DEBRIEF

Social responsibility and financial performance: Trade-off or virtuous circle?

By Marc Orlitzky

Research suggests that New Zealand companies have been slow to adopt social initiatives. Are they missing strategic opportunities? Finally, there is some definitive research.

According to some research, New Zealand companies have generally been lagging behind their international counterparts in terms of ‘triple bottom line’ implementation and reporting. Two related factors might explain New Zealand companies’ reticence in adopting voluntary social and environmental programmes: These initiatives are, perhaps, too costly for New Zealand business, and the relatively small size of New Zealand firms makes these initiatives particularly unaffordable.

This article examines those two assumptions because it seems time to take stock of these beliefs and examine them from a strategic angle, and summarises the evidence accumulated to date. The evidence suggests that, because of their hesitation to adopt social and environmental initiatives, New Zealand business may be missing out on important strategic opportunities. The sidebar on research methods provides a brief overview of the research methodology and definitions of conceptual and statistical terms.

Findings from multiple studies
The most important finding from this meta-analysis of 52 studies, spanning 30 years and several industries, is that business social performance (SP) is positively correlated with business financial performance (FP). This means that the economic rationale for social and environmental performance offered by the New Zealand Business Council for Sustainable Development (NZBCSD) and New Zealand Business for Social...
Research methods

Science takes stock through meta-analysis. Psychometric meta-analysis is a statistical research integration technique that can correct for a number of study artefacts by which any primary research study (of one data set in one industry at one point in time) is affected. Arguably, the two most important study artefacts which may distort findings in primary studies are sampling error and measurement error.  
(1) Sampling error is the deviation of any sample from its population size, which can typically be assumed to be infinite.  
(2) Measurement error is the deviation of any measure used in primary studies from ideal, completely reliable measures. No variable can be measured perfectly. Statistically correcting for sampling error and measurement error, the meta-analyst can transform observed-score correlation coefficients  \( r_{obs} \) (reported in primary studies) into true-score correlations  \( \rho \) (i.e., the Greek letter “rho”, reported in meta-analysis). Thus, meta-analysis is concerned with the generalisability of an entire research stream across different study contexts and different industry environments. Studies conducted on a small number of cases or observations may give us rich and detailed descriptions of the problems, issues and opportunities, but these findings may be case-specific and not translate into other contexts. A meta-analysis, on the other hand, provides empirical evidence on the confidence we can have in the wide applicability of its findings because the study focus is not on a single case, several cases, or a sample, but the population of organisations. 

The 2003 meta-analysis paid careful attention to the underlying normative conceptualisation of these ‘social and environmental initiatives and programmes.’ Based on theory, they may all be aggregated under the rubric of business social performance (SP). One useful definition that we followed in our efforts of coding SP was: “a business organisation’s configuration of principles of social responsibility, processes of social responsiveness, and programs, and observable outcomes as they relate to the firm’s societal relationships.” This definition illustrates that SP is broader than the concept of corporate social responsibility and typically can be seen to apply to organisations other than corporations and include ecological ‘sustainability’ initiatives and programmes. Our definition of business financial performance (FP) included measures of market and accounting rates of return. Defining FP so broadly, we were able to investigate on what type(s) of FP social performance had a relatively strong impact, and on what other type(s) SP had a relatively weak impact, as illustrated in the Findings below.

Responsibility (NZBSR) is not so much a promise or hope as it is a reflection of organisational reality. Given that a statistical association can be demonstrated, what is the causal relationship between social and financial performance, i.e., what comes first? As it turns out, high social performance (SP) might be both a determinant and a consequence of high financial performance (FP). This suggests that causality occurs simultaneously and does not exhibit long lead-lag cycles. In short, a firm’s good reputation may pay off without delay, especially in a country where people tend to be well-informed about social and environmental issues. But, this is not to say that the relationship is always the same, or even that a totally consistent pattern is possible to detect. As shown in Figure 1, the influence of social performance on financial performance, and vice versa, varies considerably from study to study.

Figure 1 shows the rank order of various SP measures according to their correlation with FP. First, the figure shows that in terms of financial performance what matters most is SP ‘reputation’, followed by social audits and executive values and attitudes. Interestingly, overall, company disclosures of SP seem to matter the least. Second, Figure 1 shows that SP reputation and disclosures are more highly correlated with share market return measures of FP than accounting rates of return (such as return on assets or return on equity). The opposite is true for social audits, corporate processes and outcomes. (Prior studies only examined relationships between executive value measures of SP and accounting returns, but not share price returns).

