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When and how is corporate social responsibility profitable?[☆,☆☆]

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ABSTRACT

Firms in various markets such as health care, financial services, software, consumer goods, etc. spend a significant amount of money on corporate social responsibility (CSR) activities. The literature suggests that consumers take into consideration firms' CSR activities when making purchase decisions, noting that and doing so either increases their purchase intention or makes them willing to pay higher prices for the firms' products and services.

Unfortunately, notwithstanding its strategic benefits, the empirical findings regarding the impact of CSR on firms' financials are mixed. In this paper we explore when and why investing in CSR can have positive or negative impact on a firm's profitability. In doing so, we model two types of CSR (i.e., company ability relevant CSR (CSR-CA) and company ability irrelevant CSR (CSR-NCA)). We allow firms to choose which one to pursue if they decide to invest in CSR, and we incorporate the indirect effect of CSR through expectancy disconfirmation on consumers' utility, which has been ignored by the extant literature. Our analysis reveals the conditions under which it is optimal to invest in CSR and of what type. Then, we extend our analysis by investigating how the increase in consumers' appreciation of CSR and increase in consumers' sensitivity to evaluative context affect firms' optimal CSR strategies.

1. Introduction

Firms in various markets such as health care, financial services, software, consumer goods etc. spend significant amount of money on corporate social responsibility (CSR) activities. Recently Financial Times (2014) reported that the Fortune 500 companies have spent more than $15 billion on CSR, and the publication indicates that this spending has come in various forms, which include: donating free drugs (Johnson & Johnson), giving free software (Oracle), investing in educational programs in developing countries (Prudential) or creating a more productive work environment for various minority groups (Chicago Fed).

The literature suggests that consumers take into consideration firms' CSR activities when making purchase decisions, noting that doing so may either increase their purchase intention or make them willing to pay higher prices for the firms' products and services (Bhattacharya & Sen, 2004; Creyer & Ross, 1997; Pen Schoen Berland, 2010). In a recent global survey conducted by Nielsen,[1] 50% of 29,000 respondents across 58 countries were found to have had an intention of paying a higher price for the products and services developed by companies that invest in CSR.

CSR programs can be costly and also they can compete for firms' limited financial resources for marketing activities such as new product development and advertising. Naturally, firms are concerned about the financial impact of CSR. Unfortunately, notwithstanding its strategic benefits, the empirical findings regarding the impact of CSR on firms' financials are mixed (Margolis, Elfenbein, & Walsh, 2009; Margolis & Walsh, 2003). Given this confusion in the empirical findings, Margolis et al. (2009) suggested that future research needs to establish the causal mechanism between CSR and a firm's financials, and characterizing the conditions under which firms should engage in CSR and how to do it effectively.

In this paper we propose a much more nuanced explanation for when and why investing in CSR can have positive or negative impacts on a firm's profitability, which also provides a roadmap to the managers for investing efficiently in CSR. First, there are mainly two types of

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[1] http://www.nielsen.com/us/en/press-room/2013/nielsen-50-percent-of-global-consumers-surveyed-willing-to-pay-more-fo.html.

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CSR[2]: company ability relevant CSR (CSR-CA) and company ability irrelevant CSR (CSR-NCA). An example of CSR-CA would be Ben & Jerry's implementation of fair trade norms in their production and creating a dairy farm sustainability program that might eventually enhance the company's performance and bring in better quality products. Another example would be the introduction of the Tide Coldwater brand by Procter and Gamble (P&G), an investment in green technology that helped P&G to offer a better quality product that can save 395 pounds of carbon di-oxide per household per year.[3] On the other hand, an example of CSR-NCA would be a company like Tom's shoes which donates a pair of shoes to a child every time a customer purchases its product – clearly this is a CSR strategy that, would not improve company ability per se.[4] Since consumers appreciate firms engaging in CSR they become willing to pay a higher price for a firm's products when they observe the firm invest in CSR, of either type. But, when a firm invests in CSR-CA, doing so helps the firm to improve its product development and manufacturing capabilities (Sen & Bhattacharya, 2001). On the other hand, CSR-NCA does not influence corporate ability. A recent article by Rangan, Chase, and Karim (2015) discussed how one firm's activities were divided among different 'theatres of practice' - while some firms use the CSR activities to focus on philanthropy; others utilize the CSR opportunity to improve their operational effectiveness.

When a firm invests in CSR-CA, the investment improves the process of new product development and/or increases manufacturing capability. As a consequence, consumers expect the firm's new product to be of higher quality. In fact Green and Peloza (2014) found that consumers' expectations were one of the two most important antecedents that strongly affect the success or failure of a CSR investment. Due to this increased quality expectation consumers derive less utility from the firm's new product. This effect is explained by the expectancy disconfirmation framework. The expectancy disconfirmation model (Churchill & Surprenant, 1982; Oliver, 1980; Oliver & Swan, 1989) states that consumers have expectations about the performance of the product/service, compare and contrast the actual performance to their formed expectations, and then experience a positive or negative disconfirmation that in turn affects satisfaction and purchase intentions. More specifically, performance above the standard has been termed positive disconfirmation, while performance below is referred to as negative disconfirmation. The degree of incremental (dis)satisfaction is a direct function of positive (negative) disconfirmation. Therefore, unlike CSR-NCA, CSR-CA has two conflicting effects on consumer utility. While the direct effect (i.e., the extra utility from buying a product that is produced by a firm that invests in CSR) is positive, the indirect effect (due to expectancy disconfirmation) is negative. Hence, when a firm is deciding whether to invest in CSR, it should also consider what kind of CSR to pursue.

