Redesigning Resources

Social Responsibility - Business Challenge

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Introduction

The theme of this conference is one which, a few years ago, would have seemed extraordinary to most people in business: the idea that environmental responsibility could actually be wealth-enhancing. It is a vision which is part of a re-appraisal of the relationship between business and the societies of which it forms part. It is a recognition that the objectives of business, and those of other groups within society, are complementary rather than in opposition.

In this presentation I have a complementary purpose; to make the case that social responsibility, also, is wealth-enhancing and to go on to argue that in New Zealand, at the present time, we have a particular need to:

- act to restore what can be seen as a relative lack of trust in business
- consider whether given the unique values of New Zealand society, we should be encouraging the emergence of new business models to build on those characteristics, looking at this first from a private sector perspective and then considering the potential within the public, especially local government, sector.

The paper is divided into five parts:

- corporate social responsibility: the value(s) challenge for business
- rebuilding trust
- a new business model for the private sector?

- and for the public?
- conclusions.

1. Corporate Social Responsibility: The Value (s) Challenge for Business

The past few years have seen intermittent debate between advocates of a socially responsible role for business, such as Dick Hubbard of Businesses for Social Responsibility, and opponents, such as the New Zealand Business Round Table, arguing that "the business of business is business".

Common ground between the two sides has been the view that someone who owns his or her own business is free to do as they think fit subject only to the general requirements of the law such as not defrauding creditors. Accordingly, there is no debate over whether it is proper for the business owner/manager to divert profits from the shareholders' pockets to whatever community, social, cultural or other objectives he or she sees fit.

The difference arises when ownership and management are in different hands; classically in the listed company with widespread shareholding and whose shareholders appear to have little influence over the actions of company management other than the option, if they wish, to sell their shareholding.

It is in this area that we have seen the main argument against New Zealand businesses taking on a social responsibility function. At its strongest, the two elements of this argument have been:

- if shareholders, individually, wish to promote social or other goals then they are free to apply their income from the company for that purpose exercising their individual choice rather than, if the company were to do it for them, finding their wealth diverted to purposes which they might not support
- in plain terms, for managers to divert funds from shareholders to social or other goals is little more than theft.

Research shows that, despite the apparent strength of the argument against social responsibility, many New Zealand corporates actually undertake activity supportive of social responsibility goals. Here I am indebted to my colleague Adrienne von Tunzelmann, the author of the leading New Zealand study, "Social Responsibility and the Company: A new Perspective on Governance Strategy and the Community" which not only provides an overview of CSR within New Zealand but also the compelling rationale for its relationship to shareholder value which I outline shortly.[1]

The reality is that, in arguing against a social responsibility role for corporates, those New Zealand commentators who do so are increasingly out of line with international practice. Thus:

- In January of this year the World Business Council for Sustainable Development published "Corporate Social

Responsibility: Making Good Business Sense"[2]. The report both provides a robust definition of corporate social responsibility as "the commitment of business to contribute to sustainable economic development, working with employees, their families, the local community and society at large to improve their quality of life" and presents conclusions on its importance for business including "a coherent CSR strategy, based on integrity, sound values and a long-term approach, offers clear business benefits to companies and a positive contribution to the well being of society".

- In the United Kingdom PIRC (Pensions Investment Research Consultants Limited) provides research and advice on socially responsible investment for pension funds, with a current client base of institutional investors with combined assets of over £300 billion. At its most recent annual corporate governance conference Sir Ian Vallance, chairman of British Telecom, stated "there are those who believe that a concern with ethics, values or, indeed, the community at large is incompatible with the business aim of creating shareholder value; that managers should steer clear of the difficult compromises and trade-offs involved in balancing the interests of the various stakeholders. That is a misplaced belief".

It would be possible to provide numerous other examples of business leaders from widely respected corporates, many recognised as hard-nosed and competitive in their own businesses, making the case for corporate social responsibility. Of itself, that might not be enough to silence the critics. After all, corporate managers spending their shareholders' money on CSR activities are hardly likely to say that it is a bad idea - the fact that they argue in support of it maybe no more than a collective endeavour to justify improper activity.

There is a second and stronger argument which goes right to the heart of the case against corporate social responsibility and, in my judgement, reduces it to little more than semantics. This is that corporate social responsibility is in fact value enhancing.

First, some recent practical evidence. New York city-based Innovest Group recently compared the environmental records and practices of 23 drug makers in the S & P 500 against each company's financial data. Companies were then given a rating based on projected stock market return.

