SOCIALLY RESPONSIBLE INVESTMENT

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THE MANY DIMENSIONS OF SOCIALLY RESPONSIBLE INVESTMENT

- One can do well by doing good
  - Investing in a responsible manner can be good for returns
  - Especially when social responsibility anticipates broader society movements
    - Anti-tobacco
    - Conservation, renewable energy
  - Or when social responsibility contributes to better corporate governance
    - Reducing scope for “tunneling” and other agency problems, where management uses discretion to advance its interests over those of shareholders

BEYOND SHAREHOLDER VALUE MAXIMIZING

- Good business goes beyond maximizing shareholder value
- There are multiple stakeholders — workers, customers, communities
  - A broader view of corporate governance
  - Reflected in many European countries legislation

Two Perspectives Overlap

- Firms as communities—people working together to produce goods
  - But workers work better in response to intrinsic rewards—when they feel that their firm is socially responsible
    - Including responsible to the community in which they work
    - And the broader global community of which they are a part
  - And when they have a sense of community (team)

KEY QUESTION

- WHY CAN'T WE SIMPLY RELY ON FIRM'S MAXIMIZING MARKET VALUE?
- ADAM SMITH'S INVISIBLE HAND SUGGESTS THAT DOING SO WILL LEAD TO EFFICIENCY
- MODERN ECONOMIC THEORY HELPS EXPLAIN WHY MAXIMIZING SHAREHOLDER VALUE DOES NOT LEAD TO ECONOMIC EFFICIENCY

ADAM SMITH'S INVISIBLE HAND…

- Adam Smith's theory of the Invisible Hand said that pursuing self-interest leads to economic efficiency
  - But does not ensure either social justice, the preservation of the environment, or human rights
- Many market failures involve externalities—including environmental failures
  - When there are these market failures, maximizing shareholder value does not lead to efficiency or societal well-being

NEW UNDERSTANDING OF MARKET FAILURES

- Far more extensive — When information is imperfect and markets are incomplete, the reason that the invisible hand often seems *invisible* is because it's not there
  - Corporate greed in the 90s did not lead even to maximization of long-term shareholder value, let alone interests of others, including the economy in general

MORE RECENT EXAMPLES

- In this decade, financial markets did not lead to maximization of long-term shareholder value
  - Exploited especially the poor
    - **3 million Americans already lost their homes, 2 million more likely to in next 12 months**
    - **Not only an economic problem, but a social problem**
    - **Lobbied against legislation to prevent predatory pricing**
    - **Lobbied for legislation to limit rights of poor in bankruptcy, to give them more power to exploit**
  - But even more stable revenue base exploitive
    - **Non-transparent fees associated with limitations in competition—anti-trust violations**
  - Negative sum

GENERAL PROBLEM OF CORPORATE GOVERNANCE

- Often took advantage of imperfect and asymmetric information
  - Scandals involving investment banks, accountants, mutual funds, etc.
- Imperfect and costly information means that decision-making has to be delegated to management
  - But delegation gives management power to advance their interests at the expense of others
  - And they frequently do that
  - Especially in the absence of good corporate governance laws
  - And management lobbies against such laws

MORALITY AND REGULATION

- Recognizing that self-interest in an imperfect guide to behavior restores the need for morality in economic behavior of businesses and investors
- Market Failures provide important rationale for Regulation
  - Environment
  - Human rights
  - Conflicts of interest

Questionable Defenses

- Hard question—should banks not lend to tobacco companies?
  - – Defense: responsibility of government to decide on what is and is not acceptable
  - – If governments say smoking is legal, who are they to second guess
    - But defense questionable: private sector lobbies against restrictions

Sovereign Wealth Funds

- Investment policy of democratic government's sovereign wealth funds needs to reflect these *broader* societal views
- Further restraints—may be political consequences, e.g. to pulling money out of country rapidly
  - Sovereign wealth funds may be "forced" to behave more responsibly than private sector
  - But investment policies need to take into account these constraints

Worries about Sovereign Wealth Funds

- Partially reflect old-fashioned protectionist sentiment
- Partially reflect worries about inadequacy of our regulatory structures
  - Both competition (can a firm be so large that its actions become “relevant”?)
  - And regulations concerning conduct
  - Though most of the potential problems could arise with any form of private ownership, whether foreign or domestic
  - Implication—need to strengthen regulatory regimes

G-7 Solutions Not Well Thought Out

- Transparency
  - Fashion of the day
  - Cure-all for all problems
  - Part of long-standing strategy of diverting attention (used in 1997-98 crisis)
- But what *information* would *guarantee* that they behave “well”?
- So long as there are unregulated, secret hedge funds, they could always buy ownership through hedge funds

Socially Responsible Investment Model

- If profits do not fully measure “social returns,” then focusing on monetary returns provides inadequate guide to investment
- Ought to focus on broader social returns
- Investments which promote environment, human rights, good corporate governance, and development yield social returns beyond private returns

SOCIALLY RESPONSIBLE INVESTMENT: DEVELOPING COUNTRY CONTEXT

- Important role for business social responsibility in developing countries
- Especially since regulatory structures highly imperfect
- And “moral” values often stop at national borders

Particular Areas of Corporate Responsibility Relevant to Developing Countries

a. Promoting development

- Through training
- Supporting affirmative action programs
- Supporting government efforts to increase efficiency and efficacy of public services

Particular Areas of Corporate Responsibility Relevant to Developing Countries

b. Competition, corporate governance, securities markets

- General principle: Do not take advantage of lack of adequate regulation (e.g. for environment, consumer protection, anti-trust)

Particular Areas of Corporate Responsibility Relevant to Developing Countries

c. Environment

- Even when corporations can "get away" with spoiling environment, they shouldn't do it

BUSINESS SOCIAL RESPONSIBILITY: DEVELOPING COUNTRY CONTEXT

d. Transparency, corruption, conflict
- – Do not take advantage of opportunities for bribery and corruption
- – Take active stance to reduce corruption
- – Secret bank accounts
- – Extractive industries transparency initiative
- – Support policies like ‘Conflict Diamonds’

e. Human rights
- – Especially important in period in which human rights are being attacked on many fronts

- Liability laws (Alien Torts Act) may help align corporate interests with general interests

BUSINESS SOCIAL RESPONSIBILITY: DEVELOPING COUNTRY CONTEXT

- MARKETS ARE AT THE CENTER OF SUCCESSFUL DEVELOPMENT
- But confidence in markets will depend on how responsible businesses behave