We construct an analytical model in which there are two identical firms, working on developing a new product. There is an R&D uncertainty; a firm's new product can be of high quality or low quality. Each firm receives an additional fixed budget to spend either on pure R&D to improve its product development and manufacturing capabilities or on a CSR activity. We will refer to the former investment as NCSR (in short for non-CSR type of investment). If a firm chooses to invest in CSR then it also has to choose whether to pursue CSR-CA or CSR-NCA.

Once the firms decide on their CSR strategies, new product development outcomes are resolved and firms launch their new products. Then, firms optimally set their prices. If a firm chooses to invest in CSR, consumers' utility from the new product increases. Furthermore, if a firm chooses to invest in either CSR-CA or in NCSR then its product development and manufacturing capabilities improve and, given the uncertain nature of new product development, the probability of the new product being of high quality increases. The investment in NCSR is not observable to consumers, but the investment in CSR-CA by the firm is observable to consumers because in real life the investments in CSR are highly advertised and publicly shared. Hence, when the firm invests in CSR-CA, consumers become aware of this improvement in the firm's product development and manufacturing capabilities and expect the quality of the firm's new product to be higher.

We find that both firms prefer to invest in CSR-CA if consumers' appreciation of CSR is high (i.e., the extra utility consumers derive from buying a product from a company that invests in CSR) and only one firm prefers to pursue CSR and that is of NCA type if consumers' appreciation of CSR is low. If consumers' appreciation of CSR is in medium range then the firms' optimal CSR strategies depend on consumers' sensitivity to evaluative context-i.e., consumers' sensitivity to expectancy disconfirmation. For high sensitivity, the firms are better off pursing asymmetric CSR strategies-i.e., one firm investing in CSR-CA, while the other firm investing in CSR-NCA. For low sensitivity, only one firm prefers to invest in CSR and that is of CA type.

We conduct our analysis for two cases: the case in which firms sequentially choose their CSR strategies and the case in which firms simultaneously choose their CSR strategies. Our analysis shows that firms' CSR strategies are robust to the timeline of the game. However, when firms sequentially set their CSR strategies, our results also reveal that the firm can strategically use CSR to alter both the consumers' and its rival's behavior (i.e., the decision of whether to invest in CSR and if so, in which type of CSR) and hence it is advantageous to be a first mover in setting CSR strategy. Furthermore, first mover's profits are higher when consumers are highly sensitive to evaluative context. When firms simultaneously set their CSR strategies, we find that if consumers' appreciation of CSR is high the outcome is a prisoners' dilemma. In equilibrium firms choose to invest in CSR-CA, but they would be better off if they could coordinate on investing in CSR-NCA.

Finally, we conduct two behavioral experiments which provide support for the existence of expectancy disconfirmation in the CSR-context and show that consumers' new product evaluations are lower when a company engages in company ability related CSR than when it engages in company ability irrelevant CSR. In line with the extant literature, these experiments make it clear that firms should not ignore the indirect effect of CSR on consumers' utilities when deciding whether to invest in CSR.

2. Literature review

In recent years a number of papers have shown that CSR may lead to many commercial benefits for the business organizations. For example, CSR activities would have positive influence on brand/company evaluations, brand choice, brand recommendations, customer satisfaction and loyalty, customer-firm identification, and consumers' attributions in a product-harm crises situation (Berens, Riel, & Bruggen, 2005; Brown & Dacin, 1997; Klein & Dawar, 2004; Luo & Bhattacharya, 2006; Sen & Bhattacharya, 2001). Some existing work even claims that CSR may directly influence consumers' purchase intention, for example according to Mohr and Webb (2005) CSR activity would have a stronger effect than price on consumers' purchase intentions.

However, the empirical findings regarding relationship between CSR and financial performance are mixed. Some find positive relationship between CSR and firm financials (Beurden & Gossling, 2008; De Velde, Vermier, & Corten, 2005; Gregory, Tharyna, & Whittaker, 2014; Maron, 2006; Orlitzky, Schmidt, & Rynes, 2003; Wu, 2006), some find negative relationship (Brammer, Brooks, & Pavelin, 2006; Griffin & Mahon, 1997; Wright & Ferris, 1997), and some find no significant relationship (McWilliams & Siegel, 2000; Moore, 2001; Seifert, Marris, & Bartkaus, 2003, 2004; Soana, 2011). As summarized in the review paper Margolis et al. (2009), across a total of 251 papers there is a

[2] See Sen and Bhattacharya (2001).

[3] Please see http://www.pg.com/en_US/downloads/sustainability/reports/PG_2014_Sustainability_Report.pdf.

[4] Please see http://www.businessnewsdaily.com/4679-corporate-social-responsibility.html.