notice. What is important is that the decisions taken within different time horizons have to be mutually consistent like the dolls of a matrioska, all held within a larger one, which corresponds to our reference time horizon[6].

The above remarks should have made it clear that the two qualifying elements of the definition of sustainable corporation herein proposed, that is the reference to long-term value creation and the attention for all stakeholders, are correlated but not redundant.

The deep link between the definition of sustainable development and sustainable firm may be better understood by realizing that the stakeholders play in the definition of sustainable firm about the same role that generations play in the definition of sustainable development. We may say that generations are the stakeholders of economic development while the stakeholders are the relevant sections of the overlapping generations of stakeholders concerned with the firm's sustainability. In the case of sustainable development we have a distributive conflict between and within generations, while in a corporation we have a distributive conflict between different stakeholders and between current and subsequent generations of them. In both cases the criterion of sustainability is based on a principle of equity that may balance the different interests through time.

Having ruled out that there is, in the long term, a systematic conflict between corporate objectives and development sustainability, we may wonder whether and to what extent this conflict exists in the short term. Up to the fairly recent past, environmental and social issues were often perceived as a barrier to economic development and a threat to employment due to legal constraints and repressive measures taken by public authorities. In recent years, however, the perception of this conflict has greatly subsided for a series of reasons. Most of

[6] To be fully rigorous, the reference horizon should be infinite, as this would be the only time extension that would take account of all future generations. In a too long time horizon, however, sound assumptions cannot be made on preferences, therefore an infinite time horizon does not allow a motivated choice between numerous and considerably differentiated filtered decision strategies. Thus we must assume a reference time horizon, which we could call "operative", based on well-defined preferences (Vercelli, 1999). The *operative* reference time horizon cannot thus be extended beyond a few decades, and normally it does not stretch beyond 5-10 years. This poses no problems if the strategies that are taken into consideration have passed long-term sustainability *screening*. In this chapter we use the term "reference time horizon" to denote what we have specified here as *operative* reference time horizon.

all, there is a growing *market pressure* towards greater attention to the environmental and social quality of products and production processes. This stems especially from increasing environmental and social sensitivity on the part of consumers. According to recent surveys, about 75% of consumers prefer to avoid, at least on some occasions, the purchase of goods and services from firms deemed to have little respect for the environment and direct their choices towards the most responsible firms. To these stimuli we have to add the incentives and disincentives which derive from environmental legislation which in the last three decades of the 20th century became increasingly rigorous so as to provide incentives for respecting the environment and disincentives for wasting resources and pollution.

Contrary to a commonly-held opinion, the traditional criterion of efficiency pursued by companies is *per se* fully compatible with development sustainability. Producing efficiently means producing goods and services at minimum costs, which entails the minimum use of human and natural resources, as well as minimum pollution given that the latter – other conditions being equal - is proportional to resources consumed as productive input. The traditional criterion of economic efficiency, however, is insufficient as not all the environmental or social costs and benefits are recorded by the market (inasmuch as they correspond to negative or positive externalities). In the last 30 years a growing number of companies have actively undertaken to revise the traditional concept of efficiency, transforming it into the more comprehensive criterion of *eco-efficiency* that takes into account also environmental externalities. This concept should be further generalised in order to consider also external social costs. Hence the need to draw up a criterion of "sustainable" efficiency that fully allows for implicit environmental and social costs, even before they emerge in consequence of progressive consumer awareness as well as environmental and social policy measures[7].

Finally, the concern for environmental and social values is increasingly perceived by firms as an *investment opportunity* rather than a mere cost or constraint. Such opportunities partly concern *defensive* investment, as an instrument to defend the market share. For example,

[7] The eco-efficiency criterion has been taken up by various influential associations of business people sensitive to development sustainability (as for example the 'World Business Council for Sustainable Development'). See the survey by Schmidheiny and Zorraquin (1996) published on behalf of the latter.

investment to obtain a recognised environmental certification (e.g. ISO 14000, EMAS) or ethical certification (e.g. SA 8000) are increasingly becoming a *sine qua non* for firms seeking to export to countries with stricter environmental and social laws, such as Germany and other northern European countries. Moreover, increasing importance is being attached to opportunities for *pro-active* investment in order to design and commercialize new products on new markets. Many firms are becoming convinced that being in the forefront in the CSR field may give them a decisive competitive edge in business operations.

In the light of these considerations, the conflict between social and environmental objectives on one side and traditional corporate objectives on the other side boils down to an aspect of the ubiquitous conflict involved in any investment strategy, given that the costs of an investment in physical capital and new technology must be borne immediately while benefits are distributed in various future accounting years. What impedes sustainability-orientated investment is thus chiefly the short-sightedness of economic agents which derives from a speculative rather than entrepreneurial mentality, from a lack of confidence in the future which depresses expectations, or from the lack of imagination concerning future scenarios and opportunities. It is a serious problem which affects the global market in all its aspects, not only in reference to development sustainability, with the difference that in the latter case uncertainty over future investment returns is reduced by the reasonable expectation that, despite ups and downs, the trend towards more rigorous environmental, social and health legislation is bound to continue.

3. CSR initiatives and the stakeholder theory

The rising wave of CSR initiatives and the lively debate on their meaning and scope started in the 1970s, gathered momentum in the 1980s and 1990s and became a very hot topic years after the appalling financial scandals that inaugurated the new millennium. This is strictly related to the progressive extension and deepening of global markets since WWII and their deregulation since the late 1970s. The deep crisis of the 1970s was interpreted by most observers as the consequence of excessive political interference on the functioning of markets, tense industrial relations, disruptive oil shocks and systematic failures of a too cumbersome welfare state. This interpretation greatly increased the widespread conviction that remedies to overcome the crisis could be found only by giving more power to markets through their systematic deregulation accompanied by a systematic privatisation of public goods.

The rekindled faith in the virtues of the market brought about important changes also in corporate behaviour and theory. In particular, the objective function of the firm was restated in more reductive terms than it was usual before. The only social responsibility of the firm, it was claimed with unprecedented emphasis, is that of maximizing profits. According to the economic theory of competitive markets, maximisation of profits is a necessary and sufficient condition for optimizing the social welfare. Any other preoccupation on the part of a firm's DMs would be self-defeating and would just bring about suboptimal results, also from the point of view of social welfare. Milton Friedman was particularly influential in propagating this doctrine not only in his contributions to the learned literature but also in articles written for a larger audience[8].

