

# What is the Business of Business?\*

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March 30, 2017

## Abstract

This paper develops a simple framework for understanding the emergence of new organizational forms, such as socially responsible firms and social entrepreneurs, that embody the private sector's efforts to resolve problems that typically have been within the purview of government and traditional public charities. We consider organizations that can generate both financial and social returns. Differences in the technologies between the for-profit sector and the social sector give rise to comparative advantages and play a key part in the analysis. This allows us to analyze the conditions under which hybrid organizations emerge in place of traditional charities and profit-maximizers.

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\*The authors are grateful to Josh Lerner, Yasin Ozcan, and Scott Stern for suggestions on the current draft. Hengjie Ai, Ulf Axelson, Paul Bloom, Ronnie Chatterji, Shawn Cole, Ofer Eldar, Rich Mathews, Alex Nichols, Adriano Rampini, Pian Shu, Per Strömberg, and seminar participants at the Swedish House of Finance, the Skoll Research Colloquium on Social Entrepreneurship, Duke, MIT, and the Harvard Social Enterprise Conference provided many helpful suggestions on earlier drafts. Special thanks for detailed suggestions and encouragement go to Brian Trelstad, Jean de Bettignies and the late Greg Dees. Much of this work originated when Robinson was the Olof Stenhammar Professor of Financial Entrepreneurship at the Stockholm School of Economics and when Nilsson was a Visiting Fellow at Harvard Business School. The authors are grateful to these institutions for their hospitality. Any errors are ours alone.

# 1 Introduction

In 1970, Milton Friedman famously argued that the only social responsibility of business was to maximize profits (Friedman, 1970). These profits, if only returned to the firm’s owners (the shareholders, on whose behalf the management should rightfully act), could be put to charitable purposes as shareholders saw fit. By essentially delegating the task of collecting and disbursing taxes to corporate managers, in Friedman’s analysis, shareholders allowed themselves to unwittingly become pawns in a larger battle to derail the capitalist system. Levitt (1958) captured this perspective succinctly when he wrote, “the business of business is profits.”

In the almost half century since Friedman’s admonition, business has evolved along a trajectory quite contrary to what he advocated. It seems as if the business of business is more than just business: socially responsible businesses, which pursue hybrid goals of social good and financial gain, are commonplace. Today it is standard to see for-profit businesses pursuing double-bottom-line objectives. At the same time, Dees (1998) notes that nonprofits are increasingly adopting business methods, writing, “*Faced with rising costs, more competition for fewer donations and grants, and increased rivalry from for-profit companies entering the social sector, nonprofits are turning to the for-profit world to leverage or replace their traditional sources of funding.*” Why has this occurred? Why have the lines between business and charity become so blurred?

One prominent view for why this has occurred is captured succinctly by Benabou and Tirole (2010) when they note that, “Society’s demands for individual and corporate social responsibility *as an alternative response to market and distributive failures* are becoming increasingly prominent” (emphasis added). This is the view that increasing awareness of the social cost of consumer goods, coupled with the difficulty government actors face when attempting to regulate across global supply chains or otherwise seek redistributive solutions, has driven the rise in corporate social responsibility (CSR).

The central goal of this paper is to put forward a different argument, one that centers on the importance of innovation in business practice. Our argument is that business model innovations from both charities and for-profit firms give these new hybrid firms a comparative advantage over traditional organizations in delivering what other non-market actors provide. The analysis we provide makes it clear that if we were simply living through a period of evolving preferences for financial and social returns, we would see increases in pure charity, not changes in business practice. In short, our analysis argues that the emergence of socially minded business activity must be the result of technological changes on the supply-side, rather than the result of demand-side changes in investor or consumer preferences.

But before we dive too far into our analysis, we should take a step back. Clearly, some aspects of so-called social responsibility need no special explanation. For instance, hotels frequently encourage guests to hang their towels to be reused rather than washed each day. While this is often promoted as environmental stewardship, it can be just as easily understood as an attempt to lower the hotel's operating costs.

While business activities like this are simply alternative strategies for profit maximization, there are many examples of firms that either sacrifice profits by operating in a manner that involves stricter environmental or social guidelines than they are required by law, or that take a share of their profits and donate them to causes that could easily be supported by the firm's shareholders directly. Ben & Jerry's ice cream and Patagonia are two corporations that have historically stressed environmental stewardship, the latter famous for an advertising campaign admonishing their customers not to buy new Patagonia jackets when the old ones still had use. The Body Shop, a beauty products manufacturer and retailer, works to end animal testing of cosmetics, and in so doing presumably embraces higher production costs than they might otherwise face. Tyson Foods provides grants to organizations that abate child hunger. Molson Coors invests in education to promote responsible drinking behavior. Many law firms and consulting

firms encourage their employees to offer their time on a pro bono basis to important causes in their community. Of course, any of these strategies can be viewed cynically as a marketing ploy, and indeed many observers tout these firms as providing examples of successful CSR strategies precisely because their CSR strategies align well with their core corporate mission. But the fact remains, as Friedman pointed out, that consumers and investors could carry out these charitable acts on their own account. Moreover, as we discuss in Section 2, the evidence is far from persuasive that firms are acting in their own best interest by engaging in these activities. Why, then, do firms do this? Or put differently, how does this behavior survive the forces of competition in the market?

At the same time, many organizations that would traditionally be labelled as ‘non-profits’ adopt a hybrid approach that blends the pursuit of profit with charitable purpose. Take the example of VisionSpring, an organization that promotes vision correction in the developing world by distributing eyeglasses. While they rely on a combination of philanthropic support as well as strategic partnerships with eyeglass retailers like Warby-Parker, they also distribute eyeglasses at a profit through a variety of channels. One is a model in which local merchants who have been trained to diagnose and correct simple vision problems sell glasses at a modest profit in the communities in which they live. Another is retail outlets in local clinics and hospitals. Why do they blend the pursuit of profit with charitable purpose instead of operating like a pure charity?

One reason these questions persist is that we lack a well accepted, overarching framework for thinking about mixing charity and business. Thus, to explore these questions, this paper develops a simple graphical framework for understanding the emergence of new organizational forms that blend profit and stewardship. For us, Friedman’s analysis is not just a convenient rhetorical straw man: the intuition that we develop hinges critically on a central theme in Friedman’s analysis, which is that idea that investors always have the ability to take “ill-gotten” profits and put them to work for social aims of their own desire. Put differently, Friedman’s central observation is that we do not need to

delegate the task of impact investing to either a firm or an intermediary—any of us can act as an impact investor by taking returns we have earned and directing them towards charities of our own choosing. This observation is the fundamental building block of a simple framework for how to think about the emergence of socially conscious business activity.

We start by assuming that investors have preferences over financial returns as well as social returns. That is, investors not only want to invest in profit-making enterprises, but they also place monetary value on social goods such as increased literacy in a developing country or better environmental stewardship. While many environmental, social or governance objectives—a clean environment, good working conditions, etc.—have the flavor of public goods, nothing in our analysis hinges on the existence of externalities. In other words, we do not assume that markets are broken in order to create a motivation for CSR.

