



# ISSUES IN BRIEF

## Call for a Corporate Social Conscience Index



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In 2008, Prime Minister Nicolas Sarkozy of France formed the Commission on the Measurement of Economic Performance and Social Progress. Headed by Joseph Stiglitz, Amartya Sen and Jean-Paul Fitoussi, the commission worked to “identify the limits of GDP as an indicator of economic performance and social progress, including the problems with its measurement, [and] to assess the feasibility of alternative measurement tools.” The commission was formed at a time when world economic markets were distressed, big banks were failing, and recession roiled much of the world. Some commission members believed that neither market participants nor government officials were focusing on the right statistical indicators, with the result that accounting systems did not alert us that the apparently strong growth of the world economy between 2004 and 2007 was likely achieved at the expense of future growth. Wherever policy decisions are based on flawed measurements, the outcomes of these decisions are likely to be flawed as well.

The looming environmental crisis also highlights the need for alternative measures of economic activity that incorporate costs that transnational corporations have previously externalized to the environment and society. This is a particularly important issue for policy makers in least developed countries (LDCs), since deregulated international trade encourages industries to shift their production activities to the countries that have the lowest standards for cost internalization (Daly 1996). Thus countries that have very lax environmental regulations are highly attractive to industry; corporations that locate their production facilities in such countries can produce cheap products in part because of the lower costs of lax environmental and labor regulations. For example, residents of Nigeria’s oil-producing Niger Delta have been living with continuous oil spillage since 1958. Royal Dutch Shell operates in 100 countries around the world, but 40 percent of all its oil spills happen in Nigeria where there is little or no government oversight (Ejikeme 2010). Compare that to the \$20 billion that the U.S. government has demanded that British Petroleum put into escrow for anticipated cleanup costs of its 2010

oil spill in the Gulf of Mexico, as well as its loss of market value, and it is clear that transnational corporations have incentive to exploit lax regulatory requirements in LDCs.

Additionally, many multinational corporations (MNCs) are larger economically than some governments of LDCs. For example, the 2009 revenues of Exxon Mobil were nearly as much as

the combined GDP of Malaysia, Pakistan and Peru for that year. The relatively greater financial resources of MNCs enable them to capitalize on corruption and pressure governments to adopt lower labor and environmental standards. This gives large MNCs unprecedented power to influence the policies of poor countries, whose governments are often stretched by the need to repay loans to international organizations. And even governments that

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are doing a good job combating internal corruption are subject to the rules of trade agreements that give companies the right to sue local governments should they enact any regulations that are deemed to reduce company profitability.

The recommendations of the Commission on the Measurement of Economic Performance and Social Progress essentially validate the premise of the Human Development Index (HDI), albeit extending it to a more nuanced and granular set of metrics. In 1990, the United Nations Development Programme (UNDP) initiated the HDI to address the problem that metrics for between-country statistical comparisons were all based on GDP or other growth-oriented measures, which made it impossible to use them for understanding and creating social and other non-economic policies. It is a testimony to the robustness of the HDI that it has been so widely used for research and policy development since, and that the fine work of Sarkozy's Commission has extended its potential for non growth-based policy development.

However, both the HDI and the report of the Commission are essentially tools for comparing countries. Now that MNCs have attained the size and power to significantly influence the regulatory environment in LDCs, we need metrics for comparing MNCs. One source for such metrics is the output of research and analysis firms produced for the purpose of socially responsible investing. The data sets created by these companies are extremely thorough; many are based on over 600 indicators. But because they are expensive to create and maintain, these data sets are proprietary. This limits their usefulness for MNC analysis, since any effective set of metrics for comparing MNCs should be transparent and verifiable.

Also, such data sets often rely on corporate social responsibility (CSR) reports produced by the corporations themselves. In the early years of the CSR reporting movement, companies striving to implement ethical business practices produced CSR reports to publicize their good works in hopes of gleaning financial rewards. Unfortunately, now that every large company produces CSR reports, the worst companies have learned to game them, spending on the most visible and measurable indicators of social responsibility while continuing to hide less positive information (Kelly and Greider 2003). When unethical companies “greenwash” their CSR reports, this erroneous information pollutes otherwise valid data sets making it difficult for users to distinguish valid data from bogus data.

