

by Michael E. Porter and Mark R. Kramer

# Strategy & Society

## The Link Between Competitive Advantage and Corporate Social Responsibility

**G**overnments, activists, and the media have become adept at holding companies to account for the social consequences of their activities. Myriad organizations rank companies on the performance of their corporate social responsibility (CSR), and, despite sometimes questionable methodologies, these rankings attract considerable publicity. As a result, CSR has emerged as an inescapable priority for business leaders in every country.

Many companies have already done much to improve the social and environmental consequences of their activities, yet these efforts have not been nearly as productive as they could be—for two reasons. First, they pit business against society, when clearly the two are interdependent. Second, they pressure companies to think of corporate social responsibility in generic ways instead of in the way most appropriate to each firm's strategy.

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The fact is, the prevailing approaches to CSR are so fragmented and so disconnected from business and strategy as to obscure many of the greatest opportunities for companies to benefit society. If, instead, corporations were to analyze their prospects for social responsibility using the same frameworks that guide their core business choices, they would discover that CSR can be much more than a cost, a constraint, or a charitable deed—it can be a source of opportunity, innovation, and competitive advantage.

In this article, we propose a new way to look at the relationship between business and society that does not treat corporate success and social welfare as a zero-sum game. We introduce a framework companies can use to

companies discovered that they were expected to respond to the AIDS pandemic in Africa even though it was far removed from their primary product lines and markets. Fast-food and packaged food companies are now being held responsible for obesity and poor nutrition.

Activist organizations of all kinds, both on the right and the left, have grown much more aggressive and effective in bringing public pressure to bear on corporations. Activists may target the most visible or successful companies merely to draw attention to an issue, even if those corporations actually have had little impact on the problem at hand. Nestlé, for example, the world's largest purveyor of bottled water, has become a major target in the global debate about access to fresh water, despite the fact

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identify all of the effects, both positive and negative, they have on society; determine which ones to address; and suggest effective ways to do so. When looked at strategically, corporate social responsibility can become a source of tremendous social progress, as the business applies its considerable resources, expertise, and insights to activities that benefit society.

**The Emergence of Corporate Social Responsibility**

**H**eightened corporate attention to CSR has not been entirely voluntary. Many companies awoke to it only after being surprised by public responses to issues they had not previously thought were part of their business responsibilities. Nike, for example, faced an extensive consumer boycott after the *New York Times* and other media outlets reported abusive labor practices at some of its Indonesian suppliers in the early 1990s. Shell Oil's decision to sink the *Brent Spar*, an obsolete oil rig, in the North Sea led to Greenpeace protests in 1995 and to international headlines. Pharmaceutical

that Nestlé's bottled water sales consume just 0.0008% of the world's fresh water supply. The inefficiency of agricultural irrigation, which uses 70% of the world's supply annually, is a far more pressing issue, but it offers no equally convenient multinational corporation to target.

Debates about CSR have moved all the way into corporate boardrooms. In 2005, 360 different CSR-related shareholder resolutions were filed on issues ranging from labor conditions to global warming. Government regulation increasingly mandates social responsibility reporting. Pending legislation in the UK, for example, would require every publicly listed company to disclose ethical, social, and environmental risks in its annual report. These pressures clearly demonstrate the extent to which external stakeholders are seeking to hold companies accountable for social issues and highlight the potentially large financial risks for any firm whose conduct is deemed unacceptable.

While businesses have awakened to these risks, they are much less clear on what to do about them. In fact, the most common corporate response has been neither strategic nor operational but cosmetic: public relations and

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media campaigns, the centerpieces of which are often glossy CSR reports that showcase companies' social and environmental good deeds. Of the 250 largest multinational corporations, 64% published CSR reports in 2005, either within their annual report or, for most, in separate sustainability reports—supporting a new cottage industry of report writers.

Such publications rarely offer a coherent framework for CSR activities, let alone a strategic one. Instead, they aggregate anecdotes about uncoordinated initiatives to demonstrate a company's social sensitivity. What these reports leave out is often as telling as what they include. Reductions in pollution, waste, carbon emissions, or energy use, for example, may be documented for specific divisions or regions but not for the company as a whole. Philanthropic initiatives are typically described in terms of dollars or volunteer hours spent but almost never in terms of impact. Forward-looking commitments to reach explicit performance targets are even rarer.

This proliferation of CSR reports has been paralleled by growth in CSR ratings and rankings. While rigorous and reliable ratings might constructively influence corporate behavior, the existing cacophony of self-appointed scorekeepers does little more than add to the confusion. (See the sidebar "The Ratings Game.")