We assume that for-profit corporations can choose to operate in a socially minded fashion in addition to simply maximizing profits, and that charities can make operational choices to mitigate their financial losses, sacrificing charitable output to stave off financial losses. Because we are concerned with understanding the tradeoffs between social and financial output, we assume that all win-win opportunities, such as hotels “going green” by encouraging guests to hang up their towels, have already been exhausted. Instead, we focus only on situations in which achieving social goals comes at the expense of profits.

This framework allows us to explore the interplay between for-profit corporations that can engage in CSR, charities that can incorporate profit motives into their operations, and investors who allocate resources between profit-making and charity. The mechanics of our framework are exactly what Friedman imagined: investors can choose to allocate their own wealth between social and financial returns, and therefore do not necessarily need corporations to act charitably. The question we ask is whether, and under what conditions, investors will ask corporations to operate with an eye towards social good

even though these same investors are perfectly capable of acting charitably on their own account. In other words, we ask “What is the business of business?”

The key insight of our analysis is that the optimality of Friedman’s prescription hinges critically on the *relative* tradeoffs that investors and organizations face when they substitute between charity and profit. By *relative*, we refer to the fact that businesses, charities and investors each have the ability to make tradeoffs between financial and social output; the optimal organizational structure is the one that trades off these goods optimally. The fact that shareholders can take profits and redistribute them to pure charities does not necessarily compel organizations to avoid a dual purpose; instead, it imposes constraints on them by establishing a minimum level above which organizations must trade off social and financial output. When the tradeoff between social and financial returns is sufficiently favorable inside for-profit corporations, competition for investment dollars requires for-profit corporations to produce below the maximal level of financial return and instead produce a blend of social and financial returns. In our analysis, this corresponds to the emergence of corporate social responsibility. Similarly, when the tradeoff is sufficiently favorable inside charities, they are optimally required to pursue twin goals of social and financial return. This corresponds to the emergence of social entrepreneurship.

When the tradeoffs between social and financial returns are sufficiently weak within *both* the corporate and the social sectors, investors drive the provision of social goods by allocating wealth between two extreme technologies: a pure charity and a pure profit-maximizing technology. This describes exactly the situation prescribed by Milton Friedman and Theodore Levitt in their admonition against corporate social responsibility. However, whenever the tradeoffs between social and financial returns inside both types of organizations are favorable, this investment rule is no longer optimal and investors will allocate their capital between a socially responsible profit-making firm and a “financially savvy” charity.

Although our analysis is intentionally stark, it sharpens our understanding of several open questions in this area. First, whether investors push firms to be “pure-play” profit maximizers or socially minded hybrid businesses depends not on society’s preferences over the amount of social and financial profit that holds in the aggregate, but rather in the technological implications of the business models that organizations operate. The flip side of this observation is that business model innovations that have the potential to be more CSR-friendly need not result in more social output in the aggregate, just better tradeoffs.

Our analysis also offers a guide for thinking about which types of CSR activities firms should engage in. Here, the logic is simple. For CSR to survive the forces it competition, it is not necessary that CSR increases a firm’s bottom line. But it must be the case that the organization can exploit opportunities that its investors cannot. This would be the case, for example, if information asymmetries created complementarities between financial and social returns that were visible to the corporate manager but not to outsiders. This naturally suggests that firms should engage in CSR programs that involve the highest degree of complementarity with their core business.

A number of other academic studies also work to develop frameworks for thinking about tradeoffs between alternative mechanisms for providing socially valuable goods. Kotchen (2006) develops a general model of private provision of a public good where investors have preferences over social welfare and private consumption and maximize utility by allocating wealth across three investment opportunities: a pure private good (e.g., coffee), a pure public good (e.g., environmental quality) and a hybrid, “green” good—an example might be environmentally friendly, shade-grown coffee. His model shows that green goods can either increase or decrease private provision of the associated environmental public good, depending heavily on whether the public good is a complement to or substitute for private consumption. Small and Graff Zivin (2005) and Baron (2007) also develop models in which investors can give directly to charities or

invest in firms that engage in CSR and focus on the degree to which one activity crowds out another.

The remainder of the paper is organized as follows. To set the stage for our theoretical discussion, we begin in Section 2 with a brief overview of the evidence linking CSR and value creation. We lay out the basics of our framework in Section 3, and provide an analysis in Section 4. Section 5 discusses some potential shortcomings and challenges that our framework must confront, while Section 6 explores implications for innovation policy at various levels. Section 7 concludes.

## **2 Can Firms Do Well by Doing Good?**

Because the business case for CSR often centers around the claim that businesses can do well financially by doing social good, we begin by reviewing some of the recent evidence on the value implications of CSR. This is not intended to be an exhaustive survey, but rather to set the stage for our theoretical analysis with a discussion of the key empirical issues. Kitmueller and Shimshack (2012) and Benabou and Tirole (2010) provide excellent reviews of the role of the business sector in producing social outputs.

### **2.1 CSR and Corporate Profits**

Like the example of the hotel from Section 1, many firms engage in social activities for the purpose of increasing the bottom line. This can either take the form of environmental or social stewardship activities that result in cost reductions, or stewardship activities that stimulate demand.

This motive has received significant attention by academic scholars. Numerous papers try to estimate the effect of corporate social responsibility on financial performance, but the evidence of different business practices is mixed. There is clear evidence that



employees are willing to sacrifice wages to work at companies that engage in social responsibility. Frank (2004), for example, uses survey evidence from Cornell graduates to point to a compensating salary differential for corporate social responsibility. The more recent work of Nyborg and Zhang (2013) shows that firms with a strong reputation for social responsibility pay 38% less than firms with a weak reputation for CSR. This difference drops to about 24% when one accounts for industry and gender/demographic composition of the work force. Finally, in a compelling new study using natural field experiments, Burbano (2016) identifies a negative causal effect of receiving information about an employer's social responsibility on prospective workers wage requirements for a job. Indeed she finds that a 44% decrease in the wage bids submitted by workers after learning about the employer's CSR activity.

In a similar vein, Edmans (2010) finds that companies recognized in the "Top 100 Places to Work" in terms of how they treat their employees earn risk-adjusted rates of return that are 4% per annum higher than other, non-friendly companies. Recent work by Bloom et al. (2010) shows that better-managed firms are not only more productive, but they also have a smaller carbon footprint.

On the other hand, Hong and Kacperczyk (2009) finds that companies involved in the production of alcohol, tobacco and gaming have higher expected returns than otherwise comparable stocks, suggesting that investors pay a financial price for a higher social return. A meta-study by Margolis et al. (2007) covering 167 papers concludes that corporate social responsibility has a small, positive effect on financial performance. However, Margolis et al. (2007) point out that many papers in their study struggle to overcome the inherent endogeneity bias that exists in studies of this nature. In other words, it is difficult to distinguish between firms that do well financially because they do good socially and firms that are able to do good socially because they do well financially.

CSR may not only operate by affecting labor or product costs, it may also help to attract customers who identify with certain causes. Heal (2008) offers countless examples

of firms that witness soaring profits by taking poorly selling products, and rebranding them in a manner that promotes a social cause. One such example is the Calphalon Corporation—makers of high-end cookware—who co-branded a poorly selling pan with the Share Our Strength, a national anti-hunger campaign, donating \$5 from every pan sale to the charity. According to Heal (2008), sales of the pan increased by 250 per cent.