Additionally, analysts focused on socially responsible investing collate these data with the needs of investors in mind. And even the most ethical investor seeks financial returns on his or her

funds, as measured in quarterly financial reports. When they reward companies for short-term profit growth, even ethical investors put pressure on companies to make short-sighted changes that improve the bottom line rather than longer-term changes to enhance their sustainability and social responsibility. While many CSR initiatives are consistent with profit growth (Hernandez-Murillo and Martinek 2009), others are not. The fundamental need for companies to internalize costs that they have long externalized onto society and the environment is not fully addressed within a growth-based paradigm (Meadows et al. 1974; Speth 2009; Korten 2009).

Still, the CSR reporting and socially responsible investing movements are making important contributions toward motivating companies to be more socially and environmentally responsible. But to compare MNCs for activities that better capture their commitment to social and environmentally responsible behavior, we should consider alternative sources of data. An alternative approach for providing clear, verifiable metrics about corporate practices

## Smartphone Apps Aid Ethical Consumption Movement

A five-country study in 2007 by the market research group GfK NOP found widespread pessimism about corporate practices. Almost half of the 5,000 consumers surveyed believe that corporate behavior has become increasingly unethical. A 2009 survey by AccountAbility in the U.K. found that over half the public (56 percent) say businesses themselves must be accountable for their own behavior, but only six percent of people trust them to do so. Such distrust of corporate practices is bolstering the ethical consumption movement, which began at the turn of the 20th century when the National Consumers League worked to combat sweatshop

abuses and develop a union label for consumers.

While the ethical consumption movement is not new, some important new tools have recently been added to its toolkit. Smartphones are cellular phones with the ability to run programs on them — the iPhone is currently the market leader with over 50,000 applications available for downloading. Many applications are available that provide consumers with information about a product and/or the practices of the manufacturer that made it, some with a simple swipe of the bar code. For example, *Non-GMO Product Shopping Guide* tells consumers

whether a particular product contains genetically-modified ingredients, and *What's on my Food?* informs them of pesticide residues. *GoodGuide*, the current market leader in this area, uses more than 600 indicators to provide information on over 10,000 products. These smartphone applications promise to alter the traditional relationship between consumers and corporations by providing consumers with a window into the CSR practices of companies that they have never had before. Used en masse, these applications are poised to create a new market mechanism for motivating companies to adopt socially responsible practices.