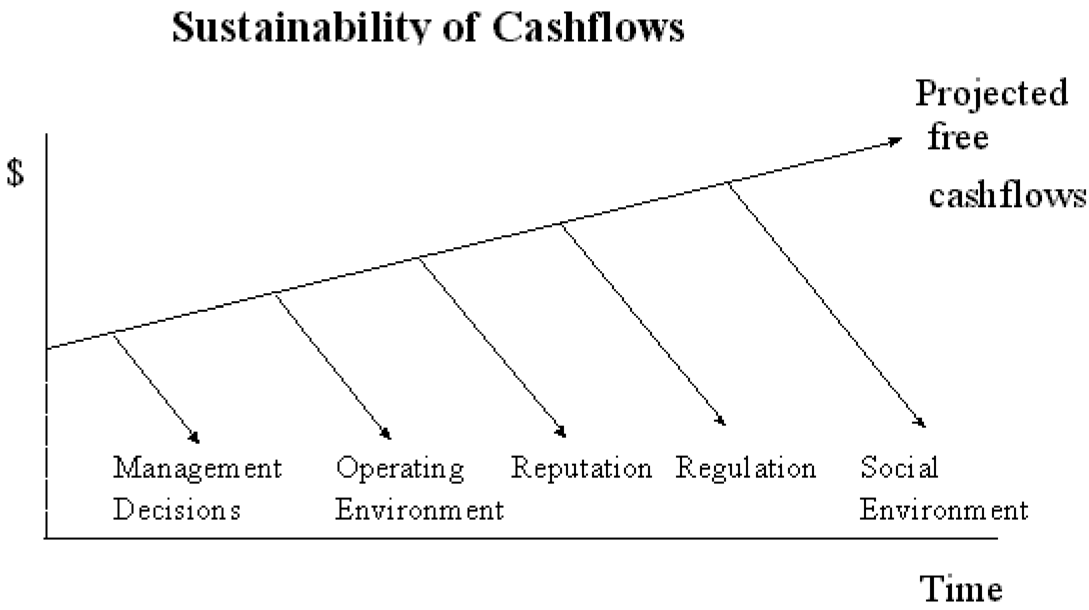
That study showed that the pharmaceutical companies with the best environmental records out-performed the S & P 500 in 1999 by 15%.

Now to what can be seen as a compelling argument from a shareholder value perspective developed for the first time, as far as I am aware, in the New Zealand study cited above.

Consider how financial analysts now think about the value of a company. Traditional measures such as price-earnings ratios have been set aside in favour of a net-present value approach - taking a weighted average cost of capital appropriate for the company concerned, what is the present value of its expected future earnings stream (free cash flow)?

That is an approach which focuses attention squarely on the sustainability of net earnings over the life of the company and directs attention to factors which will influence their sustainability. Some are under the direct control of the company itself. Most, however, are only indirectly controlled by the company but can be influenced by the way it conducts its affairs and by public perceptions of that conduct.

Represented diagrammatically, the company faces a number of risks to the sustainability of future value:



Adverse public perceptions of a company's behaviour can, for example, result in threats of regulatory intervention - as with the electricity and telecommunications industries in New Zealand; in adverse reputational impacts - which may affect firms believed to be following unacceptable environmental or labour practices, such as the alleged use of child or other exploited labour in developing countries; or adverse reaction from the social environment as the behaviour of firms is seen as unacceptable from a citizen perspective - the pressure currently coming to bear on major New Zealand banks over withdrawal of/pricing for services provides an immediate example.

The New Zealand critics of socially responsible business practice have been correct to argue that the business of business is business but wrong in the inference they then draw that businesses should not be proactive in addressing stakeholder concerns.

The business of business is to enhance shareholder value in the long term, but this is something which can only be done if the business is focused on ensuring that it satisfies - indeed exceeds - the standards of behaviour expected of it by the community or communities in which it operates.

2. Corporate Social Responsibility: The Value (s) Challenge for Business

From a business perspective, the ideal operating environment is one in which society accepts that self-regulation is both the most efficient (in the sense of least cost) and effective (in the sense of consistent with societal values) means of managing society's interest in the performance of business.

The American writer Francis Fukuyama in his influential 1995 work "Trust: the Social Virtues and the Creation of Prosperity" argues that the United States has historically had enough trust in business to permit the building of large corporations but that decreasing trust has seen the need for more rules to regulate them - and particularly to regulate the interaction between corporations and other interests in society. He argues that this imposes a substantial additional cost on business with a threat both to its long-term competitiveness and to national prosperity.