Fisman et al. (2006) develops a signaling model in which CSR may serve as a means of vertical differentiation in a market where quality is difficult to observe. In their analysis, there is no complementarity between the production of a good and the provision of CSR. Instead, entrepreneurs can be of one of two types: either purely profit minded or socially minded. For the latter group, it is less costly to adhere to a CSR agenda, even if the focus of the CSR is completely uncorrelated with the firm's core activity. Thus, the CSR activity provides a signal to discerning customers who are interested in high quality products.

The idea of the paper can be illustrated with the following example, which they provide. Consider a consumer who is interested in buying hormone free beef. They may be motivated by personal health motives or animal husbandry considerations, but in either case they find it virtually impossible, even after consuming the product, to verify the absence of bovine growth hormones. This creates an incentive for a socially minded grocery chain, or meat brand, to establish its trustworthiness in the eyes of its customers. This encourages the chain to engage in CSR expenditures which are visible to the consumer, even if they are unrelated to the firm's products, because they provide useful signals of the firm's trustworthiness in providing unobservable quality.

In empirical work, the authors find that the link between profitability and CSR activity is stronger in advertising-intensive industries, and in settings where competition is more intense. This not only supports the model but illustrates that the link between profits and CSR activity depends heavily on the industry setting in which it is occurring.

## 2.2 CSR as a Strategic Asset

Even if CSR initiatives do not immediately affect a firm's profitability through higher product revenues or lower costs, there are other reasons why it might increase value. Corporate social responsibility can also be a strategic asset that firms use to build a reputation with key stakeholders. Godfrey (2005) first proposed the idea that firms invest in CSR in order to purchase a form of 'insurance' against negative firm events. The idea in Godfrey (2005) is that by engaging in CSR, firms create a reputation for behaving with regard to other actors, and that this forms a "moral capital" that the firm can draw upon in times of adversity. Godfrey, Merrill and Hansen (2009) test this idea by relating stock price reactions associated with negative legal or regulatory actions to measures of CSR activity and engagement and find that high CSR scores erase 1/2 to 3/4 of the overall negative stock price effect associated with the negative shock.

Relatedly, Kotchen and Jungbien Moon (2011) provide an empirical investigation of the hypothesis that companies engage in CSR in order to offset corporate social irresponsibility (CSI). Using data from KLD Research & Analytics, a firm that specializes in collecting data related to compliance with environmental, social and governance objectives, they find general support that companies which do more "harm" also do more "good". In particular, they find that firms that score poorly in terms of being "harmful" in a social dimension also generate more "good" in that same category (the results are significant for community relations, environment, and human rights). One way of interpreting this result is that firms are better placed to offset negative influences they have on a social issue through its production by generating social output relating to the same issue.

Minor and Morgan (2013) offer a closely related perspective, which is that firms use CSR so that market participants will give the firm the "benefit of the doubt" in the event of a corporate disaster—for example, an oil spill or a chemical factory explosion. The idea in Minor and Morgan (2013) is that any adverse business event could be due

to some combination of bad luck and managerial negligence. Investors and other market participants place weight on each of these explanations, and update their beliefs about negligence in the wake of the corporate disaster. CSR initiatives shape the opinions of outsiders, causing them to believe that firms are more conscientious, which in turn causes observers to place more weight on bad luck, as opposed to managerial incompetence, as the reason for the disaster.

Minor (2015) builds on these arguments with evidence that certain types of CSR activities protect firm value in the case of adverse events, while other types do not. When firms engage in CSR activities that are related to the negative event, the firms are punished less by market participants, amounting to an average of about \$1 billion less loss in market value. In contrast, when the CSR activities are disconnected from the business activity associated with the event, there is no preservation of market value, and indeed markets punish these firms even more than those with no CSR initiatives.

Another perspective on CSR as a strategic asset is provided by de Bettignies and Robinson (2017), who study the interaction of a firm, a government, and a citizenry, some of whom have preferences for CSR activities. They assume that firms unavoidably generate negative spillovers in the pursuit of profits. In their baseline analysis, governments maximize social welfare by setting regulatory thresholds, such as pollution limits or mandatory labor practices. Because governments optimally balance profits against spillovers in the baseline, there is no scope for CSR to emerge, because firms could never improve social welfare by deviating from the threshold. But the analysis changes completely when frictions are introduced that affect the government's ability to set thresholds optimally. When this occurs, firms can benefit by engaging in CSR: they extract surplus from CSR-minded individuals (for example, in the form of lower wages) who wish to see better social outcomes than those provided through regulation. A dark side to CSR can emerge in certain circumstances: in the extreme, when the frictions are strong enough, firms may act strategically to cause distortions to be greater than they

would otherwise be in order to capture greater surplus from CSR-minded citizens. This analysis stresses the difficulty of conducting welfare analysis based on the observed CSR outcomes, and also helps to rationalize seemingly conflicting empirical findings by nesting many results as special cases based on whether the firm's rent extraction is passed along to shareholders or trapped inside the firm through managerial agency.

### **2.3 CSR as managerial agency**

The flip side of the argument that firms increase shareholder value by engaging in CSR is that CSR is instead another form of managerial agency. Under this motive, CSR is a form of rent extraction by corporate managers who invest in pet projects of charitable nature. Even though the charitable output of the pet projects may be valuable for society, it constitutes managerial agency because either (a) it works against the preferences of shareholders, in whose interests the managers should act, or (b), it is wasteful in the sense that it does not represent the lowest cost way of achieving the social good it aims to achieve. For example, if \$100 of shareholder value are destroyed to create a \$50 improvement in a manager's passionate social cause, then many would argue that value has been destroyed even if all are in agreement that the social cause is worthy.

Cheng, Hong and Shue (2012) explore the agency motive empirically with two sets of tests, both of which zero in on shocks to the level of managerial entrenchment. First, they use the 2003 Dividend Tax Cut as a shock to managerial ownership and finds that this had a negative effect on CSR spending. The idea here is that the dividend tax cut effectively increased the sensitivity of a manager's financial payoff to her firm's underlying value. By showing that increasing the sensitivity of pay to financial performance decreases CSR spending, the authors argue that CSR spending on the margin is an artifact of managerial agency problems.

The second test studies the effects of an exogenous change in firm governance by using discontinuities that arise in the context of close voting outcomes. Using proxy contests regarding shareholder-initiated governance proposals, they find that firms in which shareholder proposals *narrowly pass* experience much slower growth in CSR than firms in which the proposals *narrowly fail*. The idea here is that by comparing narrow passes to narrow failures, firms that are otherwise equal face different corporate governance regimes. The fact that the more restrictive regime results in less CSR spending demonstrates that CSR spending itself is on the margin higher in settings with more lax governance, which in turn is further evidence that it is a symptom of managerial agency problems.

### **3 A Framework for Analyzing Hybrid Organizations**

Our presentation proceeds in three steps. First, we lay out the basic economic environment in terms of what types of economic actors are involved in our analysis and what types of economic outputs they care about. Next, we discuss the key technological assumptions behind the tradeoffs that we study in the paper. Finally, we discuss the role of consumers or investors in greater detail.