What is perhaps most striking in Figure 1 is the fact that investors, whose aggregate equity-purchasing activities determine a firm’s share price return, tend to ignore social audits, processes, and outcome measures, and disclosures...
are in fact slightly negatively correlated with accounting returns.\textsuperscript{10} In combination, these two observations point to ‘stakeholder mismatching’\textsuperscript{11} as one major reason for the variability of findings in primary studies. The stakeholder mismatching thesis posits that SP-FP correlations vary depending on expectations and evaluations of SP, which differ from one stakeholder group to the next. No positive correlations would be expected between measures that cannot be linked theoretically and practically within firms, such as SP disclosures and accounting-based measures of FP, which generally reflect an organisation’s efficiency in its use of resources. This means that, for positive SP-FP relationships to hold, managers must be able to identify the exact areas where SP and FP form a virtuous circle. Particular SP activities must match particular stakeholder expectations before a firm can expect to reap economic benefits from them.

Returning to the positive impact of SP on FP being due mostly to reputation,\textsuperscript{12} note that a firm’s environmental performance (e.g., pollution abatement, resource conservation, or recycling policies and programs) was not as highly correlated with FP.\textsuperscript{13} Environmental performance is usually considered one element of overall SP, but this suggests that there are many other important aspects, which are not associated with the natural environment. Figure 2 shows differences in correlations between financial performance and environmental performance of firms (EP) compared with other forms of socially responsible performance. The evidence here suggests that environmental performance does not have the impact on financial performance that other, non-environmental social behaviours have. Because so much of the effect seems mediated by reputation in the marketplace, environmental activists may need to work harder on raising consumers’ awareness of a range of ‘green’ issues in corporations (e.g., conservation of energy and paper or reduction of pollution through telecommuting practices). Before various stakeholders can reward organisations for praiseworthy environmental actions, they must be able to differentiate accurately those organisations that score high in environmental performance from those scoring low.\textsuperscript{14}

The evidence indicates that high SP is not only a determinant, but also consequence of high FP. This makes intuitive sense in that high financial performance provides the extra resources required for investments in socially responsible activities. This is particularly relevant for genuine SP (the way this was defined is explained in the Methods sidebar) which is not mere window-dressing by organisations and, thus, typically requires genuine commitment of a firm’s economic and human resources.

In addition, SP does not appear to increase business financial risk, which is defined as the unpredictability or variability of FP. Rather, it decreases financial risk.\textsuperscript{15} This meta-analytic finding again mirrors claims made by the NZBCSD and counters resistance by some managers to investing more heavily in socially responsible corporate activities.\textsuperscript{16}

Finally, organisations of all sizes, regardless of whether they are big or small, may benefit from SP financially.\textsuperscript{17} This is an important finding because, theoretically, some researchers expected organisational size to be driving increases in both SP and FP. However, empirically, size does not appear to be the driver behind SP and FP and thus, contrary to some speculation, cannot be said to ‘confound’ the SP-FP relationship. Although large New Zealand firms tend to be more active in social and environmental performance than small- and medium-size New Zealand firms,\textsuperscript{18} the meta-analysis suggests that all firms can actually benefit from these initiatives financially.

**Practical implications**

The previous section already hinted at some practical implications of this research programme on SP and FP. However, let me summarise the most important implications briefly in five principles.

**Principle 1: Social/environmental management is a legitimate and increasingly important element of business strategy.**

The trade-off between social and economic performance, so often invoked by scholars (primarily business ethicists and economists), is a false dichotomy. With few exceptions (as noted in the 2003 article),\textsuperscript{19} this dichotomy generally is not supported by empirical observations of organisational reality. In this area, as in so many others in management, conventional wisdom (for instance, expressed in the “SP = cost (only)” assumption) has obviously got it wrong. Even though New Zealand companies seem to lag behind their international counterparts\textsuperscript{20} in terms of SP reporting and, arguably, implementation, New Zealand firms of all sizes would be well-advised to heed the strategic importance of social and environmental management.