New Zealand as a society has always been somewhat suspicious of business[3]. In this respect, the last decade and a half will probably be seen with the benefit of historians' hindsight as something of an aberration. We swung away from a highly regulated society and business environment, to one which for a brief period saw us regarded as one of the least regulated economies in the developed western world. We seemed to have a policy setting based on the view that best government was least government and prosperity would be most easily achieved by leaving business alone to get on with the job of wealth-generation.

We applied this approach not only to the private sector but also, extensively, within the public sector. An assessment of how far we went comes from last September's OECD symposium "Government of the Future: Getting from Here to There". Allen Schick, an expert in comparative public management, presented an overview paper "Opportunity, Strategy and Tactics in Reforming Public Management" in which he said of our public sector reforms "New Zealand…has advanced much further than any other country in establishing internal markets…no other country has extended contractual relationships into so many areas of public management and program operations" and then went on to pose a series of questions suggesting a measure of scepticism, from a public management perspective, of the effectiveness of what we have done.

Leaving aside the effectiveness of our extensive reform program, within either the private or the public sector, what does seem clear is that it has added to the mistrust which New Zealanders generally have for business and business-based strategies. The causes of this distrust seem to include:

- the narrow focus on shareholder wealth creation as the sole purpose of business which has characterised much of the public comment from the business community over the past few years
- the flow on impact of greater liberalisation, globalisation and the increasing use of new technology. The resulting pressures have compelled many businesses to rationalise -- the closure of bank branches is a good example -- but from a community perspective this has all too often been seen as a conscious withdrawal of service cynically benefiting shareholders at the expense of the less well-off
- · New Zealanders have always been suspicious of business, at

least big business (perhaps part of the tall poppy syndrome). The last few years have seen an increasing belief that business is substantially the enemy of the decent society. This has set the scene for a significant backlash against much of the deregulation of the past few years as is reflected in a number of the initiatives which the new government is taking.

In essence we have two major problems which could probably be addressed by a common solution. The problems are:

- an increasingly anti-business climate which is gradually constraining the degrees of freedom which businesses have to operate

- a growing belief that the market is inconsistent with a socially just society as numbers of people are excluded from effective access to the benefits of operating within the market because they lack the resources, the skills, or both. Here, the risk is that the government will regulate to force outcomes which it believes the market will not deliver.

It is probably no exaggeration to say that one of the reasons why we now have a Labour/Alliance coalition government is that the electorate generally wanted a move away from a business-dominated market-based approach to dealing with social issues back to something more akin to New Zealand's tradition of highly interventionist government. To put it in another way, after 15 years of economic reform and relying primarily on a hands-off approach the electorate had simply lost faith.

For New Zealand this is a serious matter, not just because of the patchy record of past government interventions but more importantly because of what it says about the likely future operating environment for business. In my judgement, you do not have to be a rampant capitalist (whatever the term capitalist might mean) to be concerned at the evidence we now have of a pervasive mistrust within the New Zealand community of the way in which business operates.

Trust in business and the accompanying "licence to operate" free from arbitrary interference either from government, from other regulators, or from public pressure, is not a right. It is a privilege which business earns and which it can lose.

Arguably, this is exactly what has happened over the past few years. The apparently self-interested approach of a number of major businesses, and of some business lobbyists[4], has clearly persuaded the New Zealand public that business's "licence to operate" should at best be a restricted rather than a lifetime licence.

Individual firms, adopting principles of corporate social responsibility and seeking to apply principles such as the "factor four" approach of natural capitalism, can help turn around public perceptions. However, that of itself will not be sufficient. If business is to make good the damage done to its public standing over the past few years, then there will need to be a concerted demonstration, from business leaders and business groups, that New Zealand business accepts the obligations of corporate citizenship and that socially responsible business is the way of the future.

Today, it is not my purpose to spell out how this should be done. Instead I simply make the point that the task is both urgent and will require the concerted action of a business community not accustomed to acting collectively in the public interest as opposed to pursuing somewhat more narrow commercial interests.

3. Towards a New Business Model

The New Zealand business model, as currently practised, is very much of an import. Most importantly, the emphasis on private property rights and associated market disciplines as the appropriate (almost only) means of encouraging efficiency within our business sector comes most directly from the work of American financial economists although, ironically, we appear to have taken the model somewhat further even than American practice - our relative lack of control over take-overs is a good example.