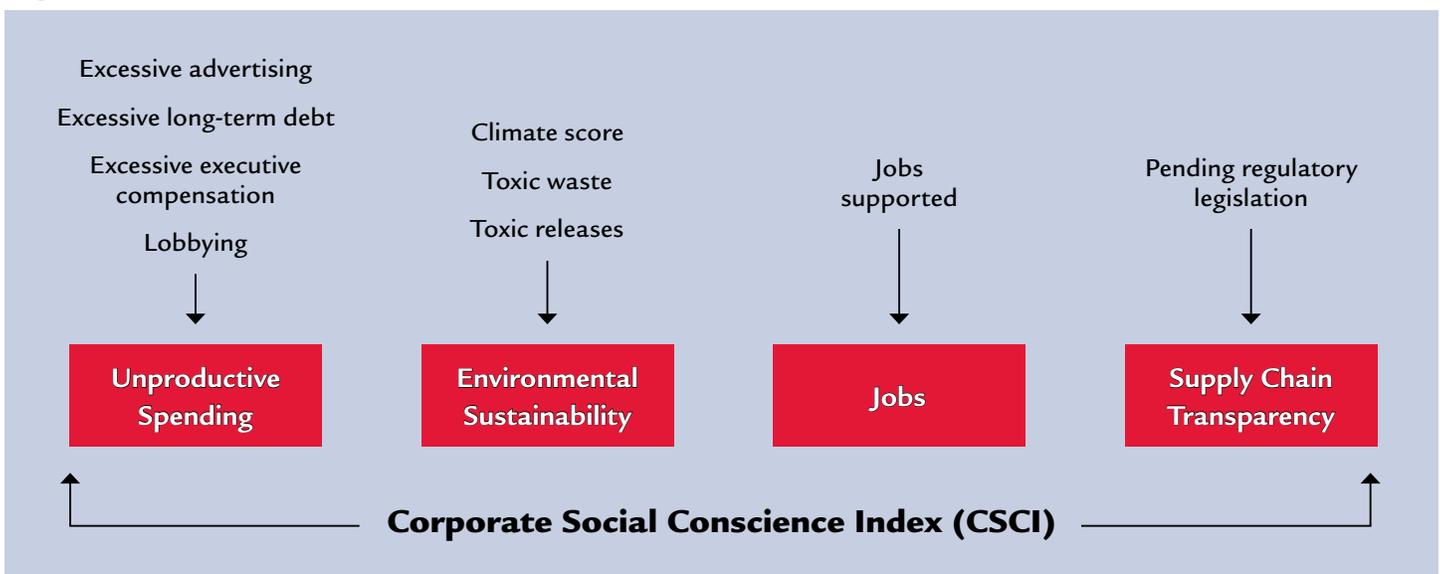
is analogous to the approach used to produce the Human Development Index (HDI). The HDI ranks countries according to only three simple indices: a nation's GDP; its citizens' education, based on adult literacy and school-enrollment data; and its citizens' health, based on life-expectancy statistics. The beauty of the HDI is its parsimony and corresponding simplicity, but this simplicity comes at a sacrifice of data richness and nuance, a limitation that Sarkovsky's Commission and others are working to address. The HDI has become one of very few successful tools for non-growth centric measurement of development that is used widely. It is in this same spirit that we propose a parsimonious, transparent, and non-growth based index for comparing MNCs, calling it the Corporate Social Conscience Index (CSCI). Note that it applies to publicly held MNCs only, since privately held companies are not required to disclose some of the metrics that the index is based on.

## A Proposed Corporate Social Conscience Index

One important indicator of a corporation's capacity to internalize costs that it has been externalizing to society and the environment is how wisely the company spends the money it earns. Companies that spend their earnings wisely have more funds available for improving environmental and social performance than do spendthrift companies. For this reason, we identify four categories of large business expenses that are widely accepted in the corporate world, but that common sense and history suggest are unproductive use of funds. The four areas of excessive corporate spending proposed for this index are: advertising, long-term debt, executive salaries and bonuses, and government lobbying. These figures are publically available for most large multinational corporations. According to the metrics described in detail below, for example, the Kraft Corporation spent \$1.5 billion in 2009 on unproductive spending in these four categories, but only made \$3 billion profit on \$40.4 billion in sales revenue. Thus for this company, unproductive spending amounted to about one half of its 2009 profits. This suggests that if it were to cut back on these unproductive expenses, it (and other companies like it) could channel more resources for improved programs for workers, local communities and the environment.

In addition, we suggest metrics for this index that capture corporations' activities that promote environmental sustainability, job creation, and supply chain transparency (See Figure 1).

Figure 1



## A Financial Metric for Unproductive Corporate Spending

**Metric component #1a: Excessive spending on advertising, defined as an amount greater than or equal to 20 percent of reported annual profits**

While all companies need to advertise, a number of corporations spend more than half their profits on advertising. Socially responsible companies of the future will choose to spend less on advertising and public relations, and more on things like good wages and benefits for their workers, environmental management systems, philanthropy, etc. This would have the direct effect of doing good works, and also the indirect effect of generating positive perceptions of the company, which in turn drives sales. Considering that the influence of advertising on consumer purchasing has been steadily diminishing over the past few decades, especially for those below age 30 (Keller and Berry 2003), this is good business policy. Nor does advertising get high grades for its impact on society in general and on children in particular. Advertising affects our cultural

understanding of what is valuable and can fuel materialism, consumption, superficiality, and insecurity (Ewen 2001). For these reasons we contend that spending excessively on advertising and PR is an unproductive use of corporate earnings, relative to the environmental and social good that could come of spending those funds more wisely. The 20 percent limit is an arbitrary designation reflecting the value judgment that spending more than 20 percent of profits on advertising is unproductive relative to other potential uses of those funds.