#### **3.1 Actors and Outputs**

The economic environment we consider centers around the production of two types of output: financial output,  $F$ , and social output,  $S$ . Financial output is simply money—this requires no special explanation. Social returns can be thought as non-pecuniary returns accruing to the investor such as increased literacy in a developing country or increased biodiversity. The precise nature of  $S$  may vary from setting to setting. At this point in the analysis, we are intentionally vague about the specifics of  $S$ , and later in

the discussion we will return to some challenges associated with enumerating  $S$  in terms that investors can quantify.

Three types of economic actors interact with one another to determine the amount of  $F$  and  $S$  produced, as well as the manner in which it is produced. These are for-profit businesses, charities, and investors. Businesses naturally generate operating profits, or financial returns,  $F$ , but can sacrifice these to generate social output,  $S$ . Charities naturally generate social returns,  $S$ , but can sacrifice these to generate  $F$ . Charities and businesses need capital from investor in order to operate.

Although our analysis does not require specific assumptions about the operating structure or legal organization of charities and businesses, it is useful for fixing ideas to offer some specifics around organizational design. For charities, it is useful to think of them as operating with a loss but relying on endowment income to subsidize these losses. For firms, it is customary to think of them as being operated for the benefit of their equity owners, who provide capital to the firm in exchange for shares. It is also possible to think of firms as operating from the profits associated with selling their goods in the market. In that sense, it is possible to think of capital as provided by interchangeably by investors, consumers or citizens.

## **3.2 Business models for Businesses and Charities**

A key element in our analysis is that the idea of a *business model*. A business model is not a final production decision—it is not a choice of a particular level of  $F$  and  $S$ —but rather a description of the technological tradeoffs involved by an organization. This is a simple way to capture the idea that businesses and charities have different objectives, and combine resources in different ways to achieve these objectives. Business models can differ from one another both within and across types of organizations.

In terms of the difference between a business and a charity, we can imagine that either type of organization is capable of generating  $F$  or  $S$ , but with varying degrees of efficiency. Businesses are naturally better at making financial returns, but can sacrifice financial returns to generate social output. Charities are naturally better at making social returns, but can sacrifice these to generate more financial output. In other words, in a horse race to produce pure financial profit, the business will win, while in a horse race to produce pure social output, the charity will win.

There are also differences within each type of organization in terms of the nature of the business models they operate. This is captured in Figure 1, which depicts three different potential business models for charities. Each line represents the feasible set of social and financial returns that can be achieved.

Figure 1 about here

Each of the business models depicted in Figure 1 involves a different set of tradeoffs between social and financial output. For instance, the business model labeled “1” involves a constant tradeoff between social and financial output. The slope of the straight line for 1 describes the rate at which social output is sacrificed when additional profits are obtained. Comparing business models 1 and 2, it is clear that business model 2 is strictly superior: although both business models involve constant tradeoffs, business model 2 trades off financial and social output at a more favorable rate than does business model 1. Anything business model 1 can do, business model 2 can do better.

In comparison, business model 3 initially involves relatively favorable tradeoffs between social output and financial output than either 1 or 2. The fact that the curve representing business model 3 is initially very flat implies that a charity operating this business model sacrifices very little social output to generate initial financial output. Then as their search for more financial output increases, it grows more difficult, and the tradeoff becomes less favorable.



Moving along any of these lines from a “pure- $S$ ” business strategy to a mixed ( $S, F$ ) business strategy represents the commercialization of non-profits. Dees (1998) notes that nonprofits are increasingly adopting business methods. These activities range from supplementary revenue-generating activities to a commercialization of the core programs through which they accomplish their missions. The sacrifice of  $S$  implied by moving along any of these lines reflects the concern in Weisbrod (1998) that increased commercialization leads to reduced social output, because it may distract management attention or cause a deviation from the organization’s mission, i.e. its social output.

The business models 4, 5, and 6 are similar in spirit to what have been described above, but reflect the tradeoffs faced by businesses, which are naturally better at generating financial output but can generate social output by sacrificing financial returns. Business model 5 dominates business model 4, in that more social output can be achieved per unit of financial sacrifice, even though both business models involve constant tradeoffs between  $S$  and  $F$ . Like model 3, model 6 displays decreasing returns to the “non-core” activity, even though low values of  $S$  can be achieved with much more favorable tradeoffs than available through either model 4 or 5.

One example of these tradeoffs might be corporate philanthropy, in which managers shift resources towards increasing social output on behalf of approving shareholders. Having a corporate manager act on behalf of a large group of like-minded shareholders interested in transferring money to a social cause may be an efficient way to overcome burdensome transactions costs otherwise associated with each shareholder acting individually. Alternatively, these tradeoffs might naturally arise if social and financial output are connected through some fundamental technological aspect of production. For example, financial returns might be generated through natural resource extraction while social returns might represent environmental quality. In such a case, the business owner would be a mining company and the charity would be an organization devoted to environmental stewardship. Or the business might be a retail goods manufacturer,

in which case the social output might be related to labor standards, like whether child labor is prevalent or whether workers are paid a living wage.

### 3.3 Investors

Investors are agents with financial capital who have preferences over social and financial output. They take the existing business models as given, and allocate capital in order to maximize their utility. Depending on their preferences, they could give all their capital to a charity, all of it to a business, or they could mix between the two. Because our goal is to reflect broad tradeoffs in society, it is perhaps most natural to think of the investor in this analysis as an aggregation of many small investors.

To keep the analysis as simple as possible, we will assume that there are no managerial agency or corporate governance problems that, given a particular business model, prevent investors from contracting with businesses and charities over the exact manner in which they operate their business model. In other words, investors observe the business models that charities and businesses operate and can direct both types of organizations to produce certain pairs of  $(F, S)$  given the business models they have available to them.

In theory, investors could be ordinary citizens in the spirit implied by Friedman's analysis, but in practice, investors may take many forms. Many large institutional pools of capital, such as foundations, university endowments, or family offices that have their own views on social responsibility. Many private charitable foundations operate with a clear orientation towards certain social goals and also manage large pools of investment capital that provide operating income for the foundation. For example, the Kresge Foundation, founded by the founder of the Kmart Corporation, is a \$3.6 billion endowment that specifically works to serve low-income and vulnerable populations, especially in the Detroit area, where Kmart first began. The William and Flora Hewlett Foundation has the environment as one of its key focus areas. In both examples, it is natural to think

that their investment strategies will be guided in part by the desire to maximize financial returns, but also by the desire to pursue philanthropic goals. Alternatively, investors could be private equity or venture capital funds, in which case their investment choices may reflect the underlying preferences of their limited partners, many of whom will be exactly the types of foundations, pensions and endowments described above.

## 4 Analyzing the Framework

### 4.1 The World of Friedman and Levitt

The central message of Friedman (1970) and Levitt (1958) is that the socially optimal investment strategy is to allocate wealth between a purely profit-maximizing firm and a purely social-output maximizing charity. They argue that this dominates alternatives that involve hybrid firms. This rule allows an investor to achieve a continuum of return combinations on her own simply by creating a portfolio of the profit-maximizing firm and a pure charity. Figure 2 provides an illustration of this logic.