According to the SVT the shareholders are the only stakeholder whose interests should be taken into account in the firm's objective function. In this view the other stakeholders could be taken into account only for instrumental reasons: the clients to the extent that costumers satisfaction drives their demand, the employees to ensure smooth industrial relations, the suppliers to guarantee the quality and timeliness of their supply, the local communities to obtain the necessary infrastructures and avoid excessive taxation, and so on. The main justification of this theory is that the shareholders hold the residual rights on the surplus produced by the firm. They have thus a concrete interest in its maximization. In this view managers and directors are seen as mere agents of the shareholders. The principal-agent theory restricts the area of potential conflict of interest to the opportunism of agents who pursue their own interest in a situation of limited information. In order to realign the interests of the agents (managers and directors) with that of the principal (shareholders) it is sufficient

[8] The first comprehensive statement of this point of view may be found in Friedman who divulgated it in a famous newspaper article (Friedman, 1970). He confirmed many years later his position (Friedman, 1993).

in this view to introduce specific economic incentives aimed at maximising the shareholders value. A case in point is the distribution of stock options to the top managers, and sometimes directors, in order to induce a conduct committed to increase the shareholder value as much as possible.

These arguments raise two sorts of objections. A shareholder may have a prevailing interest in short-period value creation having in mind the sale of revaluated shares. Nothing guarantees that, within the shareholders, the point of view of those who are more concerned with the long term performance of the firm always prevails. In any case the shareholders should not be seen as an homogeneous subject since they are often divided by a fundamental conflict of interest between those who have a short-term time horizon and those who have a longer time horizon. The second objection is that the legitimisation of shareholders on the grounds of their residual rights highlights the existence of a basic conflict of interest between shareholders and other stakeholders. The shareholders may easily approve strategic and managerial decisions that increase the surplus by damaging other stakeholders: paying low wages or salaries, restricting the rights of workers, holding unfair contractual relations with suppliers, altering the quality of products to the risk of jeopardizing the health of clients, producing negative externalities and so on. The increasing prestige of the SVT, often entertained in simplistic versions, increased the conflict of interest between shareholders and other stakeholders shifting the balance of power in favour of shareholders. In this light the introduction of CSR initiatives may be seen as a physiological reaction meant to safeguard the interests and values of all the stakeholders.

The view that was dominating before the 1970s was much less monist and extreme, although perhaps more ambiguous. The managers were seen not as simple agents of the property but as professionals having fiduciary duties in regard to all the stakeholders (Sacconi, 2000). The managers associations defended with success this point of view and the discretionary power that descend from it until the early 1980s when the SVT succeeded to realign the economic, judicial, social and ethical points of view around the mono-stakeholder approach. This new perspective immediately translated in a different management philosophy. The first and foremost victim was the only stakeholder different from shareholders that had managed to gather a real power in the crucial decisions of the firm: the employees. In particular, the power of trade unions started to be energetically curbed with a novel determination that was absent in the different climate of the Bretton Woods period. Under the flag of flexibility, by developing processes such as overtime, outsourcing, delocalisation, and so on, the influence of employees on the strategic and managerial decisions of the firm rapidly declined. It is in this new situation of increasing neglect of the rights and needs of stakeholders different from shareholders that a few scanty CSR initiatives started to be adopted. In a second time they were progressively diffused and then coordinated in a CSR philosophy. The rapid diffusion of the CSR initiatives was nurtured by different, partially contrasting, motivations.

First, the exclusive emphasis on shareholder value raised the reaction of people and groups with religious motivations who emphasised the ethical dimension of the economic activity. In particular they promoted successful initiatives of ethical finance. At the same time people and groups of liberal inspiration, persistently aware of the limits to markets, argued that the SVT rigidly applied in real markets encouraged the social irresponsibility of firms and started to introduce countermeasures (see section 5). The introduction and diffusion of CSR initiatives, however, could be seen as the fruit of market, i.e. as brought about by spontaneous and decentralised self-regulation. Interpreted in this way, the CSR initiatives were seen with favour also by the rising new liberal stream: the substitution of market self regulation for judicial, and policy regulation was considered as a progressive evolution, or at least an unavoidable collateral effect of deregulation. Summing up, the growth of systematic CSR initiatives in the last three decades has been pushed by cultural and policy streams of different inspiration having in mind different purposes and limitations. This observation contributes to explain why the debate on the meaning and perspectives of the CSR initiatives has been so far particularly ambiguous and confused. In order to put some order in the issues raised by the CSR initiatives a theoretical anchor is needed. Most supporters of these initiatives looked for foundations in the "*Stakeholders Theory*" (ST), while most critiques focused on its shortcomings.

The emergence of ST that accompanies that of the CSR initiatives provides a multi-stakeholder prospective that may be seen as a reaction to the rigidly monist SVT. Though it is possible, as usual, to find predecessors, what is now called ST has been introduced by Freeman in the early 1980s (Freeman, 1984). The basic idea is that shareholders are not the only subject that has a legitimate stake in the performance of the firm and that all the stakeholders should be taken into account in its managerial and strategic decisions. The vast and growing literature stimulated by Freeman's seminal contributions is characterised by many areas of disagreement. The definition of stakeholder itself is quite controversial. It is generally claimed that it includes all the people who have a relevant and legitimate interest in the activity of the firm. In particular it encompasses all the individuals, or groups of individuals, that made a specific investment in the firm. This includes shareholders who invested in total capital of the firm, creditors who invested in its financial capital, employees who invested in their human capital, suppliers who invested in their own capital having in mind the needs of the client firm, costumers who invested in trust. It is less clear whether it should include the local communities where the firm operates. Also in this case, however, it is possible to argue that the local communities invested in specific infrastructures and facilities. The stakeholders listed above may be defined as the stakeholders in strict sense. In what follows we intend by stakeholders only those in strict sense that made a specific investment in the firm.