In an effort to move beyond this confusion, corporate leaders have turned for advice to a growing collection of increasingly sophisticated nonprofit organizations, consulting firms, and academic experts. A rich literature on CSR has emerged, though what practical guidance it offers corporate leaders is often unclear. Examining the primary schools of thought about CSR is an essential starting point in understanding why a new approach is needed to integrating social considerations more effectively into core business operations and strategy.

#### Four Prevailing Justifications for CSR

**B**roadly speaking, proponents of CSR have used four arguments to make their case: moral obligation, sustainability, license to operate, and reputation. The moral appeal—arguing that companies have a duty to be good citizens and to "do the right thing"—is prominent in the goal of Business for Social Responsibility, the leading nonprofit CSR business association in the United States. It asks that its members "achieve commercial success in ways that honor ethical values and respect people, communities, and the natural environment." Sustainability emphasizes environmental and community stewardship. An excellent definition was developed in the 1980s by Norwegian Prime Minister Gro Harlem Brundtland and used by the World Business Coun-

### The Ratings Game

Measuring and publicizing social performance is a potentially powerful way to influence corporate behavior—assuming that the ratings are consistently measured and accurately reflect corporate social impact. Unfortunately, neither condition holds true in the current profusion of CSR checklists.

The criteria used in the rankings vary widely. The Dow Jones Sustainability Index, for example, includes aspects of economic performance in its evaluation. It weights customer service almost 50% more heavily than corporate citizenship. The equally prominent FTSE4Good Index, by contrast, contains no measures of economic performance or customer service at all. Even when criteria happen to be the same, they are invariably weighted differently in the final scoring.

Beyond the choice of criteria and their weightings lies the even more perplexing question of how to judge whether the criteria have been met. Most media, nonprofits, and investment advisory organizations have too few resources to audit a universe of complicated global corporate activities. As a result, they tend to use measures for which data are readily and inexpensively available, even though they may not be good proxies for the social or environmental effects they are intended to reflect. The Dow Jones Sustainability Index, for example, uses the size of a company's board as a measure of community involvement, even though size and involvement may be entirely unrelated.<sup>1</sup>

Finally, even if the measures chosen accurately reflect social impact, the data are frequently unreliable. Most ratings rely on surveys whose response rates are statistically insignificant, as well as on self-reported company data that have not been verified externally. Companies with the most to hide are the least likely to respond. The result is a jumble of largely meaningless rankings, allowing almost any company to boast that it meets some measure of social responsibility—and most do.

1. For a fuller discussion of the problem of CSR ratings, see Aaron Chatterji and David Levine, "Breaking Down the Wall of Codes: Evaluating Non-Financial Performance Measurement," *California Management Review*, Winter 2006.

cil for Sustainable Development: "Meeting the needs of the present without compromising the ability of future generations to meet their own needs." The notion of license to operate derives from the fact that every company needs tacit or explicit permission from governments,



communities, and numerous other stakeholders to do business. Finally, reputation is used by many companies to justify CSR initiatives on the grounds that they will improve a company's image, strengthen its brand, enliven morale, and even raise the value of its stock. These justifications have advanced thinking in the field, but none offers sufficient guidance for the difficult choices corporate leaders must make. Consider the practical limitations of each approach.

The CSR field remains strongly imbued with a moral imperative. In some areas, such as honesty in filing financial statements and operating within the law, moral considerations are easy to understand and apply. It is the nature of moral obligations to be absolute mandates, however, while most corporate social choices involve balancing competing values, interests, and costs. Google's recent entry into China, for example, has created an irreconcilable conflict between its U.S. customers' abhorrence

Philanthropy may contribute to the "sustainability" of a society. However true these assertions are, they offer little basis for balancing long-term objectives against the short-term costs they incur. The sustainability school raises questions about these trade-offs without offering a framework to answer them. Managers without a strategic understanding of CSR are prone to postpone these costs, which can lead to far greater costs when the company is later judged to have violated its social obligation.

The license-to-operate approach, by contrast, is far more pragmatic. It offers a concrete way for a business to identify social issues that matter to its stakeholders and make decisions about them. This approach also fosters constructive dialogue with regulators, the local citizenry, and activists—one reason, perhaps, that it is especially prevalent among companies that depend on government consent, such as those in mining and other highly regulated and extractive industries. That is also why the approach is

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of censorship and the legal constraints imposed by the Chinese government. The moral calculus needed to weigh one social benefit against another, or against its financial costs, has yet to be developed. Moral principles do not tell a pharmaceutical company how to allocate its revenues among subsidizing care for the indigent today, developing cures for the future, and providing dividends to its investors.