**Metric component #1b: Excessive spending on debt financing, defined as a debt-to-capitalization ratio that exceeds 20 percent**

Corporations take out loans to finance things like new buildings and production facilities, company acquisitions, and stock buy-backs, and then pay interest on these loans. Clearly such borrowing is necessary and desirable, to a point. However, companies that borrow too much spend unproductively on interest payments. High levels of debt financing constrain managerial choice because interest on this debt must be repaid on a contractual schedule. Companies with high levels of debt do not have the financial flexibility to react effectively to unforeseen costs, for example the costs of an environmental accident or new labor demands. Socially responsible companies keep their debts to a reasonable level so that they can pay them off without having to cut spending in other important areas. Thus the second component of our unproductive spending metric uses the ratio of long-term-debt to capitalization. Capitalization refers to how much the company is worth on the stock market and so is an indicator of net worth. For the purposes of this index we suggest this ratio shouldn't be higher than 20 percent, although the precise amount of long-term debt that is most appropriate for MNCs to bear is an issue requiring further research. Note that this figure does not include funds spent on research and development since these are usually listed separately.

**Metric component # 1c: Excessive executive compensation, defined as more than \$3 million per year (total package) for a single top executive**

It is widely acknowledged that many companies spend large sums paying their top executives disparately large salaries and bonuses. This occurs regardless of whether the firm is currently laying-off workers, cutting benefits, or paying subsistence wages. Clearly top executives should be paid well, but there are negative consequences to the organization when they are paid hundreds of times more than their employees. High levels of executive compensation are associated with high employee cynicism, which in turn reduces employees' organizational citizenship and increases the chances that they will agree to engage in unethical behavior such as workplace sabotage (Andersson and Bateman 1997). Indeed, wide disparities in corporate pay scales can directly and adversely affect the value of the firm (Thomas 2003), due to a variety of effects such as lower employee productivity, higher turnover, and higher absenteeism. Thus companies that pay their executives disproportionately not only incur the direct costs of paying these high sums, but also a variety of indirect costs that can have a negative effect on the bottom line. For these reasons, we suggest that companies that pay unreasonably high levels of executive compensation are spending this money unproductively. The \$3 million cutoff is an arbitrary designation; many executives may view \$3 million as a paltry salary, but their employees earning \$15 per hour would probably find it acceptable. More research needs to be conducted to determine an optimal amount that is high enough to attract and retain leadership talent, but not so large as to incur the negative effects on employees and firm value discussed above.

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## Metric component #1d: Excessive spending on government lobbying

The final area of unproductive corporate spending that we propose for this index is government lobbying. In the U.S., companies spent \$3.49 billion on Federal lobbying in 2009 (Center for Responsive Politics 2010), an average of over \$6.5 million per congressperson. Clearly this gives corporations a lot more power to influence what laws get passed than most individuals have. Many of the laws proposed by legislators are designed to protect citizens from things that corporations choose not to protect them from, such as limiting advertising to children under six, or excessive waste and pollution releases. Other laws are designed to inform people about questionable corporate practices, such as the inclusion of toxins in their products. The governments of the European Union, Scandinavia, Brazil and Japan all do a better job of protecting their citizens from the effects of this type of cost externalization than the U.S. government does (Schapiro 2007), partly because they have stricter controls on lobbying. Companies that spend excessively on lobbying are using their financial power to influence legislation, a practice which Adam Smith and many other free-market proponents are against. Lobbying is not a productive use of earnings relative to other socially responsible spending opportunities. Thus the final element of our proposed spending metric is the total amount a firm spent on Federal lobbying the prior year, which companies are required by law to disclose. This has the disadvantage of not accounting for the size of the company. However, when politicians vote in congruence with lobbying efforts, it is the total dollars spent that are influential, regardless of company size.

