Should Government Force Companies To Be Responsible?

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This article from the December 2012 edition of the IPA Review is by Lecturer at the International Graduate School of Business at the University of South Australia, Kesten Green.

Since at least the 1960s, advocates have called for firms to be socially responsible. Governments have responded. But what does it mean for firms to be socially responsible? And do government subsidies and regulations help?

Calls for firms to be socially responsible suggest that they are not. But firms are perhaps the greatest social invention after families. Firms are a way for people to cooperate to earn incomes and create wealth. They are able to do this by providing goods and services that people want and need.

Firms invest in infrastructure, land improvement, capital equipment, and people. Firms encourage innovation by spreading entrepreneurial risk and sharing the rewards. Finally, the activities of firms provide dignity and meaning to the lives of the people that work in them. Firms have a strong incentive for doing good: they are rewarded by profits. They are also punished for causing harm: by losses, by penalties from contract and tort laws, and by damaged reputations. Regulators, on the other hand, seldom receive clear and timely feedback about the effects of their regulations.

To determine whether efforts by advocates and regulators to force firms to be even more socially responsible are justified, I looked for evidence on the effects of corporate social responsibility regulations with my colleague Wharton Professor Scott Armstrong. We started by asking what conditions would need to be met in order to be confident that corporate social responsibility regulations would improve people's lives.

The basic conditions regulators need to meet are to, first, know the endowments, relationships, and preferences of people who are affected. Second, to identify how the situation could be improved for them. Third, to design regulations that would produce the intended changes and no others. And, fourth, to implement and enforce the regulations so that they do produce the intended changes, and no others, in such a way that the cost is less than any benefit.

It is hard to imagine how such detailed and specific knowledge could be available to a regulator. For example, we are ignorant of our own true preferences—including those related to social and environmental matters—until we are faced with specific choices. Having made our choices, our reports of how we made them are unreliable. What is more, making our own choices is important for our happiness. (Imagine a day with someone else making all of your choices for you!) Regulation substitutes the choices of the regulator for our freedom to choose what we believe is for the best. For some that is sufficient grounds to reject regulation, but even for those for whom it is not, it is surely socially responsible to ask for good evidence that we would be better off with the regulation.

We describe our search for evidence that corporate social responsibility regulations improve welfare in our forthcoming article in the *Journal of Business Research*. We were unable to find a single scientific study that showed improvements. In a related study, to be published in the *Journal of Public Policy and Marketing,* we conducted an experiment and looked for evidence that regulating commercial speech protects the public. We found that rather than enforce social responsibility, government-mandated messages harm both sellers and buyers. Our findings are consistent with the *Iron Law of Regulation:* 'There is no form of market failure, however egregious, that is not eventually made worse by the political interventions intended to fix it'.

Why, then, is regulation so popular? Two reasons are salient: we overreact to fearsome risks, and we believe expert forecasts will be accurate. Recent experiments have confirmed that when we are alerted to the possibility of a fearsome outcome, such as being bitten in half by a shark, we pay little or no attention to the chances that the outcome will occur. Whether the probability is one-thousandth or one-millionth, 1 per cent or 100 per cent matters little: we react in the same way to a vivid and emotional description. And we react even more strongly if we are persuaded that someone else is responsible.

A warning that some fearsome outcome might occur is of course a forecast not a certainty, and alarming forecasts are common: 'Put your coat on or you'll catch your death…' We are bombarded with such forecasts and even in the domain of public policy making they are almost always the product of experts' judgments unaided by any scientific forecasting procedure. Despite overwhelming evidence that even the best of experts cannot make accurate forecasts about complex uncertain situations—such as regulating corporate social responsibility— we keep falling for them. The phenomenon of believing that seers exist despite overwhelming evidence that they do not is described by Armstrong's Seer-sucker theory.

Do some firms behave irresponsibly? Undoubtedly. But this is not saying more than that some people sometimes behave badly in business, just as they do in families, in communities, and in political life. Yet people in the role of owner or manager of a firm have perhaps the strongest incentives to make responsible decisions. Decisions that aim to maximise long-run profitability are responsible decisions because they seek to maximise benefits and minimise costs. Both the value of benefits and the cost of inputs are determined by voluntary transactions; in other words, investors, lenders, employees, suppliers, and customers make choices that they believe are the best when assessed against their own criteria.

Government-mandated or subsidised efforts to improve social responsibility inevitably distort the allocation of resources and thereby harm welfare. Most importantly regulations restrict our freedom to make decisions in our relationships with others that we believe are the most responsible.