

## 5. Overview of the links between Corporate Social Responsibility and Competitiveness

### 5.1. Introduction

Corporate Social Responsibility (CSR) is “a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis” (European Commission, 2001). In its Communication to re-launch the Lisbon Strategy in 2005, the Commission stated that CSR “can play a key role in contributing to sustainable development while enhancing Europe’s innovative potential and competitiveness” (European Commission, 2005). In March 2006 the Commission adopted a Communication on CSR which reaffirmed CSR as a business contribution to the Growth and Jobs Strategy and to sustainable development (European Commission, 2006). In the Integrated Guidelines for Growth and Jobs, the Council recommends that Member States should “encourage enterprises in developing their corporate social responsibility.”

In recent years there has been a significant growth in the number of enterprises that have an explicit policy on CSR. At the same time, the practice of CSR has evolved considerably. In an increasing number of companies, CSR and sustainability have become cross-cutting issues that are deeply integrated within both operations and strategy.

CSR can contribute to a number of social, environmental and economic policy objectives. The aim of this chapter is to provide an up-to-date overview of how CSR can contribute to competitiveness. The principal focus is on how CSR might contribute to competitiveness at the level of the individual enterprise. The links between CSR and macro-level competitiveness are also explored, although there has been comparatively little research at this level of analysis.

For the firm-level analysis, the economic effects of CSR on 6 determinants and indicators of competitiveness are considered: cost structure, human resources, customer perspective, innovation, risk and reputation management, and financial performance. These are the determinants and indicators of competitiveness where CSR is most likely to have a positive influence.

This chapter also takes account of arguments suggesting that CSR may inhibit competitiveness. Such arguments include, for example: that CSR is a cost, with no apparent benefit; that a causal link at firm level may

exist from competitiveness to CSR instead of (or as well as) from CSR to competitiveness; and that investors and shareholders have no interest in CSR.

To date most of the key concepts and tools addressing CSR have been developed by and for large enterprises. Whenever possible, this chapter also considers the situation of SMEs. CSR as practiced in SMEs is usually less formal and more intuitive than in larger companies. It is often closely tied to the personal and ethical values of the SME owner-manager. As a general rule, the smaller the enterprise the greater the relative importance of personal and ethical values as a driver for CSR. In any case, SMEs are less likely than larger enterprises to make a conscious analysis of the costs and benefits of following a more socially and environmentally responsible course of action.

### 5.2. Definitions

The link between competitiveness and CSR at firm level has long been an important topic for both CSR researchers and practitioners, often under the banner of “the business case for CSR”. This chapter uses the terms “business case for CSR” and “link between CSR and competitiveness” interchangeably.

#### 5.2.1. Competitiveness

The concept of competitiveness can be applied at different levels, from the firm (micro) level, to the sectoral, regional and national (macro) level. Competitiveness at macro-economic level is defined earlier as a sustained rise in the standards of living (see introduction to this report). Sector-level competitiveness refers to the performance of a given industry in a given country or region relative to the same industry in other countries or regions. A sector could be characterised as competitive on the basis of its capacity to grow, to innovate and to produce more and higher-quality goods and services, and to keep or gain market shares in international and domestic markets. A frequently cited definition of competitiveness at the firm level is provided by the US President’s Commission on Industrial Competitiveness: “A firm is competitive if it can produce products or services of superior quality or lower costs than its domestic and international competitors. Competitiveness is then synonymous with a firm’s long-run profit performance and its ability to compensate its employees and provide superior returns to its owners” (Francis, 1989). In the narrow sense, measures of competitiveness at the firm level therefore comprise indicators of financial performance, such as the development of sales, profits, and costs, as well as stock performance. One could add that firm-level competitiveness is not only a question of producing products and services of superior quality or at lower costs, but can also be a

question of producing new or different products and services. Capacity for product innovation can therefore also be a source of firm-level competitiveness.

### 5.2.2. CSR

The European Commission (2001) defines CSR as “a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis.” This definition has a number of important implications.