## Non-financial Metrics in the Corporate Social Conscience Index

### Metric #2: An indicator of a corporation's environmental record

In addition to the financial metrics, we recommend including in this overall index an indicator of a corporation's environmental record and sustainability. There are several options of available information that might be used for this metric. For example, the U.S. government's mandated Toxic Release Inventory — toxic releases plus toxic wastes — provides a transparent indicator of corporate environmental behavior that is in the public domain. For assessing a firm's carbon footprint and efforts to reduce it, the non-profit organization Climate Counts creates highly credible and well-validated corporate climate scores and makes these freely available to the public. Other organizations provide candidate scores of similar quality.

### Metric #3: Job creation

Another indicator we might include addresses the number of jobs supported by the particular company, relative to revenue earned. This is an important indicator since, for all jobs except those at the highest levels of expertise and creativity, it is less expensive for companies to use automation and computerization than it is to hire individuals at a living wage. Additionally, automation tends to increase product quality by driving out the variances that come from employing people rather than computers. For example, people get sick and injured, they are sometimes tardy, they get tired and emotional, they may unionize, and they may even sabotage the company. Firms have a clear economic incentive to substitute machines for people.

At the same time, people need to work. Increasingly, small farms that once produced enough of a variety of indigenous foods to feed the local populace are being replaced by industrial farming of a single crop for export, forcing rural populations into cities in search of employment. Countries with large numbers of unemployed workers are easily destabilized, characterized as they are by high levels of crime (Narayan et al. 2010), domestic violence (Kyriacou 1999), and national health issues (Ostry 2009). High unemployment levels are also associated with wide income disparities between the wealthy few and the poor masses (Wilkinson 2009), such that few of the benefits of having a strong stable middle class can be realized. Thus we propose that

a potential metric for our index is the number of jobs created by the company, relative to their revenues. Companies with high sales revenues can obviously employ more people than companies with low sales, hence the need for a ratio. This data is publicly available since corporations are required to release it for tax reporting purposes.

#### **Metric #4: Supply chain transparency**

A final metric that we would include in this index would be a measure of supply chain transparency. This is an extremely important issue for development policy, since most of the environmental and human rights violations by businesses in LDCs are perpetrated not by the large MNCs themselves but by their smaller suppliers. Often we have accurate information about which overseas companies are doing which egregious things, but since MNCs are not required to disclose who their supply chain partners are, they cannot be held accountable for violations. And while many of the large MNCs have policies that ostensibly prohibit them from trading with unethical suppliers, it is expensive to monitor supply chains effectively and they have no incentives to do so.

## **Conclusion**

We have proposed a parsimonious, non-proprietary index of corporate social conscientiousness that consists of four sub-metrics — unproductive spending, environmental sustainability, job creation, and supply chain transparency. For those working in commerce, such an index would provide a benchmark for CSR practices, helping them to reap the documented benefits of CSR, such as fostering consumer and employee engagement (Hoeffler, Bloom, and Keller 2010), enhancing corporate reputation (Liu, Wang, and Wu 2010), and lowering firm-idiosyncratic risk (Luo and Bhattacharya 2009). For those in government, such an index would provide a means for comparing potential vendors and investors. For researchers, the index could serve as the basis for understanding the relationship between financial and CSR performance and provide a means for comparing firms on this over time.

The implementation of an index similar to the one proposed here is relatively easy, since most of the data is in the public domain. The biggest challenge in data collection is the supply chain transparency metric, since disclosure of this information is not regulated, and is difficult for companies to collect. Yet it is also the most important component of the index, since companies often use suppliers in countries with low regulatory oversight to cut costs on labor and environmental protection. For this reason supply chain transparency is a critical area for research and legislation.

In the meantime, healthy debate about the need for and design of such an index is the first step to gaining consensus on its ultimate form. We look forward to such engagement. ●

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