Another crucial point of disagreement is whether the firm should take account of the interests and values of all the stakeholders. There are two basic responses. First we have to acknowledge an ethical reason since all the stakeholders contributed to the performance of the firm; second there is an instrumental reason since a systematic attention for the interests and values of the stakeholders, generally improves the performance of the firm. None of these explanations taken alone is sufficient to justify CSR self-regulation on the part of the firm. A purely instrumental point of view would introduce interests and values of the stakeholders only as a constraint and not in the objective function and would subordinate the CSR initiatives to the tenets of SVT. The "enlightened" version of the SVT is ready to agree that serious attention should be given to the stakeholders in order to attain the maximisation of the shareholder value in the long period (Jensen, 2001). The CSR perspective, however, has the dignity of an authentic alternative theory of corporate governance only if it faces the problems raised by the inclusion of the stakeholders' interests and values in the objective function of the firms, a move that is harshly opposed by the SVT in all its versions.

On the other hand a purely ethical approach to the CSR initiatives would risk remaining rather sterile. A simple exhortation to a more ethical behaviour has never been particularly efficacious and often happened to be counterproductive. In our opinion the ST is interesting to the extent that it succeeds to coordinate ethical and instrumental considerations. The CSR initiatives may have a real impact in the business world to the extent that they succeed, through an apt system of incentives and disincentives, to reduce the gap between the required standards of ethical behaviour and self-interested behaviour. In what follows we intend to coordinate ethical and instrumental considerations from the viewpoint of the firm's sustainability, development, and the CSR initiatives themselves.

Having discussed a few preliminary issues, we have now to survey very synthetically the main uses of this theory (Donaldson and Preston, 1995). We should mention first its *descriptive* use. The ST suggests and supports a definition of firm as a network of relations between stakeholders that are in part cooperative, mainly in the productive process, and in part conflicting, mainly in the distribution of the surplus and of decision power. This point of view is more comprehensive than the prevailing view that interprets strategic and managerial decisions as a mere implementation of an agency relation in favour of a unique stakeholder, i.e. the shareholders. The second use is *instrumental*, as ST helps individuating the stakeholders interests to be taken into account in order to improve the performance of the firm. The third use is *prescriptive*, since the analysis of the interests of the stakeholders and of their impact on the performance of the firm leads to prescriptions concerning stakeholder management in an instrumental perspective.

As we have argued before, we cannot neglect the ethical implications of ST. We have thus to consider it also from the normative point of view. As soon as we accept the idea that stakeholders are not only an instrument for a better performance of the firm but also ends in themselves of its activity, an unescapable problem emerges. Since the interests of the stakeholders are, at least in part, mutually conflicting, the firm's DMs should promote a dialogue between the stakeholders in order to find a sound criterion to balance them. This is the great challenge arising from ST. It is often maintained by both supporters and critics that this problem cannot find an exact analytical solution. It is possible to demonstrate, however, that under reasonable assumptions, the strategic conflict between stakeholders, restated as an evolutionary game, under suitable conditions has in principle an exact analytical solution (Sacconi, 2004). In any case, under fully realistic conditions, a systematic and well organised dialogue between stakeholder and firm's DMs may produce a deeper awareness of the interests and values involved in the firm's strategic and managerial decisions leading to a reasonable compromise capable to orientate its activity.

Finally, in the light of the preceding considerations, the ST provides a model of corporate governance alternative to the prevailing one based on the SVT. In the latter the firm's DMs are seen as agents of the shareholders having fiduciary duties exclusively in their regard. The ST suggests a different model of CG in which the firm's DMs have fiduciary duties in regard to all the stakeholders. They have to find an equilibrium between interests and values that are likely to be heterogeneous, by promoting a constructive dialogue with and between them. The discretionary power of firm's DMs is therefore limited by the active participation of stakeholders. The more the latter are active and proactive, the more circumscribed is the effective discretionary power of the firm's DMs.

The hot debate that has developed on the virtues and limits of ST does not question its contributions from the descriptive and instrumental points of view, but its prescriptive and normative roles. The ST can play a role as autonomous theory, alternative to the mainstream approach, only by coordinating its instrumental role with its normative role. While the theory of sustainable firm that we intend to sketch in this paper may provide microeconomic foundations to the macroeconomic theory of sustainable development, the latter provides a benchmark and solid foundations to the ST and CSR.

The point of view of sustainability is immediately appealing. With the only exception of speculators, the interest of stakeholders and society at large in the activity of a firm is its healthy survival, and its capability of obtaining satisfying average returns. The concept of macroeconomic sustainability is founded on ethical values concerning distributive justice, the value of life and biodiversity. The same values provide the necessary ethical foundation to the sustainability of firms. The point of view of sustainability does not play down the importance of the firm's economic performance. In other words, the point of view of sustainability shifts the focus on the long term performance of the firm and its consequences for the stakeholders and society at large. A firm that aims to be sustainable includes the interests and values of all the stakeholders in the objective function within a long term time horizon. In order to achieve the most satisfactory sustainable performance, the firm's DMs have strong incentives to take CSR initiatives in order to strengthen a constructive dialogue with the stakeholders.

4. CSR and business ethics

In recent years the issues concerning CSR have attracted growing attention. This is partly due to a progressive awareness of the importance of ethical values in economic and financial relations. For example, the increasing awareness of the importance of environmental sustainability has driven a growing number of managers, directors and stakeholders to examine the implications of corporate decisions for the internal and external environment of the corporation. The growing focus on ethical standards, however, may also be interpreted as a reaction to their perceived deterioration in many areas of the business world. The awareness of the crucial role of CSR increased also in consequence of the recent financial scandals: Enron, Worldcom, Tyco, Global Crossing, Vivendi, ABB, Ahold, Cirio, Parmalat, Lehman Brothers, Banca Monte dei Paschi di Siena and so on. These two explanations are not contradictory. Directors and managers who are more concerned with the ethical rigour of their own behaviour have a short-term comparative disadvantage with respect to those who have fewer scruples, and are thus driven by this situation to express their convictions and take increasingly effective initiatives. In the case of stakeholders, it is evident that their progressive awareness of the importance of CSR self-regulation is also reinforced by the unprecedented series of financial scandals that shook the corporate community at the down of the new millennium. A further source of interest in corporate social responsibility lies in the evident difficulty encountered by the legal system to identify and sanction financial

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misbehaviour rapidly and efficiently. Many scholars and experts have thus felt that CSR self-regulation may constitute a way out from these problems (see in particular Sen, 1987 and 1991).