In this part of the paper I want to pose the question of whether that is an appropriate model for New Zealand business, at least if it is to be seen as the only or dominant model.

New Zealanders are a somewhat odd bunch. To illustrate what I mean by this consider two different ways by which a complete stranger might start exploring the idea of what type of business model would be appropriate in a New Zealand environment. The stranger might pick up on the "number 8 fencing wire" myth with its message that New Zealander is a self-reliant innovative individual who can turn his or her hand to almost anything and make a go of it. Relying solely on that model, the stranger might conclude that New Zealanders were a nation of entrepreneurial individuals for whom the appropriate business model was one which maximised individual freedom and celebrated success measured in terms of the personal wealth the individual could achieve.

Now let us select a different starting assumption. Our stranger looks instead at the extent to which New Zealanders have shown a preference for collective action, whether through relying on government as the main driver of economic growth and creator of significant business structures (think of the long line of government-owned businesses successive governments built up) or as regulator of business activity on behalf of what was seen as the collective good. Our stranger might also, pursuing this line of enquiry, get an understanding of the so called "tall poppy" syndrome and putting all of this material together conclude that New Zealanders are inherently collectivist and that the appropriate business model should play up the collective interest and play down the individual interest including the maximisation of individual wealth.

Our problem - or our opportunity - is that both perceptions are correct. We are, at one and the same time, both strongly individualistic and strongly collectivist, a combination quite different from those commercial societies from which we have drawn our predominant business model. Perhaps we should not be surprised that we are neither particularly comfortable with the dominant US/UK model nor particularly good at it. In support of this, consider the following:

- a story sometimes told by investment bankers to illustrate the difference between American entrepreneurs and New Zealand entrepreneurs is that when the American's net worth gets to $10 million or so his or her reaction is typically 'how do I get to $100 million?'. In contrast, the New Zealander is likely to sell up, or at least slow down, and go to the beach

- an alternative story, again from New Zealand investment bankers, is of the reluctance of New Zealanders to continue building their business once their personal wealth has reached the $10-$20 million mark; seemingly at this stage a number will want to sell out concerned that it is not socially acceptable to build major private wealth (even though the consequence might be significant employment and wealth gains for other New Zealanders as well).

Perhaps a more sobering insight into our comfort with, and acceptance of, the dominant model is the recent work by Joseph Healy, head of corporate finance for ANZ Investment Bank in New Zealand. His study "Shareholder Value Performance of Corporate New Zealand" was in the headlines earlier this year. The study covered some 500 companies with a turnover of approximately $90 billion. His findings include:

- although total turnover was equal to 90% of GDP, aggregate before-tax profits amounted to only 3% of GDP

- in 1998, some $6.5 billion of EVA[5] was lost from the 500 companies reviewed.

The study put forward a number of different hypotheses in an attempt to explain this poor performance. They included a preoccupation with accounting measures which were essentially irrelevant from a value-creation perspective; an undue emphasis on dividend distribution rather than wealth-creation as the basis for rewarding shareholders, and inadequate corporate governance.

To these hypotheses I would add a fourth; we may simply be relatively uncomfortable with a business model so strongly focused on the creation of individual wealth as the principal performance measure.

Perhaps our difficulty is that our dominant business model so closely interlinks high performance and individual wealth creation. Logically, it is possible to separate the two; it may be that it is a characteristic of the dominant business model, rather than an inherent characteristic of New Zealand business people and the society of which we are part, that the two are seen as going hand in hand.

Think about this issue from a strategic development perspective. Most modern writing on corporate strategy will emphasise the importance starting where you are. A classic text on strategy defines it as "the match between what a company *can* do (organisational strengths and weaknesses) within the universe of what it *might* to (environmental opportunities and threats)".

What might that mean for choosing a business model to suit New

Zealand conditions and characteristics? If we are both strongly individualistic and strongly collectivist, does it make sense that our dominant business model should be based solely on the individualistic side of our national character and ignore the collectivist side? The answer is probably not and the evidence I have just cited does seem to lend some support to this.

What sort of model might we look to instead (or as well - as in an open economy we can hardly reject a model widely accepted elsewhere)? Obviously we both want and need a model which can deliver high performance. This means a number of things including clear lines of accountability, decision making authority and the ability to move quickly and flexibly as market conditions/opportunities require.

We also, obviously, need a model which gives the entrepreneur the sense of excitement and achievement which comes from setting up and running your own show - an obvious motivator of many New Zealand business achievers and probably a stronger one, in the final analysis, than the wealth which results.