Of course, using social/environmental performance strategically presents a number of ethical challenges. For
example, many readers may find the economic exploitation of social and environmental responsibility morally questionable. It can be shown, though, that these objections can be addressed from various ethical perspectives, if clear boundaries are set.  

**Principle 2: Business reputation and risk are the main levers through which business can benefit financially from higher social and environmental performance.**

SP derives its instrumentality (in terms of financial benefits for the organisation) from the importance of the reputation that a firm enjoys among investors, analysts, researchers, educators, consumers, current/prospective employees,22 and other stakeholders. Therefore, it is essential that a company focus on, and analyse, three aspects of a social issue:

1. The institutionalisation of a social or environmental issue (i.e. its stage in the issue life-cycle). Expressed in a somewhat simplified way, ‘institutionalised’ issues are those that have already generated a high level of awareness among the public. Novel issues, about which there is little public awareness, are unlikely to enhance organisational reputation and may, in fact, present greater business risk than highly institutionalised issues.  

2. The visibility of organisational actions to external stakeholders. Social and environmental activities need to be visible to stakeholders (customers, suppliers, employees, etc.) before they can, in various ways, reward the organisation for them.  

3. The corporation’s publicity efforts, which are tasks typically carried out by Communications and Public Affairs departments. Publicity efforts need to be relentless, but believable. If the public regards the organisation’s social/environmental initiatives as ‘green-washing’ or a marketing stunt, companies may suffer from bad publicity in the long run and thus experience negative, rather than positive, effects from more triple bottom line reporting. One of these negative effects may be more, rather than less, scrutiny and pressure exerted by various interest groups.  

Principle 2, like Principle 1, presents a number of ethical challenges. For example, it must be acknowledged that Principle 2 entails a conservative bias toward social/environmental performance. At the same time, it is precisely the more radical or progressive initiatives and programmes that may be most highly correlated with economic performance. Husted and Allen25 point to Benetton’s campaigns as an example of this surprising finding.  

**Principle 3: The increasing influence of the mass media and other intermediaries in organisational networks (both in firm-consumer and firm-investor relations) must be acknowledged and leveraged.**

Because so few triple bottom line reports are verified by independent observers,26 consumers and investors are likely to be sceptical toward social/environmental initiatives as ‘green-washing’ efforts.  

The meta-analytic data, in fact, tend to reaffirm that organisational disclosures of such initiatives are insufficient to motivate stakeholder actions that are positive for the financial bottom line of the socially responsible organisation. Rather, organisations need to be cognizant of the mass media as important influencers of public opinion. Reporters and journalists, as third-party and thus possibly more trusted observers, can help organisations publicise their social and environmental activities.  

**Principle 4: Market mechanisms may encourage social performance.**

Were the relationships negative, business would constantly face trade-offs between the three arenas of the triple bottom line: economic, social, and environmental. With a negative relationship between SP and FP, it would be unrealistic to expect business to address social and environmental problems on its own; instead, a strong regulatory framework or at least industry-level action would be needed to bring about greater organisational social and environmental responsibility.  

However, the relationship is positive. In fact, the true score correlations found are not any lower than, for instance, the typical correlations found between different configurations of organisational structure and financial performance. And it is a common assumption today that firms do not need government guidance for the management of organisational structure. Instead, executives can achieve greater fit between strategy and structure and, thus, higher financial performance through their own analyses of internal and external contingency factors and a well-developed strategic management process.  

Likewise, government interference in many SP activities may be superfluous or inefficient because the meta-analysis suggests that the SP-FP reinforcing cycle (literally a virtuous cycle) turns quickly. By the time governments pass legislation, business may have missed its opportunity to exploit its pro-active stance on its social and environmental responsibilities economically. Legislation, by focusing social and environmental performance on process-oriented, bureaucratic compliance, may subtly undermine innovative organisational solutions to social or environmental problems.  

Despite this caveat about regulation, government ought to pay most attention to companies that are poor financial performers because these firms tend to be the least likely to fulfil their broader obligations toward society. In addition, rules and regulations could serve the function of signalling which social or environmental problems are the most urgent to address.  

**Principle 5: Without a strong commitment to the normative dimensions of social responsibility, organisations cannot hope to reap economic rewards.**

If SP is implemented as an amoral marketing stunt, with neither strong executive values nor coherent processes and structures driving the effort, it is bound to fail.  