To understand these CSR issues which are extremely elusive and intricate it is worth taking a step backwards. The initiatives to consolidate corporate social responsibility aim to promote business ethics. Beyond general principles that it shares with other sub-fields of ethics, it has some peculiarities that create unsolved dilemmas both in theory and practice. In fact economic activity is based on a myriad of market transactions that occur when an equilibrium point is found between the conflicting interests that typically set agents against one another. For example the seller is keen to maximise the sale price while the purchaser is interested in minimizing it, and so on.

From the legal viewpoint, each transaction between economic agents may be interpreted as the execution of a contract between them, whether explicit or implicit. There is thus the temptation of considering each transaction as justifiable, in both ethical and juridical terms, since there seems to be nothing wrong with a contract freely concluded between contracting parties, at least in the absence of violence or fraud or other violations of the general principles of ethics or law. However, things are much more complex than they seem at first sight. This is due to the existence of asymmetries between contracting parties which distort the equilibrium point between them to the advantage of only one (Bebchuck, 1989; Posner, 2001). A typical case is that of *insider trading* which depends on information asymmetries between someone who has exploitable private information, and other economic agents. Having more information cannot certainly be censored *in se* from the ethical or legal standpoint. What is improper is to abuse of this advantage for one's own personal gain and hence to the detriment of other persons. This is a crime, however, which is difficult both to ascertain and to sanction. The vast and disparate family of crimes called euphemistically "conflict of interests" is yet more difficult to define and ascertain. As we have seen, conflicts of interest in a wide sense are very common in the market. Such a behaviour, however, is improper only when there is a clear abuse of a situation of relative advantage. The vast set of monopolistic and oligopolistic practices is a major example of abuse of market power asymmetries.

It is widely held that in recent years business ethics deteriorated considerably. I may refer in particular to the growing weight of short-sighted speculative strategies induced by herd behaviour, to the spread of forms of remuneration and incentives linked to short-term results, the progressive extension of conflicts of interest between listed companies, accountancy firms, analysts, mass media and institutions (Budd-Wooden, 2002; De Nova, 2002). This opinion is shared by some of the foremost experts in economic and corporate governance law (for example, Rossi, 2003). This appears confirmed by the wave of unprecedented scandals which has hit the financial sector in the last ten years[9].

The growing discomfort due to this "epidemic" did not fail to produce antibodies in the social organism. There was a mushrooming of initiatives to study CSR and intervene in its support on the part of international governmental organisations (UNEP, UNDP, UNESCO, FAO, the World Bank itself, etc.), NGOs (consumer associations such as Nader's *Public Citizen*, environmental associations such as *Greenpeace*, humanitarian associations such as *Medicins Sans Frontières*, civil rights groups such as *Amnesty International*, voluntary associations, etc.). Also companies and employee associations launched a myriad of initiatives to reinforce and highlight their socially responsible behaviour. In turn, national public authorities took various initiatives, but overall the legislation to sanction ethically improper behaviour in the business world may be said to have weakened in recent years. In general, public authorities have favoured deregulation, or at any rate decriminalisation, of behaviour conflicting with business ethics in favour of voluntary self-regulatory instruments judged to be more consonant with market mechanisms. In particular the legislative measures which have followed the recent financial scandals have been very timid. For example, in the USA the final version of the *Commodity Futures Modernisation Act* of 2000

[9] Something similar happened after the Black Friday of 1929. On that occasion there emerged widespread behaviour vitiated by "conflicts of interest" on the part of lending banks: to avoid the emergence of the financial difficulties of their corporate borrowers, they had systematically purchased their shares to keep market quotations artificially buoyant (Rossi, 2003, p.53). To prevent the repetition of such anomalies the *Glass-Steagall Act* was introduced in 1933 to separate credit supply from investment in company shares. The untimely *Gramm-Leach-Bliley Act* of 12 November 1999 partially abrogated the *Glass Steagall Act* favouring a further diffusion of conflicts of interest which has led to a series of scandals without precedent and the outbreak of a serious stock market crisis.

refused to introduce any control on OTC derivatives. Analogously the *Sarbanes-Oxley Act*, passed in 2002 to make it more difficult the occurrence of financial scandals, eluded the most serious problems (Rossi, 2003, p.66). In most countries, nothing serious has been even attempted to counteract the recent wave of economic and financial scandals; in Italy under Law Decree 61\2002 the crime of false accounting has been decriminalized.

The recent experience shows that this weakening of legislation has favoured the spreading of low standards of business ethics, while self-regulatory initiatives have so far managed only to diminish their virulence and slow down their spread. We shall attempt to evaluate in the subsequent sections to what extent these business initiatives have been effective and have managed to halt the epidemic.

5. Initiatives to consolidate corporate sustainability

There is no simple policy recipe to ensure corporate sustainability. In general we may only say that strategic decisions must be taken within a long-term horizon, bearing in mind the interests of all the stakeholders. Yet there is a series of initiatives which may contribute to consolidate *ceteris paribus* corporate sustainability.

The essential logic of CSR initiatives may be represented as a feedback between the system of CSR initiatives taken by the firm and the active reaction of stakeholders. From the logical point of view, the system of CSR initiatives starts from the approval of an ethical code that sets the basic moral principles to be respected by whomever takes decisions and acts in name of the firm. In order to translate these principles in managerial rules of conduct, the firm has to adopt a management system that takes into account the environmental and social values sanctioned by the ethical code. This move by itself corroborates the long-run sustainability of the firm. The CSR standards reached by the goods and services offered by the firm, as well as by their productive and distributive processes, may be certified[10]. The achievements obtained and the CSR initiatives taken or planned to upgrade them may be

[10] Particularly popular are the environmental certification (ISO 14000 or EMAS) and the ethical certification (SA 8000).

reported to the stakeholders and public at large in periodic statements such as the environmental or sustainability report, the social balance sheet, and so on. The reports and certifications convey an additional flow of information at the disposal of stakeholders and public at large that integrates and complements the information required by law in balance sheets and budgets. Its role is the more important the more stakeholders react to it in a continuous and constructive way in order to influence the strategic and managerial decisions of firms. A particularly important reaction is that of socially responsible costumers who shift their demand towards the most socially responsible companies. Stakeholders may also react by raising environmental or social issues either directly or through representative organisations, such as trade unions, consumers associations, and so on. The confrontation may use more or less aggressive means, from the dialogue with directors and top management to the organised boycotting of products, strikes, denunciation to mass media or courts. Another instrument increasingly used is the exposure of a socially irresponsible behaviour in the assembly of shareholders, taken account that it is enough to own one share to participate in it. The impact of these and similar reactions may be considerable and may induce a deeper ethical awareness on the part of managers and directors and convince them, even if reluctant, to take action in order to strengthen the CSR standards of the firm. In addition a proactive attitude by stakeholders could induce the firm to improve the quantity and quality of information disclosed and to develop new CSR initiatives.