Figure 2 about here

In Figure 2, we have assumed that both charities and businesses operate business models that involve constant tradeoffs between social and financial output. In such a world, it is optimal for the investor both to direct the charity to ignore financial considerations and maximize charitable output, and at the same time, direct the business to ignore social output and maximize profits. In so doing, this allows the investor to choose any point along the dashed line connecting the two extremes.

Based on the tradeoffs depicted in Figure 2, the investment strategy prescribed by Friedman and Levitt is indeed the strategy that maximizes the social output for a given amount of financial output. Regardless of the *amount* of  $S$  that is optimal from a social

standpoint, the best way to organize the production of  $S$  and  $F$  is through pure charity and pure profit maximization.

Note that this logic involves two decisions on the part of the investor. The first is how to operate each business model—in this case, instructing each type of organization to focus on a “pure-play” strategy. This decision is the same no matter what are the investor’s (or by extension, society’s) preferences for the amount of social output—it is driven purely by the technology implied by each business model. The second decision is whether to have more social output and less profits, or more profits and less social output. This example helps to illustrate why it cannot be the case that the rise of CSR is simply a reflection of increased preferences for charitable output. If it were only this, we would see movement along the “Friedman Line” in a manner consistent with producing more  $S$  and less  $F$ , but we would not necessarily see charities and companies deviating from their production plans given the business models they operated.

To see this more clearly, Figure 2 describes two possible allocations based on different investor preferences. These are denoted with the two X’s along the Friedman/Levitt line. These represent a high social output allocation and a low social output allocation. Figure 2 illustrates how changes in social preferences can result in greater levels of  $S$  even if no commensurate change in business models occurs.

## 4.2 A Double Bottom Line World

The main message of our analysis is that the welfare prescriptions described in Figure 2 need not always hold. Critically, this depends on the tradeoffs implicit in the business and charity business models and how they compare to an investor’s ability to form portfolios of charities and businesses on their own account.

To see this, consider Figure 3, which reconsiders the Friedman/Levitt logic under different business model assumptions. To see how Figures 2 and 3 are linked, imagine

that the economy is first described by the straight-line business models depicted in Figure 2, where investors are choosing points along the lines connecting pure-profit and pure-charity operational decisions. Then imagine that a business model innovation occurs in each market that moves the optimal business from model A to B for charities and from C to D for businesses.

Figure 3 about here

As Figure 3 illustrates, the original Friedman/Levitt strategy is now dominated by operational choices for the both types of organization's business models that lie above the original investor allocation line. Any point above the investor allocation line is strictly preferred to the original, "pure-charity" operational choice of the charity operating the pre-existing business model, because any of these choices offers  $(S, F)$  pairs that are unavailable under the old technology. Likewise, the "pure-profit" choice under the pre-existing business model for profit-oriented organizations is now dominated by new combinations of  $(S, F)$  that are available by firms making socially responsible operational choices under the new business model.

Figure 4 about here

This implies a new equilibrium set of investor choices as depicted in Figure 4. Instead of instructing businesses to make purely profit-maximizing operational choices and charities to make operational choices that maximize charitable output, the new equilibrium requires each business model to operate in a hybrid manner. Charities tilt their business activities toward financial gain, and businesses operate in a socially responsible manner, and investors choose an equilibrium level of  $S$  and  $F$  by picking along the outer envelope of the production possibilities that are available with the new business models. As in the analysis of the Figure 3, the optimal level of  $S$  and  $F$  can be decomposed into two distinct social choices. The first is the optimal operational choice of each type of business. The second is the fraction of total resources to devote to each type of activity.

## 5 Limitations and the Need for More Innovation

The analysis up to this point makes clear the fact that supply side shocks like business model innovation must be a central element of the rising importance of CSR. But our analysis has at least three critical limitations.

The first is that our model is completely silent on the specifics of  $S$ . While we can all agree that  $F$  can be measured with money, a critical element required to measure the tradeoff between  $F$  and  $S$  is labeling and measure  $S$  itself. That is, in order to measure environmental improvement, for example, we have to be able to count the trees or lakes that have been saved by some corporate action. This task is extremely difficult, in part because it requires establishing a relevant counterfactual: what would the environment have looked like if this CSR action hadn't taken place? As de Bettignies and Robinson (2017) illustrate, establishing a counterfactual level of  $S$  is critical to undertaking any welfare analysis.

The challenge of defining and enumerating  $S$  is part of what has given rise to new legal forms, such as L3C and B Corporations. These have been developed specifically to accommodate the needs of hybrid firms striving for both social and financial returns.<sup>1</sup> That many innovations in legal form have been put forward to try to crystallize and formalize these hybrid middle grounds illustrates that the market, too, is shy on the specific meaning of  $S$  in any particular context.

Also, as we discussed in Section 2, there are non-trivial agency considerations that impact how we think about CSR. In our model, investors can direct charities and businesses to behave in exactly the manner they please, but in the real-world we must be concerned with information asymmetries and conflicting interests. For example, greenwashing is an example of misleading consumers about environmental practices. It is important to acknowledge this limitation in our analysis.

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<sup>1</sup>See Wexler (2009) for an overview of legal issues surrounding social enterprises.

These limitations, however, are echoed in the marketplace, where a lack of clearly defined metrics for environmental, social and governance outcomes makes it difficult to measure  $S$ , which in turn makes it possible for firms to engage in greenwashing and other types of misrepresentation about CSR practices. Trelstad (2016) summarizes some of the challenges associated with quantifying these tradeoffs and describes some of the attempts that have been made to overcome these challenges. Both his work and our analysis point to the need for more and better data so that investors can quantify the tradeoffs that are an integral part of our analysis.

A final limitation is the static nature of our analysis. In particular, we are silent on the mechanics of how business model innovation occurs. Our analysis simply assumes that exogenous changes in business models occur, and that these changes cause shifts in the optimal organization of the production of social goods. A more realistic analysis would allow for the possibility that certain types of investors might “pull” organizations to develop business model innovations that create more favorable tradeoffs.

## 6 Implications for Innovation Policy

Notwithstanding the empirical limitations noted above, this simple graphical analysis nonetheless sheds light on a series of questions that are important for understanding CSR. In this section, we briefly explore three policy areas that our analysis can illuminate. First, we ask how government policy fits into our analysis. Second, we point out some implications of our analysis for the *types* of CSR that firms choose and how CSR should best relate to a firm’s core business activities. Finally, we discuss the interconnections between CSR and social entrepreneurship that are implied by our model.

## 6.1 A Role for Government Policy

Although there is no explicit role for government policy in our basic framework, the structure of our analysis does offer a simple way for thinking about government policy in terms of how it affects the business models that are available to tradeoff  $S$  and  $F$ . In particular, government subsidies, tax credits, and other forms of redistribution can cause shifts in the set of business models available to corporations and charities. Consider, for example, a government that sought to improve domestic, inner-city labor force participation. In such a framework,  $S$  would be some measure linked to inner-city employment, and a charity entrepreneur  $C$  might be an agent operating a local work-force education programs. Stimulating local hiring through an investment tax credit aimed at setting up a local factory would expand the social output possibilities for business entrepreneurs, flattening the tradeoffs between financial and social output. This would correspond to shifting from business model 4 to 5 in Figure 1, for example.