The principle of sustainability appeals to enlightened self-interest, often invoking the so-called triple bottom line of economic, social, and environmental performance. In other words, companies should operate in ways that secure long-term economic performance by avoiding short-term behavior that is socially detrimental or environmentally wasteful. The principle works best for issues that coincide with a company's economic or regulatory interests. DuPont, for example, has saved over \$2 billion from reductions in energy use since 1990. Changes to the materials McDonald's uses to wrap its food have reduced its solid waste by 30%. These were smart business decisions entirely apart from their environmental benefits. In other areas, however, the notion of sustainability can become so vague as to be meaningless. Transparency may be said to be more "sustainable" than corruption. Good employment practices are more "sustainable" than sweatshops.

common at companies that rely on the forbearance of their neighbors, such as those, like chemical manufacturing, whose operations are noxious or environmentally hazardous. By seeking to satisfy stakeholders, however, companies cede primary control of their CSR agendas to outsiders. Stakeholders' views are obviously important, but these groups can never fully understand a corporation's capabilities, competitive positioning, or the trade-offs it must make. Nor does the vehemence of a stakeholder group necessarily signify the importance of an issue—either to the company or to the world. A firm that views CSR as a way to placate pressure groups often finds that its approach devolves into a series of short-term defensive reactions—a never-ending public relations palliative with minimal value to society and no strategic benefit for the business.

Finally, the reputation argument seeks that strategic benefit but rarely finds it. Concerns about reputation, like license to operate, focus on satisfying external audiences. In consumer-oriented companies, it often leads to high-profile cause-related marketing campaigns. In stigmatized industries, such as chemicals and energy, a company may instead pursue social responsibility initiatives as a form of insurance, in the hope that its reputation for social consciousness will temper public criticism in the event

of a crisis. This rationale once again risks confusing public relations with social and business results.

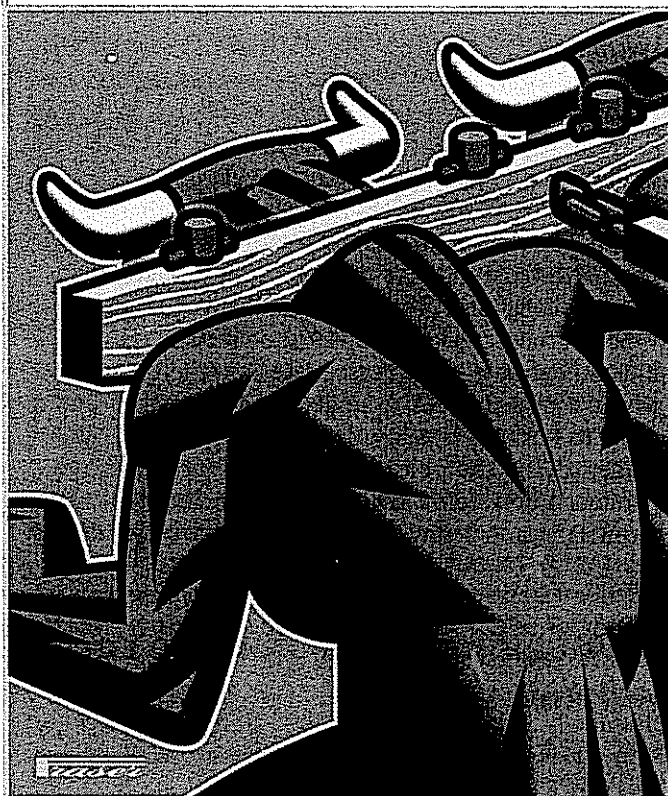
A few corporations, such as Ben & Jerry's, Newman's Own, Patagonia, and the Body Shop, have distinguished themselves through an extraordinary long-term commitment to social responsibility. But even for these companies, the social impact achieved, much less the business benefit, is hard to determine. Studies of the effect of a company's social reputation on consumer purchasing preferences or on stock market performance have been inconclusive at best. As for the concept of CSR as insurance, the connection between the good deeds and consumer attitudes is so indirect as to be impossible to measure. Having no way to quantify the benefits of these investments puts such CSR programs on shaky ground, liable to be dislodged by a change of management or a swing in the business cycle.