A representation of the inner logic of the CSR self-regulation as a feedback between the firm and its stakeholders clarifies that the success of these initiatives strictly depends on the active and proactive behaviour of stakeholders. In its absence, the CSR self-regulation remains without a mechanism of enforcement and is likely to result quite ineffective. In addition we wish to emphasise that the behaviour of stakeholders, as any behaviour, is liable to be more or less consistent with ethical principles. They may pursue particular interests that could be in conflict with those of other stakeholders and/or with the long-term performance of the firm. In particular, an association representative of a group of stakeholders could be tempted to choose contents and methods of confrontation directed more towards the visibility of the association and its short-term success than towards the

CSR and sustainability of the firm. Therefore, the behaviour of any subject involved in the CSR feedback, including that of stakeholders and control authorities, is liable to be evaluated from the ethical point of view. No one should be consider, or feel, above ethical judgment and reprobation. The assessment of CSR should thus not be seen, as often happens, as an asymmetric relation between the firm's DMs on one side and stakeholders on the other side where the former play the role of accused persons, and the latter the role of judges. The attainment of high ethical standards depends on all the subjects involved and the behaviour of each of them may be more or less consistent with crucial ethical principles.

We should conceive of the CSR feedback represented in the next Figure 1 as a persistent and constructive dialogue between all the subjects involved that progressively increases their awareness of the ethical implications of their behaviour and of the options open to improve their ethical standards. This dialogue may be seen as a process of learning that progressively improves the ethical awareness in order to improve the social responsibility of the firm and all its stakeholders and to contribute to the sustainability of its performance.

[Figure 1 abut here]

The economic benefits arising from a commitment to sustainability create incentives for reinforcing it; however, at the same time, they raise a serious problem of opportunism. Also firms which are not really committed to upgrade the social responsibility of their decisions may be tempted to do their utmost to appear so. For example, some of the companies involved in corporate scandals, such as Enron or, more recently, Volkswagen, had succeeded in becoming accredited as companies that were particularly concerned with their social responsibility (Partnoy, 2002). Many others are nonetheless camouflaged, "following the vogue" of social responsibility. This has nurtured a widespread skepticism about the real scope of such new trends. Some have even expressed a negative opinion, believing that CSR self-regulation, whether voluntary or required by law, as it is not subject to legal sanction, may distract attention from the absolute need for appropriate civil and penal legislation backed by sanctions (see section 6).

Such skepticism is only in part justified. In fact there are effective disincentives for those who go for appearance rather than facts. Ethical codes and periodic reporting require commitments and make statements whose truthfulness can be verified. Just because some reports may be ambiguous or insincere does not mean that reporting in general is pointless. This would be tantamount to inferring from the existence of imprecise or inaccurate economic and financial balance sheets that the latter are pointless, and should be abandoned. In a certain sense sustainability reporting is nothing but an extension of the balance sheets, with the advantage that, while the ability to interpret balance sheets requires highly specialised skills, checking the credibility of sustainability reporting is relatively less difficult for stakeholders. We may thus conclude that the rules established by self-regulatory and corporate governance codes are not devoid of actual sanctions, albeit not of a legal nature, in that they are liable to economic and social sanctions on the part of stakeholders. The more effectively and continuously stakeholders control the standards of CSR, the greater the effectiveness of the CSR initiatives. To achieve this, sensitisation of the firm's DMs, stakeholders and public at large is required: this may be promoted by education and publicity promoted by public authorities, NGOs, and corporations themselves.

We should point out, however, the opposite danger that has emerged in many industrialised countries. Stakeholder organisations at times intervened in sensational fashion to attract the attention of a public which is insufficiently aware of the importance of these issues. Such interventions, however, risk being counterproductive in the long term as they may discourage the transparency and openness of companies, triggering a vicious circle that may further weaken CSR standards. What is therefore required is a constructive and long-sighted dialogue between stakeholders and corporations aiming at starting a virtuous circle between the CSR initiatives and active stakeholder participation. Yet the recent globalisation process has also jeopardized CSR and hence its sustainability in the long term. Indeed, the delocalisation of production has made stakeholder control increasingly difficult. Moreover, it has led to a progressive shortening of the decision time horizon on international markets which are increasingly linked by the Internet and by deregulation, in the presence of ever more marked herd behaviour. This has led many firms to aim towards excellence in short-term results to the detriment of their long-term sustainability.

6. Critiques of self-regulation designed to reinforce CSR

As we have hinted at before, not everyone is convinced that self-regulation initiatives are effective means to reinforce CSR. Some observers maintain that the recent wave of CSR initiatives is a fashion devoid of significant effects, if not even counterproductive for the objectives proposed. In this section we discuss the main general critiques advanced against the CSR approach and the ST that underlies it. We may classify these critiques in two distinct sets, the first one is advanced by scholars and experts who believe in the power of self-regulation of markets and interpret CSR initiatives as distorting interferences with the market forces, while the second group of critiques is much more skeptical about the effective power of self-regulation and interprets the CSR initiatives as unduly substitutive of regulation by law.

Within the first group, the most detailed and well-argued critique is probably that recently made, and extensively cited, by M.C. Jensen (2001)[11]. According to Jensen (2001), self-regulatory initiatives and standards to strengthen CSR are devoid of sound theoretical foundations and end up by becoming counterproductive insofar as they are based on ST. Indeed, in his opinion, the CSR initiatives would make sense only if it was held that the company should include in the objective function value creation for all the stakeholders and not only for the shareholders[12]. Jensen (2001) raises two objections in sequential order.

First, there is a preliminary objection of a "logical" nature. In Jensen's opinion an efficient objective function must have only one argument to allow a thorough assessment of the company's performance. Otherwise, corporate behaviour could not be appraised on the basis of an unambiguous criterion, and this would leave excessive discretional power to the

[11] M.C. Jensen, emeritus professor of Business Administration at Harvard Business School with a number of business appointments that guarantee first-hand knowledge of the subject in question.