We also want a model which encourages the successful entrepreneur to stay on board rather than sell out when the business gets to the $10-$20 million level. As a society, we need businesses which grow from that level of value to $100-$200 million or indeed much greater. It is only with businesses of that kind that we can expect to provide the employment required by and to satisfy the educational, health, housing and other aspirations of our citizens.

What might that model look like? One possibility of which Tait Electronics is a well-known example, is for the entrepreneur to transfer the ownership of the business into a charitable trust whilst still retaining management control. Under this approach:

- the entrepreneur receives the level of value which he or she regards as appropriate (I have no knowledge of whether Sir Angus Tait gifted his business or sold it for value - either are options, and an entrepreneur taking this course of action would certainly be able to sell the business for full value, with the purchase price to be paid as the business could afford to do so)

- the entrepreneur retains the degree of management control which he or she regards as appropriate - in other words, the excitement of the chase, continuing to build the business, remains

- the character and profile of the business changes. The wealth it generates is now (ultimately) committed to a public purpose. Wealth generation within the business is completely supportive of the collectivist half of the New Zealand character.

Despite the problems of corporate governance identified in the ANZ report, my own view is that many New Zealanders have a good understanding of what is best practice in corporate governance. I suspect that what they lack is the environment which encourages them to practise it. Given our peculiar make-up, it seems to me that there will be a number of situations in which it will be a great deal easier for management to target matching or exceeding EVA if the benefits of doing so flow back to a public purpose than if the gains are captured by private owners.

I put this suggestion forward as an option entirely consistent with the values which underpin this conference.

4. And for the Public?

Perhaps not surprisingly, one area which has seen some quite interesting progress in reconciling the individualistic and collectivist sides of our character is the public sector - not so much central Government with its market driven reforms but local government.

One example is represented at, indeed sponsoring this conference. Orion is a council-owned company which has an enviable record in adding value for its shareholders but at the same time has built a strong reputation as a socially responsible business. Its principal shareholder is proud to endorse an enlightened version of a collectivist approach in the sense of being quite unapologetic about adding value for its community through the ownership of successful businesses. In doing so, it has been quite prepared - indeed committed - to applying best practice in corporate governance.

Christchurch City and Orion (and others of the Council's 'subsidiaries') are an example of a public sector model of combining business excellence with a sense of collective purpose.

The more interesting development, though, is in the way in which local authorities in New Zealand are now thinking about their own role in relation to the communities they serve. Most of us here are still used to thinking of local authorities as basically being in the business of "roads, rats and rubbish". That is still important in the same way as good housekeeping is important in any environment but, at least potentially, it is now the less significant part of the local government role.

Factors influencing change include:

- a growing recognition of the implications of the fact that New Zealand is now an open economy and that the powers of government to intervene in order to direct economic or social outcomes are now much less than they used to be

- the impact of differential growth as some regions expand and others contract

- the fact that adverse social outcomes - whether in employment, health, education, or income distribution - have their main impact at the local level rather than centrally

- most importantly, in acting as a trigger, the impact of the reporting and accountability requirements which local authorities now face.

Amongst the requirements of the package of local government financial management reforms introduced in 1996 is the preparation of a long-term financial strategy. This document is required to spell out, for at least the next 10 years, the activities which the local authority will undertake, its reasons for being involved in those activities, its expected revenue sources, cashflows and forecast statements of financial position, and any significant assumptions or risks to achieving the forecast outcomes.

Many local authorities, looking at this set of obligations, have realised that a service organisation can only provide a credible forecast if it knows what activities it will be servicing. A 10 year or longer forecast of (say) roading requirements, water or wastewater investment and much else requires a good knowledge of what other people are likely be doing in your district in 10 or more years time. This insight has been reinforced by growing demands within many communities that the local authority act as their advocate with central government over access to social services and play a lead role in local economic development.

The result? Many local authorities are now preparing or have prepared strategic plans for the district as a whole, engaging the community and identifying the major outcomes expected from each sector of the community.

As a crude analogy, what this really amounts to is the local authority taking the lead in developing a strategic direction for the district in much the same way as (say) the board of a multidivisional company. The process is highlighting the fact that, typically, the local authority may be the only organisation with the depth of research, analytical, policy and representational capacity to take this kind of lead. Its increasing acceptance is a recognition by many of New Zealand's communities that their futures are now more in their own hands than in the hands of central government and that one of the most important tools they have for influencing that future (and to be blunt, their own asset values whether houses or businesses, their future employment prospects and those of their children) is the local authority as an instrument of their collective purpose.