All four schools of thought share the same weakness: They focus on the tension between business and society rather than on their interdependence. Each creates a generic rationale that is not tied to the strategy and operations of any specific company or the places in which it operates. Consequently, none of them is sufficient to help a company identify, prioritize, and address the social issues that matter most or the ones on which it can make the biggest impact. The result is oftentimes a hodgepodge of uncoordinated CSR and philanthropic activities disconnected from the company's strategy that neither make any meaningful social impact nor strengthen the firm's long-term competitiveness. Internally, CSR practices and initiatives are often isolated from operating units—and even separated from corporate philanthropy. Externally, the company's social impact becomes diffused among numerous unrelated efforts, each responding to a different stakeholder group or corporate pressure point.

The consequence of this fragmentation is a tremendous lost opportunity. The power of corporations to create social benefit is dissipated, and so is the potential of companies to take actions that would support both their communities and their business goals.

### Integrating Business and Society

**T**o advance CSR, we must root it in a broad understanding of the interrelationship between a corporation and society while at the same time anchoring it in the strategies and activities of specific companies. To say broadly that business and society need each other might seem like a cliché, but it is also the basic truth that will pull companies out of the muddle that their current corporate-responsibility thinking has created.



Successful corporations need a healthy society. Education, health care, and equal opportunity are essential to a productive workforce. Safe products and working conditions not only attract customers but lower the internal costs of accidents. Efficient utilization of land, water, energy, and other natural resources makes business more productive. Good government, the rule of law, and property rights are essential for efficiency and innovation. Strong regulatory standards protect both consumers and competitive companies from exploitation. Ultimately, a healthy society creates expanding demand for business, as more human needs are met and aspirations grow. Any business that pursues its ends at the expense of the society in which it operates will find its success to be illusory and ultimately temporary.

At the same time, a healthy society needs successful companies. No social program can rival the business sector when it comes to creating the jobs, wealth, and innovation that improve standards of living and social conditions over time. If governments, NGOs, and other participants in civil society weaken the ability of business to operate productively, they may win battles but will lose the war, as corporate and regional competitiveness fade, wages stagnate, jobs disappear, and the wealth that pays taxes and supports nonprofit contributions evaporates.



Leaders in both business and civil society have focused too much on the friction between them and not enough on the points of intersection. The mutual dependence of corporations and society implies that both business decisions and social policies must follow the principle of *shared value*. That is, choices must benefit both sides. If either a business or a society pursues policies that benefit its interests at the expense of the other, it will find itself on a dangerous path. A temporary gain to one will undermine the long-term prosperity of both.<sup>1</sup>

To put these broad principles into practice, a company must integrate a social perspective into the core frameworks it already uses to understand competition and guide its business strategy.

**Identifying the points of intersection.** The interdependence between a company and society takes two forms. First, a company impinges upon society through its

Not only does corporate activity affect society, but external social conditions also influence corporations, for better and for worse. These are *outside-in linkages*.

Every company operates within a competitive context, which significantly affects its ability to carry out its strategy, especially in the long run. Social conditions form a key part of this context. Competitive context garners far less attention than value chain impacts but can have far greater strategic importance for both companies and societies. Ensuring the health of the competitive context benefits both the company and the community.

Competitive context can be divided into four broad areas: first, the quantity and quality of available business inputs—human resources, for example, or transportation infrastructure; second, the rules and incentives that govern competition—such as policies that protect intellectual property, ensure transparency, safeguard against corruption,

## **An affirmative corporate social agenda moves from mitigating harm to reinforcing corporate strategy through social progress.**

operations in the normal course of business: These are *inside-out linkages*.

Virtually every activity in a company's value chain touches on the communities in which the firm operates, creating either positive or negative social consequences. (For an example of this process, see the exhibit "Looking Inside Out: Mapping the Social Impact of the Value Chain.") While companies are increasingly aware of the social impact of their activities (such as hiring practices, emissions, and waste disposal), these impacts can be more subtle and variable than many managers realize. For one thing, they depend on location. The same manufacturing operation will have very different social consequences in China than in the United States.

A company's impact on society also changes over time, as social standards evolve and science progresses. Asbestos, now understood as a serious health risk, was thought to be safe in the early 1900s, given the scientific knowledge then available. Evidence of its risks gradually mounted for more than 50 years before any company was held liable for the harms it can cause. Many firms that failed to anticipate the consequences of this evolving body of research have been bankrupted by the results. No longer can companies be content to monitor only the obvious social impacts of today. Without a careful process for identifying evolving social effects of tomorrow, firms may risk their very survival.