The
meta-analysis by Orlitzky, Schmidt, and Ryneș paid careful attention to the underlying normative conceptualisation of SP. As mentioned in the Methodology sidebar, the meta-analysis followed Wood’s comprehensive normative definition of SP. This definition illustrates that SP is broader than the concept of corporate social responsibility. Yet, a few authors with backgrounds in consulting, economics, or strategic management distort the definition of social responsibility or SP so much that the concept becomes morally vacuous, conceptually meaningless, and utterly unrecognisable, possibly due to the scholars’ lack of training in business ethics.

Conclusion
The first quantitative meta-analysis of thirty years of studies of the relationship between SP and FP points out that social and financial performance should not be portrayed as trade-offs. Although modern capitalism may not necessitate corporate social performance, it clearly allows for it. Therefore, one might suggest that, as far as the economics of social responsibility is concerned, no radical reforms of capitalist structures are necessary. Rather, in today’s business environment, attention to social and environmental issues may just reflect good management.

To return to the assumptions and beliefs mentioned in the introduction, yes, social and environmental management, as everywhere else in the world, will involve some additional cost for New Zealand business, but any firm is likely to reap real economic returns from these investments. The old adage still applies, ‘it takes money to make money’. Admittedly, despite the prospect of financial returns, for small New Zealand firms, the cost of implementation of social and environmental responsibility may be prohibitive, so government subsidies may be necessary to overcome the initial economic hurdle. For example, to help new, small New Zealand firms become (financially, socially, and ecologically) sustainable, the Government’s Enterprise Allowance Subsidy could focus, among other things, on the firm’s commitment, in action, to voluntary social and environmental programmes. Most business plans still do not sufficiently emphasise the social and environmental elements of strategising.

Although lots of new knowledge has been gained with this meta-analysis, more work needs to be done. For example, knowing that SP, on average, can be expected to explain or predict an organisation’s competitive advantage is not enough. In future, we must be able to pinpoint the precise causal forces behind the various SP-FP relationships described in the findings above. The theoretical causal drivers, which will be explored in a forthcoming chapter in a book by the European Foundation for Management Development (efmd), do not apply to all organisations to the same extent. It is top management’s and entrepreneurs’ task to make the most out of this new knowledge for their individual firms.

REFERENCES


6. The true score correlation (ρ) between the two variables was a non-trivial .36. Using slightly different aggregation procedures in ‘sensitivity analyses’, we found the true score correlations were even slightly higher (ρ of .41 and .42, respectively, in two different statistical analyses). In other words, SP accounts for 13 to 18 percent of the variability in FP (and vice versa). Orlitzky, M., Schmidt, F. L., and Rynes, S. L. 2003. Corporate social and financial performance: A meta-analysis. Organization Studies, 24(3): 403-441. This study won the 2004 Moskowitz award for outstanding quantitative research in the social investment field. A review of the importance of this research can be found on the Internet in: Kelly, M. 2004, Winter. Holy Grail found, Business Ethics Magazine online: 3, http://www.business-ethics.com/current_issue/winter_2005_holy_grail_article.html


8. Very similar true score correlations (ρ = .288 for SP preceding FP and ρ = .294 for SP following FP in a subsequent time period) suggest that the relationship between SP and FP may be reciprocal. Interestingly, when these temporal subdivisions were examined further, the highest correlation was found between SP and FP measured during the same time period (ρ = .44).

9. p of only .04

10. p of .02


12. This is not only shown in Figure 1, but when studies were strictly coded as presenting evidence of either reputation effects of SP or internal organizational learning effects, the reputation effects (ρ = .49) dominate learning and internal efficiency effects (at ρ = .33). When managers’ perceptual measures of FP were included in the meta-analytic data set, SP reputation shows a correlation with FP of ρ = .73. This finding of substantial reputation effects notwithstanding, the average true score correlation ρ between all different measures of SP and accounting FP (at .42) was higher than SP correlations with market-based measures of FP (average p of .15).

13. p of only .12, as compared to other measures of SP (.47).

14. Generally, the study artefacts of sampling error and measurement error explained 25 percent to 100 percent of the cross-study variance in observed correlation coefficients r₁₂. In other words, after the statistical correction for only two methodological errors affecting any study, it can be shown that statistical artefacts account for quite a considerable amount of the cross-study variability in the correlation between SP and FP.