## 6.2 Innovation Policy and Firm Strategy

A comparison of the business models depicted in Figure 1 suggests that the “optimal” social cause addressed through corporate social responsibility initiatives are the ones that have the strongest production complementarities between the  $S$  and the  $F$  activities. Thus, shoe manufacturers are better suited to address child labor initiatives than they are supporting urban education initiatives in poverty-stricken US inner cities, not because one is intrinsically more or less socially valuable than the other, but because the manufacturing technology has little or no spillover effects for educating urban children. One mechanism for such complementarity, as described above, is information asymmetry. For example, the manager of a shoe factory in Vietnam is likely to have better information about child labor conditions in the country than outsiders. Thus, a key normative prescription from our analysis is that corporate social responsibility is best



directed at those causes which are most directly impacted by the normal operations of business. This concept of complementarity has also been discussed by Besley and Ghatak (2007), which finds that in the case of remediating “bads”, firms are often better positioned than nonprofits, since the corporation may itself be the perpetrator of the “bad”.

This is also consistent with how CSR is viewed by many industry observers. Many of the examples we offered in the introduction—Patagonia, Tyson Foods, The Body Shop—are touted as best practices precisely because they involve specific CSR activity that is highly complementary to the firm’s core mission. Likewise, the empirical evidence from Minor (2015) discussed in Section 2 suggests that complementarity is key to value creation, and that CSR initiatives that lack a complementarity with the core activities of the business in question can be perceived as disingenuous.

Similarly, a complementary prescription arises for the types of revenue generating activities of a social organization. Commercial activities should be selected in such a way that they are strategically aligned with the social mission. This has been noted by Weisbrod (1998), who argues that commercialization of nonprofits brings financial “interdependencies”, both positive and negative.

### **6.3 Innovation Policy and the Entrepreneurial Ecosystem**

Another implication that arises from this analysis is that the technology frontier of the business technology has a direct impact on the optimal level of commercialism in the social sector, and that the nature of operations among business-oriented charities affects the optimality of CSR in the corporate sector. To see this, consider Figure 5, which examines the change in production possibilities associated with a change in the business models available to charities.

Figure 5 about here

In Figure 5, the available business models for charities move upward, which means that more  $S$  is available for any given level of  $F$ . Intuitively, if charities experience a positive shock to their ability to transfer  $F$  into  $S$ , we should expect that the optimal organizational plan calls for charities to produce more  $S$  and less  $F$ , while businesses will engage in less CSR and instead produce more  $F$ . This is exactly what happens in the framework. As business models for charities improve, the tangency line steepens, which causes the optimal amount of CSR for firms to decrease as the optimal business model for businesses moves closer to a “pure- $F$ ” model.

This illustrates how the opportunity cost of social business connects changes in socially responsible business practice to social enterprises as well broader forces in the economy. Or put differently, this shows how the different elements of a broader business ecosystem are connected through a complex series of complementarities and tradeoffs.

## 7 Conclusion

Corporate social responsibility is an integral part of modern corporate strategy. According to the Economist, in 2014 alone the largest corporations in the UK and US spent more than \$15 billion on CSR initiatives. Whether this represents an increase in shareholder value—doing well by doing good—whether it represents a shift in the burden of the provision of social goods from governments to firms, or whether this is simply another symptom of corporate governance problems is very much an open question. A multitude of different studies have tackled these questions from numerous angles and reached differing conclusions. As is common economics, the consensus answer is: it depends.

One reason why understanding CSR is not clear cut is because we do not yet have a well accepted framework for thinking about the role of CSR, social entrepreneurship, and other organizational mechanisms that trade off social good with financial gain.

This paper attempts to offer one such framework. The framework builds from Milton Friedman’s insight, which is that instead of a firm behaving responsibly and thereby earning lower profits, it could instead maximize profits, returning the incremental profits to shareholders who could then use these extra proceeds to support charities of their own choosing.

Once we recognize that shareholders of a for-profit firm can act as “impact investors” on their own account, then we cannot explain the rise in CSR in terms of shifting preferences for social output. Shifting preferences could just as easily cause increases in contributions to endowments that support traditional charities. Demand-side considerations can only affect the equilibrium *amount* of social versus financial output in the economy, not the manner in which that is produced.

Instead, we point to business model innovation as the key to understanding the rise in CSR and social entrepreneurship. In order for CSR to sustain the forces of competition, it is not necessary that they increase profits. It is only necessary that CSR initiatives trade off profits and social good at a more favorable rate than that which can be obtained by investors and consumers acting on their own account. This alone helps to explain the tenuous empirical relationship between doing well and doing good.

Once we recognize this distinction, a number of factors on which value judgments about CSR depend come into sharper focus. The first is that CSR initiatives are most likely to be welfare increasing, even if not profit increasing, if they operate at the highest possible degree of complementarity with the core mission of the business. The second is that the effectiveness of a firm’s CSR initiatives in a certain space depend critically on what other organizations, like charities and social entrepreneurs, are already doing. One reason why observers find little correlation between CSR and profitability in the aggregate is that there is so much contextual variation in the degree of complementarity and the availability of viable alternatives.

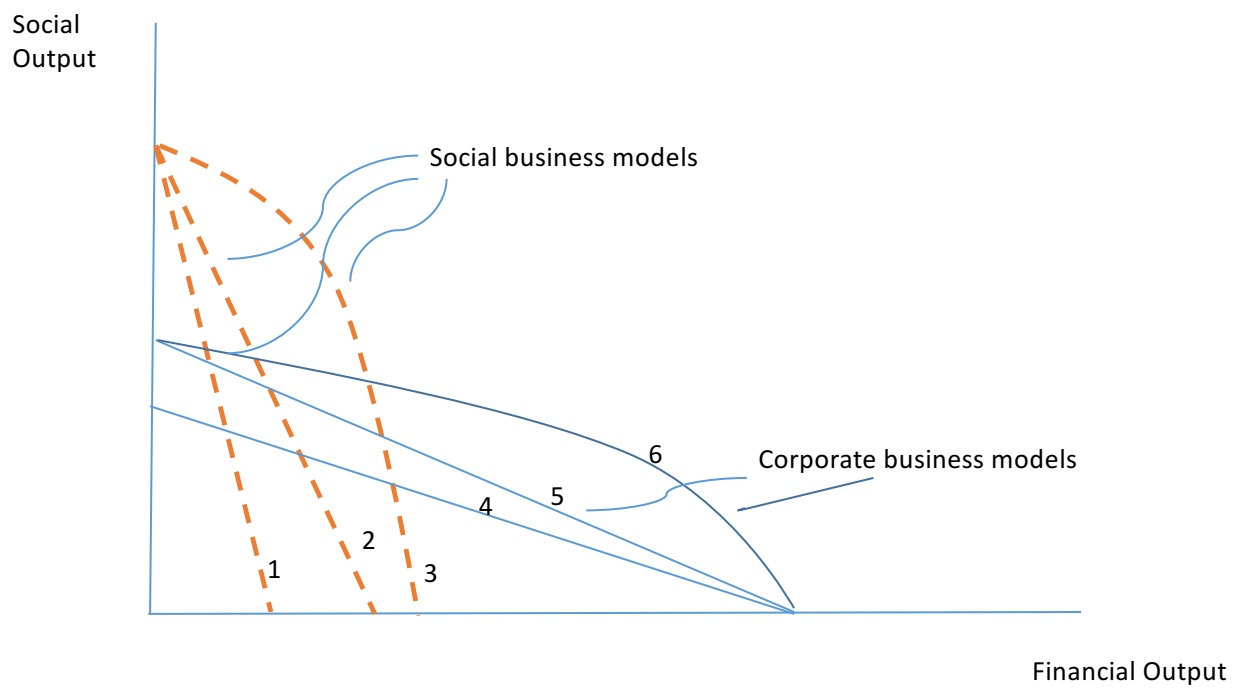
Our analysis is also a rallying cry for innovations in reporting and data collection. The central limitation in our analysis is that we define can only operate with a broad, “you’ll know it when you see it” definition of social output. While this is clearly a limitation of the analysis, it is in some sense also a reflection of an important limitation in practice: we lack a set of well-defined and widely promulgated metrics for understanding the output, and hence the implied tradeoffs, associated with various CSR initiatives. Many institutional stakeholders have explicit interests in adhering to certain social principles, but need better data to determine the tradeoffs they face. Building a robust platform for collecting and disseminating data for measuring social output is an important next step for the field.