[12] Total company value includes not only share values but also the market value of all other "financial claims" including debt, preference shares and warrants.

company's DMs who would thus manage to elude effective control on the part of stakeholders, including the shareholders themselves. This might lead to opportunist behaviour by managers and directors to the detriment of stakeholders and corporate interests. Given that, according to Jensen (2001), ST suggests a corporate objective function based on a plurality of goals which correspond to the differentiated and often conflicting interests of the various stakeholders, such a theory is unable to propose an efficient objective function. In his opinion this problem is made evident, and at the same time insuperable, by the reluctance of supporters of the theory to fix the trade-offs between various stakeholder interests. The stakeholder theory is thus unable to propose a credible alternative to the traditional objective function (maximization of the total company value) which is backed by two centuries of economic and financial research. Moreover, adds Jensen, there would be no need for an alternative criterion as economic and financial theory have shown that in a competitive market "[...] *in the absence of externalities and monopoly* [...]" (Jensen, 2001, p.11) maximisation of total company value is a necessary and sufficient condition to obtain maximum social welfare which also includes that of the company stakeholders. Thus, if on the one hand public authorities should intervene to eliminate monopolistic practices and internalize externalities, the company for its part should only be concerned with maximizing its total value to obtain much more securely and efficiently the same results of *stakeholder* theory.

Stakeholder theory is given a role by Jensen as heuristic support for long-term profit maximisation. He recognises that maximisation of company value, if restricted to the short term, could damage some stakeholders and jeopardize company value in the longer term. He thus points out that the company's objective function has to maximize total value in the long term: "such short-term profit maximisation is a sure way to destroy value." (Jensen, 2001, p.16). And it is here that, according to Jensen, stakeholder theory may provide a major contribution, especially as to how to create good relations with customers, employees, financers, suppliers, regulators and the community, since he recognises that it is not possible to maximize an organisation's market value in the long term if the interests of one or more major stakeholder are ignored or harmed (*ibidem*).

This convergence between the two opposing viewpoints of traditional theory and stakeholder theory is defined by Jensen as the "enlightened" version of SVT. This view, without abandoning the traditional objective function, would enable one to take into account many of the arguments –those that are in his opinion acceptable - that motivate stakeholder theory.

Finally, Jensen criticizes management methods of evaluating the performance of a company's employees or divisions based on a "balanced scorecard" due to their inability, as their parent stakeholder theory, to express a single transparent measurement able to ensure actual controllability of corporate behaviour. Jensen corroborates his argument with examples taken from the evaluation of sporting performance: to classify competitors unequivocally and identify the winner, a single measurement would be in his opinion necessary (time, height of the bar, length of jump or throw, and so on). On the other hand, also management techniques based on the definition of a "balanced scorecard", like the stakeholder theory that inspires them, are appraised as a useful heuristic support to understand the specific sources of value creation whose measurement is entrusted to straightforward indexes of value creation such as the well known Economic Value Added (EVA).

To summarise, even if Jensen does not explicitly discuss the practices and standards of CSR, his position clearly undermines its prescriptive role, though not necessarily its supportive role to a more constructive dialogue between company and stakeholder. Nevertheless, in our opinion Jensen's criticisms are not convincing. First of all, the preliminary argument of a "logical" nature which underpins his critique of ST and management techniques based on the *balanced scorecard* (Kaplan and Norton, 1992) is definitely groundless. The logical problem of reducing various arguments of a valuation function to a single unit of measurement is a problem which has long been tackled and solved. An obvious example is the index number theory which allows us to measure sets of heterogeneous magnitudes with the same unit. This requires the specification of different weights for each magnitude and the definition of trade-offs between the various arguments of the measurement function, but their determination is not necessarily arbitrary. There are tested techniques to determine weights and trade-offs based on dialogue with stakeholders, which have been examined and applied in multi-criterion analysis and decision procedures based thereon. There are also unique benchmarks that may be obtained in each single situation by using game-theoretic models that study the strategic interaction between different stakeholders (Sacconi, 2004).

The reference itself to the appraisal of sporting merits confirms that Jensen's critique is not well-grounded. Multiple disciplines, such as the decathlon, pentathlon and triathlon, adopt composite measurements that take account of results obtained in the various events without encountering logical difficulties in classifying competitors according to merit. Clearly, procedures to make results homogeneous in a single measurement require the consensus of stakeholders, but this does not need to be an insurmountable problem.

In any case, the "logical" problem underlined by Jensen (2001) is not wholly avoided by assuming the criterion of maximisation of total company value. Indeed, the measurement is destined to change according to the time horizon chosen, as is recognised by Jensen (2001) himself. One has to agree with his choice of a long–term time horizon but this does not solve the logical problem that he poses. Indeed, how can we univocally determine how "long" should be the long-term? To this problem there is no objective solution that avoids the need for agreement between all stakeholders based on dialogue and consensus. Besides, the previous argument shows a basic logical flaw in Jensen's position. If it is really believed that the company operates in a market with perfect competition, there could be no conflict between short and long-term decisions[13]. Otherwise, the conflict between short and long term is unavoidable. In this second case, however, the traditional objective function would also give ambiguous and arbitrary results unless the reference time horizon and the trade-offs between the different time horizons are specified, which would raise the same problems of stakeholder involvement to reach a sound agreement on the reference time horizon and the most appropriate trade-offs among the various time horizons which has the necessary consensus of all stakeholders.

As for the conviction expressed by Jensen (2001) that the maximisation of the total company

[13] In this case the principle of intertemporal coherence that underlies classical theories of intertemporal decisions (axiom of independence in the Morgenstern-Von Neumann theory and the so-called "Sure-Thing Principle" in Bayesian theory) ensure the absence of conflict between short and long term (Vercelli, 1999).

value maximizes at the same time also the social welfare, this would only hold in a perfectly competitive market (with infinite agents who are all price-takers) in the absence not only of monopolistic practices and externalities, but also of all the further conditions that guarantee the validity of the theorems of welfare economics: the completeness of the markets, perfect foresight or at least rationality of expectations, more generally the unlimited rationality of economic agents, the absence of transaction costs, weak uncertainty, and so on. It is precisely the wide gap between the real market and the ideal market of perfect competition (in which, by the way, companies could not exist) which makes it essential to explicitly take account of the interests of all the *stakeholders* to reduce as much as possible the distortions in the allocation of resources, especially intertemporal distortions, and maximize social welfare. That this is how things stand is recognised by Jensen himself in reference to the short term. Allocative distortions generated by maximisation confined to the short term cannot but stem from the shortcomings of real markets. Why they should disappear in the long term remains a mystery. Trade-offs between the interests of the various stakeholders are thus not fixed implicitly in optimal fashion by the criterion of maximisation of company value either in the short or long term.