Firstly, the fact that CSR is the integration of social and environmental concerns within business operations means that CSR is not just philanthropy. The emphasis is on how enterprises do their daily work: how they treat their employees, how they produce goods, how they market them, and so on. CSR is not so much about what enterprises do with their profit, but how they make that profit.

Secondly, interaction with stakeholders is a crucial aspect of CSR. Effective CSR requires dialogue and partnership with stakeholders such as trade unions, public authorities, non-governmental organisations, and business representative organisations.

Thirdly, by describing CSR as voluntary, this definition implies that CSR relates to what enterprises can do in the social and environmental fields over and above what they are required to do by law. This aspect of the definition works well within the European Union and in other contexts where the rule of law generally applies. In some countries, however, CSR can in the first place be a question of getting enterprises to comply with their legal obligations.

CSR is a very wide-ranging concept, which is one reason why measuring its uptake and impact presents complex methodological problems. It is often divided into four main areas: workplace, market-place, environment and community.

- Workplace CSR refers to how a company treats its employees. It includes issues such as recruitment, work-force diversity, pay and working conditions, health and safety, and recognition of trade unions. It can also refer to human rights issues.
- Marketplace CSR covers the ways in which a company operates in relation to its suppliers, customers and competitors. It covers issues such as responsible advertising and marketing, dealing with customer complaints, anti-corruption measures and ethical practice, and imposing social and environmental requirements on suppliers.
- Environment-related CSR describes the measures a company can take to mitigate its negative impact on the environment, for example energy efficiency

measures or less use of pollutants. It can also refer to goods and services that actively help to improve the environment.

- Community-related CSR refers to the relations between the company and the citizens and communities that may be affected by its operations. It includes issues such as human rights, dialogue and partnership with potentially affected communities, and active contribution to community well-being, for instance through employee volunteering schemes.

Some of these areas inevitably overlap in practice. For example, the environmental dimension of CSR can be of great importance in relations with communities affected by the operations of an enterprise.

Transparency and communication about social and environmental performance are crucial aspects of CSR which cut all across these four areas. The practice of publishing sustainability or CSR reports has become increasingly common, especially amongst large enterprises.

## 5.3. Competitiveness effects of CSR at micro-economic level

This section examines the effects of CSR on 6 determinants and indicators of firm-level competitiveness: cost structure, human resource performance, customer perspective, innovation, risk and reputation management, and financial performance.

### 5.3.1. Cost structure

#### 5.3.1.1. *The evidence that CSR reduces costs is mixed*

The question of cost savings resulting from CSR has often been at the centre of the debate on the business case for CSR. Proponents of CSR have tended to argue that responsible business behaviour can lead to cost savings. An Economist Intelligence Unit research programme (Economist Intelligence Unit, 2008) indicates that the benefits of pursuing sustainable practices outweigh the costs, although changes to profits are estimated to be small. Critics argue that CSR is expensive and that the benefits are often only experienced in the distant future, if they occur at all. Friedman (1970) states in a much-quoted article that “there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.” He concluded that consequently there is no role for CSR.

In reality, much depends on the nature of the CSR measure taken, as well as on the cost of that invest-

ment and the time period considered. Examples can be found of CSR measures that help to improve the cost structure of an enterprise (Woodward et al. 2001), and evidence can also be found of CSR measures for which the cost-benefit relationship appears to be negative. Welford (2003) argues that only some aspects of CSR strategies might reduce costs, and reaches the conclusion that the emphasis of the CSR-competitiveness relationship should be placed on “the area of differentiation where social and environmental aspects of sustainable development will have most impact”.

#### 5.3.1.2. *The effect of the environmental dimension of CSR on cost structure*

Measures to reduce energy consumption and material inputs are frequently cited as an aspect of CSR that can lead to cost savings. However, academic studies of the cost-saving effects of the environmental dimension of CSR give mixed results. According to Miles and Covin (2000), CSR-related environmental expenditures constitute investments that pay off due to cost savings from, for example, continuous improvements, low potential litigation expenditures, lower insurance and lower energy costs. In contrast, Chapple et al. (2005) find significant costs associated with CSR-related waste reduction practices when applying a cost function approach to UK manufacturing at county level. Little evidence is available for CSR impacts on the cost structure of SMEs, although few of the SMEs interviewed by Jenkins (2006) reported CSR-induced cost savings.