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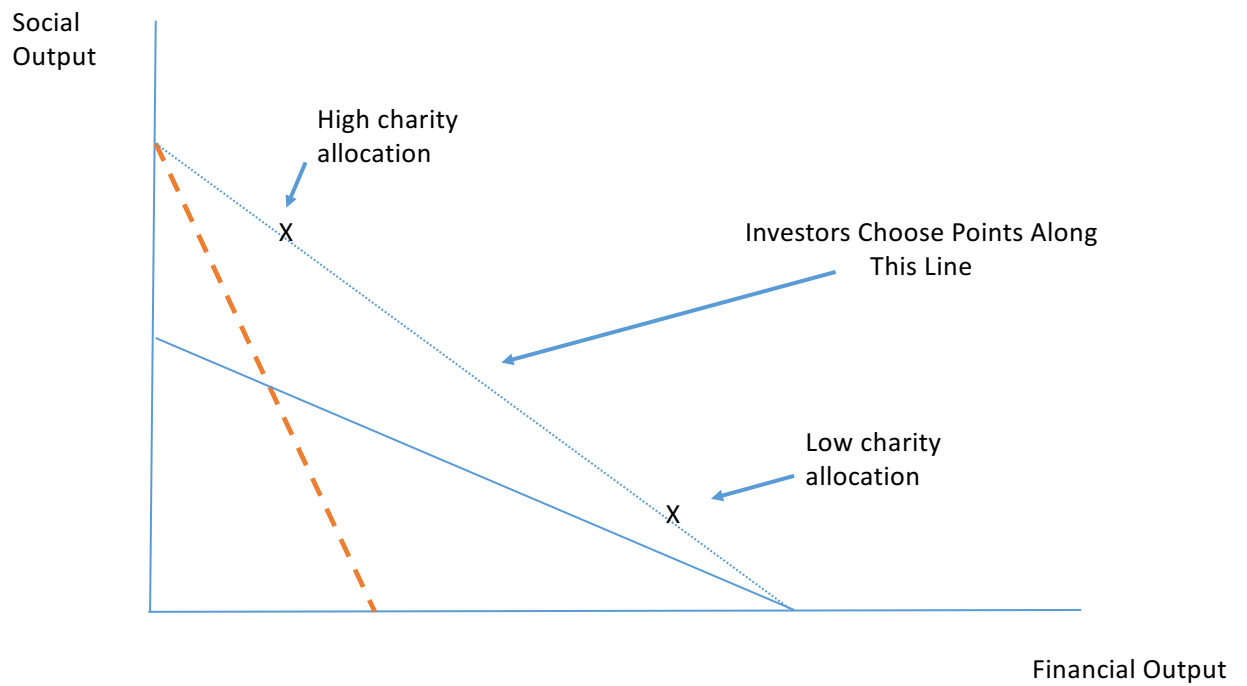
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**Figure 1: Alternative Business Models**

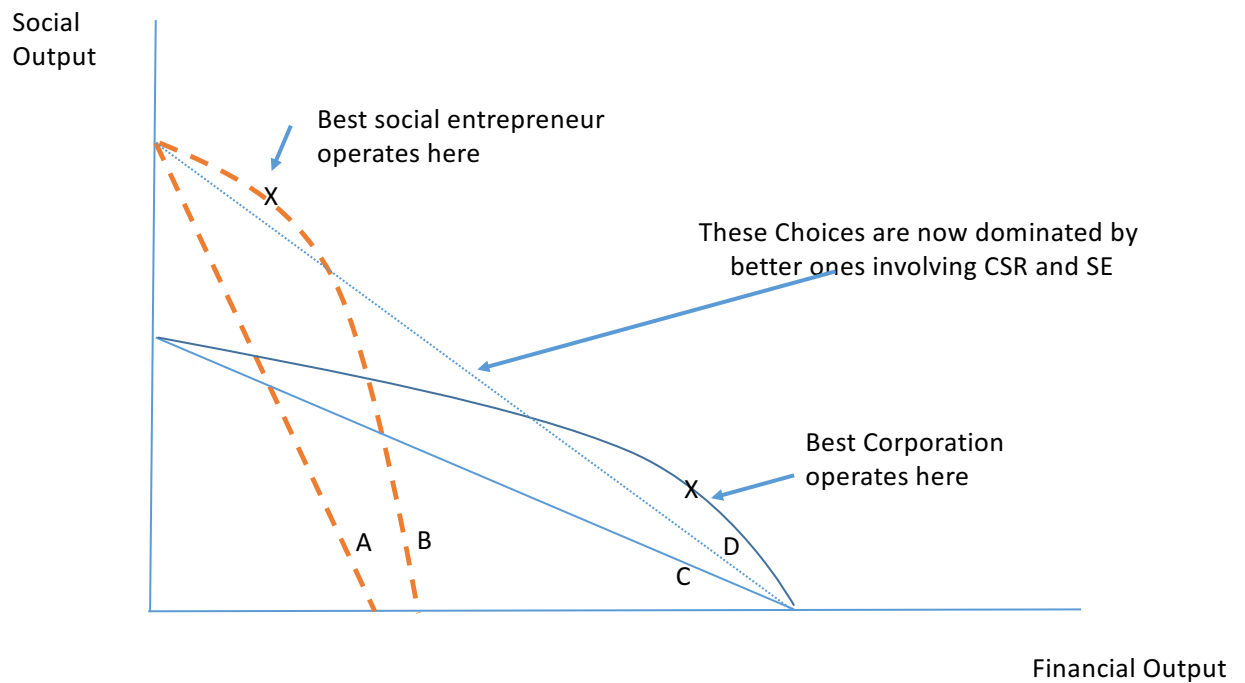
Figure 1: This figure depicts alternative business models for businesses and charities. The lines and curves in orange represent alternative business models that are available to charitable organizations. The fact that they slope downward reflects their ability to sacrifice social output,  $S$ , to increase financial output,  $F$ . The lines and curves in blue represent those available to businesses.