Jensen's criticisms of the normative importance of the ST are thus basically groundless even if they rightly recall the attention to the requirement that corporate governance should be based on a simple, clear and transparent objective function, which focuses on the long term and gathers a basic consensus on the part of all the stakeholders. Particularly in this function, as in the criteria for evaluating individual or division performance, the weights and trade-offs characterizing the interests of individual stakeholders must be made clear. Finally, the operative time horizon of strategic decisions to be agreed upon with the stakeholders should be long term. The necessary short-term maximisation should then be performed by the managers of the corporation according to the guidelines provided by long-term maximisation.

A different critical position has been taken by scholars who are skeptical about the power of self-regulation of real markets. A good example of this point of view is the critique advanced by Guido Rossi, a well-known expert in corporate law and governance (Rossi, 2003). He has

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maintained that self-regulation to reinforce business ethic and CSR is pointless if not counterproductive. Self-imposed rules to reinforce CSR would be futile since, unlike legal regulations, they would have no sanctions or enforcement mechanisms. In his opinion, the illusory fashion of corporate self-regulation aiming at CSR is counterproductive as it provides an alibi for weakening the legal regulation of corporate business. Indeed, in recent years, in line with systematic market deregulation, laws governing the behaviour of firms and markets have progressively weakened. The justification for this policy lies partly in the increasingly swift evolution of economy and finance which makes it difficult for legislation to keep pace, and also in the growing complexity of economic and financial issues which makes it ever more difficult to apply the rules and sanctions of deviant behaviour. Yet this would not be enough to justify a weakening in the law if there were not the illusion, or excuse, of a better alternative, namely corporate self-regulation.

Even this critical position is not wholly convincing. Rossi (2003) is right to stigmatize the opportunistic abuses of ethical issues and social responsibility. The more one believes that it is urgent and potentially productive to address matters regarding ethics and social responsibility concerning economic and financial behaviour, the more serious such abuses should be considered. Conversely, the idea that CSR self-regulation would be structurally powerless as it lacks enforcement mechanisms is groundless. As we noted before (see section 5 above), CSR self-regulation may be accompanied by a structure of incentives aimed at compliance and disincentives for non-compliance. The market may give a significant contribution in this direction depending on the sensitivity of end-users of goods and services (consumers and savers) to environmental, social and ethical quality of goods and services supplied by firms and of the production and distribution processes upstream of their commercialisation. The system of incentives and disincentives which is thus created may be made more effective through CSR initiatives as long as there is no illusion that the market is able, independently and spontaneously, to start and maintain this virtuous circle between companies and stakeholders. Obviously, the more sensitive consumers are to the ethical, social and environmental quality of goods and services purchased, the more effective is the system of incentives and disincentives. This requires a process of sensitisation and education of stakeholders that the market is unable to implement autonomously, but can be promoted by well-designed CSR initiatives. So Rossi (2003) is definitely right in rejecting the arguments of those who think that legal regulations should be replaced by corporate self-regulation, but he is mistaken in maintaining that the latter is condemned to be devoid of any enforcement mechanisms. The nexus between legal regulations and corporate self-regulation should be conceived not as one of competition but as one of synergy. Indeed the process of stakeholders' education is an important condition for the effectiveness of legal regulation itself. It has long been known that the more regulations are in harmony with the consensus of civil society, the more effective is the enforcement of legal regulation. This may be considerably strengthened by the virtuous circle of self-regulation assisted by public interventions of citizen sensitisation and education.

7. CSR and financial markets: some policy implications

The increasing globalisation of economic activity has jeopardized CSR and its sustainability in the long run, weaking the ability of stakeholders to monitor the CSR standards of a corporation. This has eroded the incentives of the top management to adopt satisfactory and homogeneous global CSR standards, and has induced the temptation of exploiting the economic opportunities offered by shortcomings in local market regulations and in their enforcement.

As we pointed out before (see section 6 above), the idea that CSR self-regulation would be structurally powerless as it lacks enforcement mechanisms is groundless and CSR self-regulation may be accompanied by a structure of incentives aimed at compliance and disincentives for non-compliance. In this regard, as the market may give a significant contribution, an important role may be played by financial markets.

On the investors' side, linking incentives to risk adjusted financial performance over the long run, by increasing the performance assessment period for fund managers, could be a sustainable business strategy. On the corporations' side, sustainability could be supported by a change of the incentives plan expected for CEO towards long term performance goals which includes ESG factors as indirect financial performance criteria (World Economic Forum, 2011; Huber and Hirsch, 2015).

Furthermore, the existence of identifiable ethical preferences in the utility function of investors (Consolandi *et al.*, 2009) may strengthen the enforcement of CSR regulation by giving positive incentives to the most responsible firms, and negative incentives to the others. For this reason, it is firstly necessary to develop skills - both within investors and corporations –able to assess the financial materiality of ESG corporate performance at a sector level.

The transition towards a financial system able to incorporate the issue of sustainable development, requires to overcome the existing barriers mainly given by the culture of both investors' and corporations and incentives' systems, oriented over short-term results..

From the investors' perspective, integrating ESG factors into investment decision is not in line with the conventional paradigm of many mainstream investors, which often confuse the ESG integration approach with the negatively screened ethical investments (World Economic Forum, 2011) and adopt valuation models which ignore ESG factors.

From the company perspective, it is recognized that corporations do not in practice integrate sufficiently socially responsible targets into strategic decisions related to their core business, consequently limiting their sustainability efforts on environmental and social benefits rather than considering them opportunities of value creation (Accenture –UN, 2010). In order to bypass this lack of consideration of issues related to sustainable development, and create an environment favorable to sustainable business, it is necessary a series of coordinated actions from all the key stakeholders involved (asset owners, corporations, accounting bodies and public authorities) aiming at: a) improving information, b) strengthening competencies and c) modifying incentives.