In spite of the sometimes contradictory evidence from past studies, the cost-saving potential of the environmental dimension of CSR is likely to be strengthened by rising energy costs and the prospect of stronger mechanisms for the pricing of carbon emissions.

#### 5.3.1.3. *Conclusion*

CSR can contribute to cost savings in certain circumstances. It is difficult to draw general conclusions about the cost-saving effects of CSR because they are highly dependent on the nature of the CSR measure taken. The example of the environmental dimension of CSR shows evidence of both positive and negative relationships between CSR and cost structure. In addition to cost savings from environmental measures, CSR may also contribute to cost savings in other ways, for example in the field of human resources, risk management or access to finance. These are addressed in the following sections.

Increasingly the debate about the competitiveness benefits of CSR is not confined to the question of cost savings but also encompasses the questions of new value creation and new revenue streams. Porter and Kramer (2006) state that “if corporations were to

analyse 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”. The following sections therefore look at the business case for CSR from both these perspectives: how it might reduce costs and how it might create new value.

### 5.3.2. Human resources

Management theory suggests that CSR can have a positive impact on human resource performance. According to Cochran (2007), a firm with good employee relations can lower its employee turnover rate and improve employee motivation. Additionally, good employee relations may be an important argument for firms in attracting new staff members. The theory is generally confirmed by empirical studies.

#### 5.3.2.1. *CSR as a lever for attracting, motivating and retaining employees*

Case studies illustrate the positive impacts of CSR from a human resource perspective. Brown and Grayson describe how the values of founders and employees can play an important role in the growth and commercial success of a smaller enterprise (Brown and Grayson, 2008). Cochran describes how the workplace dimension of CSR helps to provide a large IT company with an ideal environment for high labour productivity and innovation (Cochran 2007).

Evidence from econometric investigations is also compelling as far as the positive effects of CSR on human resource performance are concerned. Montgomery and Ramus (2003) show that MBAs from European and American business schools pay attention to CSR aspects such as employee relationship, environmental sustainability, stakeholder relations, and ethical corporation behaviour when making decisions about where to work. More than 90% of the persons interviewed were willing to forgo financial benefits in order to work for an organisation with a better reputation for corporate social responsibility and ethics. More recently, in a survey of MBA students published by the Aspen Institute in 2008, 26% of respondents said the potential to make a contribution to society would be an important factor in their job selection. Although other factors still rank higher, this figure has risen from 15% in 2002. Turban and Greening (1997) provide evidence that a firm’s performance in terms of CSR may provide a competitive advantage in attracting senior managers.

Representatives from large companies comment that potential new recruits now often ask questions about CSR-related issues in interviews. Large companies

realise that they increasingly need to be able to demonstrate strong CSR credentials in order to attract the right candidates. In some companies this can partly take the form of “employee volunteering”, or opportunities for employees to participate in community projects or other non-profit activities during company time. Companies that run employee volunteering programmes report that such programmes can improve employee morale and help participants to acquire and develop new skills.

According to survey evidence from Italy, the positive effects of CSR on the relationship with employees also hold for SMEs (Longo et al. 2005). Similar findings based on interviews among UK SMEs are provided by Toyne (2003) and Jenkins (2006). Survey data from Denmark moreover suggests reduced costs associated with hiring, retention, and absenteeism among SMEs that offer unusually generous employee benefits (Kramer et al., 2007). None of the Danish SMEs studied by Kramer et al. (2007), however, had actually calculated whether these savings outweighed the costs of the extra benefits.

A 2007 survey of SMEs in Estonia found that many SME managers see CSR as a way of retaining qualified employees in a tight labour market (PW Partners, 2007). If SMEs in general have to fight harder than larger companies to attract the most talented employees, then one could argue that offering job fulfilment, good working conditions and a good work-life balance are relatively more important for SMEs than for large companies. Some SMEs successfully use their commitment to CSR to build an advantageous reputation as the preferred local employer.