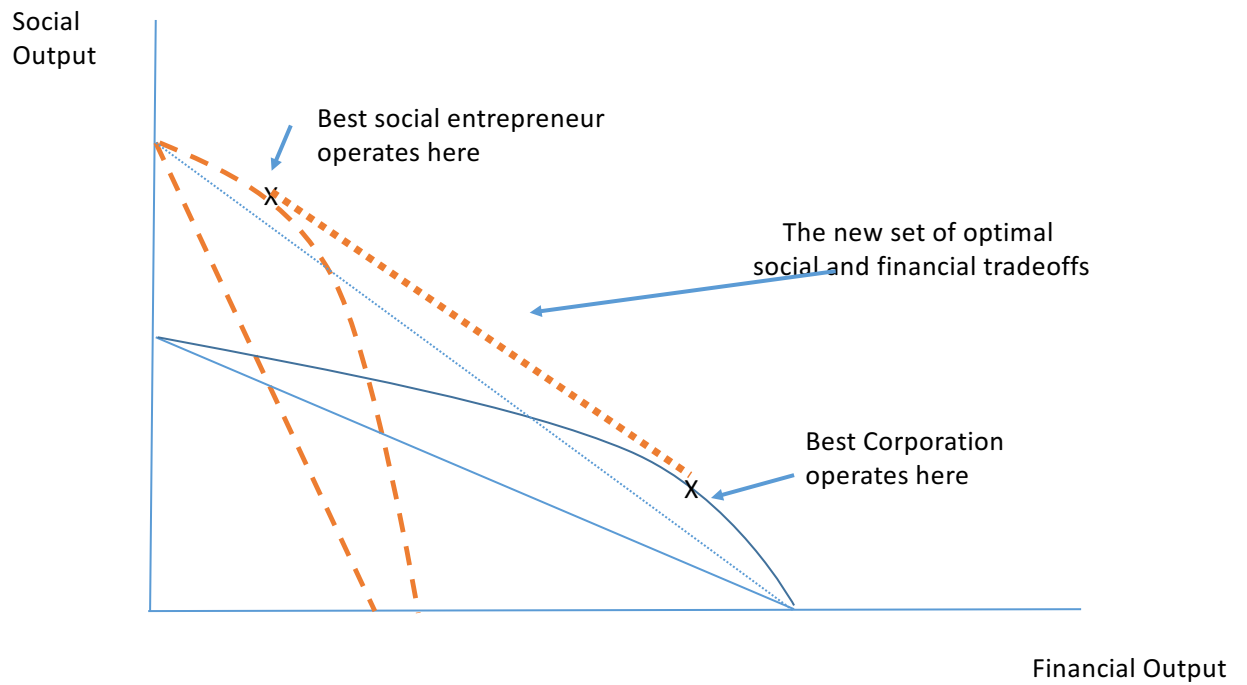
**Figure 2: A Friedman/Leavitt World**

Figure 2: This dashed line in this figure depicts the tradeoffs available to an investor who optimally chooses between a pure-play charity and a pure-play corporation. The “X” marks on the line represent potential allocations of overall investment to  $S$  and  $F$ , with the upper “X” representing a high social output allocation and the lower “X” representing a low social output allocation.



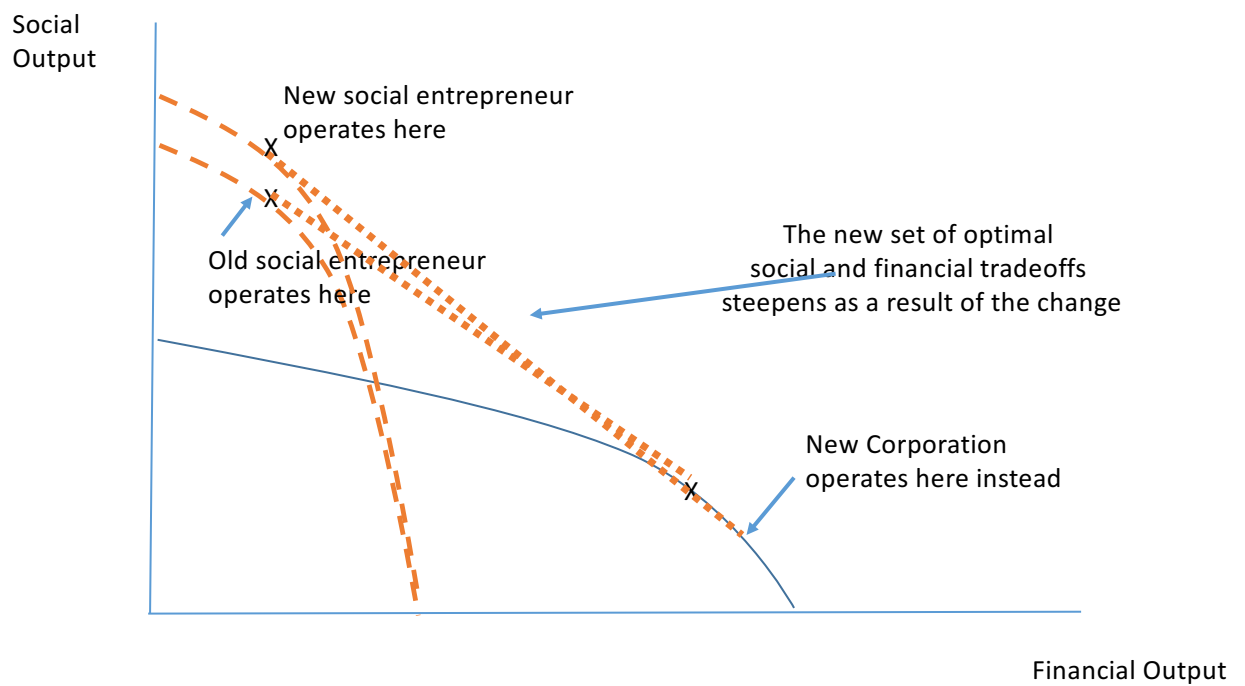
**Figure 3: Viable CSR/Social Enterprise**

Figure 3: The original dashed line from figure 2 is no longer optimal because it is dominated by combinations of points that lie along the regions of business models B and D that lie above that dashed line. The new “X” marks denote the approximate behaviors of hybrid organizations, a CSR-oriented corporation and a profit-minded charity. The optimality of these points is given by the fact that they represent the endpoints of the highest line connecting the two business models.



**Figure 4: Optimal Hybrid Organizations**

Figure 4: The new dashed line, in bold orange, dominates the original line from figure 2. It connects the two optimal "X" marks from Figure 3.



**Figure 5: Changes in the Ecosystem**

Figure 5: This figure explores changes in the optimal level of CSR produced by corporations when the business model for charities changes. The illustrates the interconnectedness of different members of an  $(S, F)$  ecosystem.