Underlying this is actually a strong economic rationale to do with what might variously be described as externalities, transaction costs or the free rider problem. Consider how the benefits of economic growth at the local level might actually be distributed. Some will go to the businesses whose prosperity is directly driving that growth. Much, and possibly the greater part, will accrue to other businesses, individuals and the community at large. In a locality whose economy is growing, business and property values will also be strong, the community will be better placed to meet its social needs, and people living in the locality will have a wider range of opportunity. What this makes clear is that the benefits from economic growth will be spread well beyond the firms or organisations whose activities are its direct cause.

Theoretically, it would be possible to construct a series of interlocking private contracts between businesses or other organisations (perhaps a tertiary institution or a research Institute) and the residents of a locality under which the residents undertook to carry part of the cost of initial investigations, feasibility studies or whatever and put up some of the required capital in the expectation that they would enjoy a share in the benefits of growth through such things as increased property and business values, greater personal opportunity and a more vibrant community. In practice, the transaction costs of doing this would be formidable. As a result, typically economic growth depends on business decisions focused solely on the private gains from investment and disregarding the potentially significant social gains[6]. The result is that regionally we may significantly under-invest in activities which could generate significant social gains because we have lacked a mechanism able to provide the means of investing in order to secure those social gains.

Local government as the collective instrument of the locality it represents is capable of filling that gap. The emerging role of local authorities in the development of strategic business plans for their localities and gaining the commitment from key stakeholders in implementing the agreed strategies presents an exciting and potentially very effective means of bridging the gap between the purely private investment decision and investment decisions driven by an understanding of the combined private and social returns which could result.

It gains part of its impetus from something which is very hard to replicate in the purely commercial arena; the willingness of people to "get in behind" when the interests of the community are at stake - provided, and this is an important proviso, that there is an evident quality of leadership and vision driving the community involvement.

This shift is still very much in the nature of an "emerging trend". It is influenced also by increasing questions over the governance and ownership of, and accountability for, very significant sums of locally held public wealth resulting from reforms of the late 1980s and early 1990s of entities such as trust banks, power boards and harbour boards.

In a parallel with what I have suggested as a possible alternative business model for the private sector, what we can see is public bodies looking to encourage/facilitate the application of business skills to seeking solutions for local problems through taking a commercial approach to maximising local opportunity but in a way which is strongly reflective of its collective origins. There are growing signs, certainly in some of the work which I am currently involved with, that the potential impact of this trend may be far greater than even the informed observer might be prepared to speculate.

5. Conclusions

The principal theme of this conference is that an informed approach to environmental management is also a wealth-creating approach to business management. In this paper I have sought to complement that argument by:

- demonstrating that corporate social responsibility is a value-adding strategy and not, as has sometimes been suggested, an indulgence of managers at the expense of shareholders
- arguing that underlying the typical New Zealander's attitude to business is a unique combination of highly individualistic and highly collectivist attitudes

- postulating that this may explain both our evident discomfort with, and our relatively poor use of, the dominant business model of maximising shareholder wealth as the principal goal of business
- putting forward an alternative model which may be able to reconcile the high performance requirements for entrepreneurial activity with the collective interest in the ultimate purpose of that activity
- arguing that in a broadly parallel fashion, the same kind of development can be seen taking place in the public sector, especially within local government.

FOOTNOTES

1. Available from the Institute of Policy Studies, Victoria University of Wellington, iops@vuw.ac.nz

2. Available on the World Business Council's website at www.wbcsd.ch

3. For an interesting historical account of the development of New Zealanders' attitudes to state and business see Bassett, Michael (1998), The State in New Zealand, Auckland: Auckland University Press.

4. The public airing of the tax avoidance and other business practices of some of our major corporates in for a such as the Winebox Enquiry have helped fuel suspicion by providing ample evidence of malpractice for those prepared to believe the worst of the private sector.

5. EVA stands for economic value added. It measures the extent to which a firm does or does not cover its required cost of capital, that is, the return required by capital providers to adequately compensate them having regard to the risk of the investment.

6. An added problem in trying to take the contractual path is that almost invariably some firms or individuals will seek to free-ride, making the assumption that they don't need to share the cost as there is no way of excluding them from sharing in the benefits when they accrue. All too often the result is then that because some attempt to free-ride those who would have been prepared to contribute hold back and nothing happens.