As Waygood (2011) points out that "[...] *Markets are driven by information: if companies do not provide an assessment of the wider sustainable development risks and opportunities associated with those numbers, it is not possible for the market to assess the sustainability of that growth* [...]". At this regard, the Asset Management Working Group of the United Nations Environment Program Finance Initiative has proposed a series of actions which should be put in place by policy makers to increase the demand of responsible investment by the capital markets.

These efforts could encourage both advisors and institutional investors: to a) include ESG issues in an ex-ante financial evaluation process; making a responsible investment option the default position (Waygood, 2011); and b) ensuring regulatory frameworks that lead to a higher level of transparency and disclosure from investors (asset owners and managers) on the integration of ESG issues into their investment process, as well as from companies on their performance on ESG issues (UNEP, 2009).

On the basis of the extensive analysis of Jurek (2014) on CSR self and formal regulation framework and its required re-modelling to build sustainability of financial institutions consistent with the requirements of sustainable development, what we want to add and highlight here is the need of a high level of engagement of investors and corporations in public policy on CSR related arguments.

Indeed, the recent global financial crisis, which stemmed from the credit crunch in 2007, has forced financial markets and companies to rethink their exposure to sistemic risks (UNEPFI, 2010). As a result, the importance of integrating ESG factors and sustainability into corporate and investment decision-making has become even more relevant.

Companies, financial market actors and regulators are called to respond to the need of new approaches to creating sustainable shareholder value that require companies and investors to adopt a systemic and longer term view, and to understand the financial materiality of ESG factors as part of a full spectrum of risks and opportunities.

Working in the framework of an *articulated regulation* presented in Utting (2005), where voluntary and legalist approaches or public policy can interact in a complementary or synergic way, investors' and corporations' engagement within the policy process may provide an important contribution in delivering effective policy rules that align investment with long-term sustainable development.

Indeed, relying only on self-regulation might be a limited successful strategy, as for corporations the implementation of CSR codes might generate high costs. In the absence of a significant market premium to responsible companies that would compensate for CSR costs we should not expect companies to lastingly incur these costs. External regulation could either create such premium or increase costs for ''irresponsible'' companies (Levis, 2006).

On the regulatory side, governments might consider four types of policy instruments in order to shape and promote CSR in various fields of action (Steurer, 2010): a) raise awereness and build capacity for CSR, b) improve transparency and disclosure, c) foster Socially Responsible Investments (SRI) d) lead by example on socially responsible practices (i.e. making public procurement more sustainable, applying SRI principles to government funds, reporting the social and environmental performance of governmental bodies).

On the other hand, CSR self regulation might not be effective as a vehicle of information to financial markets if the socially responsible behaviour is not adequately disclosed to investors.

According to the World Economic Forum's Sustainable Investing Working Group the actions which should be put in place with highest priority, due to their highest potential of effectiveness can be summarized as follows (World Economic Forum, 2011):

- Incentives system. On the investors' side, linking incentives to risk adjusted financial performance over the long run, by increasing the performance assessment period for fund managers. On the corporations' side, modyfing incentives for corporate executives towards a long term performance which includes also ECG factors as indirect financial performance criteria (namely, specify the use of CSR indicators in performance reviews and the calculation of bonuses)
- Developing skills both within the investors and corporations able to assess the financial materiality of ESG factors at sector level Once the value of sustainable actions incorporated in corporate strategies will be translated in to traditional metrics and measured in terms of cost reductions, revenue growth or risk, it is necessary that companies will improve their communication to investors on which ESG factors are financially relevant and in which timeframe.

Encouraging better corporate disclosure on environmental, social and governance issues is essential for investors to incorporate them into their investment decision-making processes. Similarly, requiring investors to engage constructively with the companies in which they are invested is an integral part of the process of long-term value creation.

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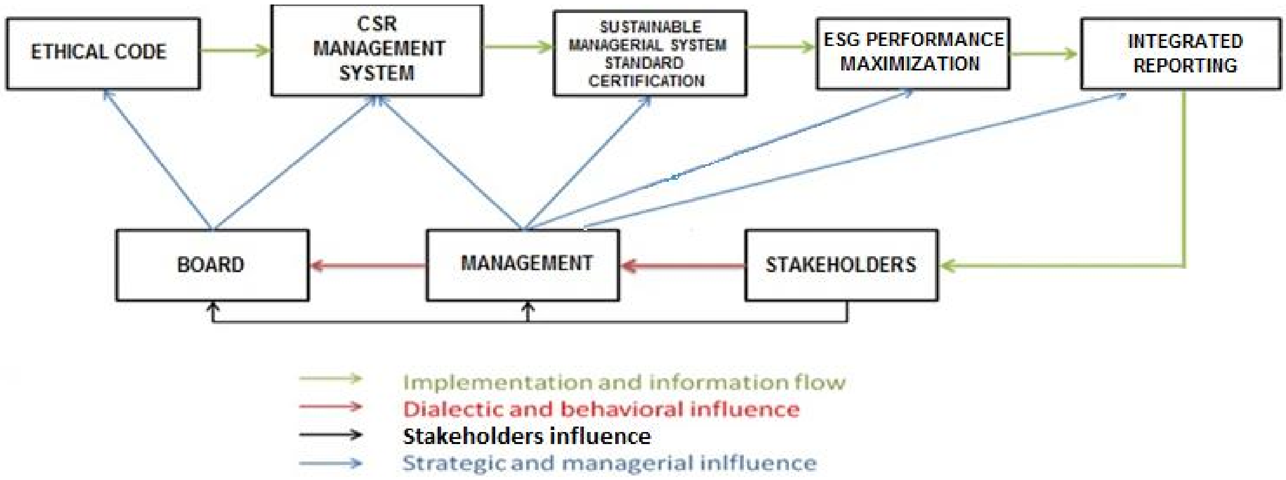
Fig. 1 – CSR self-regulation and stakeholders engagement approach



Source: Authors' elaboration.

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THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?'

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2	University of Siena	Italy
3	School of Oriental and African Studies	UK
4	Fondation Nationale des Sciences Politiques	France
5	Pour la Solidarite, Brussels	Belgium
6	Poznan University of Economics	Poland
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8	Berlin School of Economics and Law	Germany
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