and encourage investment; third, the size and sophistication of local demand, influenced by such things as standards for product quality and safety, consumer rights, and fairness in government purchasing; fourth, the local availability of supporting industries, such as service providers and machinery producers. Any and all of these aspects of context can be opportunities for CSR initiatives. (See the exhibit "Looking Outside In: Social Influences on Competitiveness.") The ability to recruit appropriate human resources, for example, may depend on a number of social factors that companies can influence, such as the local educational system, the availability of housing, the existence of discrimination (which limits the pool of workers), and the adequacy of the public health infrastructure.<sup>2</sup>

**Choosing which social issues to address.** No business can solve all of society's problems or bear the cost of doing so. Instead, each company must select issues that intersect with its particular business. Other social agendas are best left to those companies in other industries, NGOs, or government institutions that are better positioned to address them. The essential test that should guide CSR is not whether a cause is worthy but whether it presents an opportunity to create shared value—that is, a meaningful benefit for society that is also valuable to the business.

Our framework suggests that the social issues affecting a company fall into three categories, which distinguish be-



tween the many worthy causes and the narrower set of social issues that are both important and strategic for the business.

*Generic social issues* may be important to society but are neither significantly affected by the company's operations nor influence the company's long-term competitiveness. *Value chain social impacts* are those that are significantly affected by the company's activities in the ordinary course of business. *Social dimensions of competitive context* are factors in the external environment that significantly affect the underlying drivers of competitiveness in those places where the company operates. (See the exhibit "Prioritizing Social Issues.")

Every company will need to sort social issues into these three categories for each of its business units and primary locations, then rank them in terms of potential impact. Into which category a given social issue falls will vary from business unit to business unit, industry to industry, and place to place.

Supporting a dance company may be a generic social issue for a utility like Southern California Edison but an important part of the competitive context for a corporation like American Express, which depends on the high-end entertainment, hospitality, and tourism cluster. Carbon emissions may be a generic social issue for a financial services firm like Bank of America, a negative value chain impact for a transportation-based company like UPS, or both a value chain impact and a competitive context issue for a car manufacturer like Toyota. The AIDS pandemic in Africa may be a generic social issue for a U.S. retailer like Home Depot, a value chain impact for a pharmaceutical company like GlaxoSmithKline, and a competitive context issue for a mining company like Anglo American that depends on local labor in Africa for its operations.

Even issues that apply widely in the economy, such as diversity in hiring or conservation of energy, can have

greater significance for some industries than for others. Health care benefits, for example, will present fewer challenges for software development or biotechnology firms, where workforces tend to be small and well compensated, than for companies in a field like retailing, which is heavily dependent on large numbers of lower-wage workers.

Within an industry, a given social issue may cut differently for different companies, owing to differences in competitive positioning. In the auto industry, for example, Volvo has chosen to make safety a central element of its competitive positioning, while Toyota has built a competitive advantage from the environmental benefits of its hybrid technology. For an individual company, some issues will prove to be important for many of its business units and locations, offering opportunities for strategic corporatewide CSR initiatives.

Where a social issue is salient for many companies across multiple industries, it can often be addressed most effectively through cooperative models. The Extractive Industries Transparency Initiative, for example, includes 19 major oil, gas, and mining companies that have agreed to discourage corruption through full public disclosure and verification of all corporate payments to governments in the countries in which they operate. Collective action by all major corporations in these industries prevents corrupt governments from undermining social benefit by simply choosing not to deal with the firms that disclose their payments.

**Creating a corporate social agenda.** Categorizing and ranking social issues is just the means to an end, which is to create an explicit and affirmative corporate social agenda. A corporate social agenda looks beyond community expectations to opportunities to achieve social and economic benefits simultaneously. It moves from mitigating harm to finding ways to reinforce corporate strategy by advancing social conditions.

Such a social agenda must be responsive to stakeholders, but it cannot stop there. A substantial portion of corporate resources and attention must migrate to truly strategic CSR. (See the exhibit "Corporate Involvement in Society: A Strategic Approach.") It is through strategic CSR that the company will make the most significant social impact and reap the greatest business benefits.

**Responsive CSR.** Responsive CSR comprises two elements: acting as a good corporate citizen, attuned to the evolving social concerns of stakeholders, and mitigating existing or anticipated adverse effects from business activities.

Good citizenship is a sine qua non of CSR, and companies need to do it well. Many worthy local organizations rely on corporate contributions, while employees derive

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## Prioritizing Social Issues

| Generic Social Issues   | Value Chain Social Impacts   | Social Dimensions of Competitive Context   |
|---|--|--|
| Social issues that are not significantly affected by a company's operations nor materially affect its long-term competitiveness | Social issues that are significantly affected by a company's activities in the ordinary course of business | Social issues in the external environment that significantly affect the underlying drivers of a company's competitiveness in the locations where it operates |