#### 5.3.2.2. *The business benefits of employee diversity policies*

Employee diversity policies are an important aspect of the workplace dimension of CSR. In a survey of 900 European enterprises carried out in 2005, just under half of all businesses responding were actively engaged in promoting workplace diversity and anti-discrimination. The single most important benefit achieved or expected of diversity, cited by 42% of companies, was that it would help to resolve labour shortages and to recruit and retain high quality staff (European Commission 2005). In this respect, UEAPME (the European Union of Crafts and Small and Medium-Sized Enterprises) underlines the importance of non-discrimination policies to SMEs: “SMEs particularly rely on the local labour market, therefore they cannot afford to discriminate against potential employees, especially as they are lacking human resources in many sectors” (UEAPME 2007). The potential positive impact of work-force diversity on innovation capacity is addressed below in section 5.3.4.3.

#### 5.3.2.3. *The knowledge economy increases the benefits of work-place CSR*

In spite of the strong evidence that CSR can have a positive impact on competitiveness from a human resource perspective, this will not always be applicable to all enterprises. In the case of enterprises that rely heavily on low costs to create and maintain competitive advantage, the possible benefits in terms of improved employee motivation or recruiting and retaining workers will not necessarily outweigh the associated increase in costs. However, the strength of the positive relationship between CSR and competitiveness gains from a human resource perspective looks likely to grow as the knowledge economy puts an ever greater premium on human capital as a determinant of competitiveness. Accordingly, it would already seem that knowledge intensive industries such as the IT sector are particularly advanced along the work-place dimension of CSR.

#### 5.3.2.4. *Conclusion*

The evidence suggests an important positive relationship between CSR and competitiveness in terms of human resource management, although for some companies the additional costs might still outweigh the benefits at least in the short term. CSR activities in general and the workplace dimension of CSR in particular have proved to be an attractive feature of a company’s presentation when recruiting and retaining employees. Companies that favour a diverse workforce can benefit from a wider pool of talent. The link between CSR practice and human capital seems to be relevant for enterprises of all sizes, and is likely to grow as a result of the knowledge economy.

### 5.3.3. **Customer perspective**

The extent to which CSR can help to drive customer loyalty and demand remains a matter of considerable debate. Typically, consumers have tended to respond positively when asked if they are willing to pay a price premium for products with good social and environmental credentials, but have then failed to act on this when actually making their purchases.

#### 5.3.3.1. *The influence of strategy and competitive positioning*

The link between CSR and competitiveness from the customer perspective is highly dependent on the company’s competitive strategy and market positioning. For some enterprises, especially those operating at the higher end of the market, CSR can be an integral part of the quality of products and services offered. Conversely, if a firm is positioned as a cost-cutter, it will be less likely to go beyond legal compliance in the social and environmental fields. However, even cost cutters need to ensure compliance with

legal requirements and a minimum set of social and environmental standards. The fact that a number of discount retailers are paying increasing attention to the social and environmental performance of their suppliers would tend to support this argument.

#### 5.3.3.2. *Evidence of consumer demand for CSR-related measures*

Meijer and Schuyt (2005) analysed the behaviour of Dutch consumers and found that the corporate social performance of producers does not motivate consumers to buy a product. They did find, however, that CSR had to meet at least a minimum acceptable level in order not to repel possible consumers. They describe CSR as a hygiene factor or bottom line, rather than a motivator. In other words, a minimum attention to CSR may be a competitive necessity rather than a competitive differentiator.

There is evidence, however, that the success of some firms' from customer perspective is based at last partly on CSR aspects. Retail data from a telecommunications firm show that CSR-related issues are important drivers of corporate image and reputation, which are themselves major determinants of customer satisfaction (Tuppen 2004). A major European retailer has a partnership with a non-governmental organisation (NGO), which makes use of the NGO logo to endorse certain products that meet high environmental standards. In this case, the credible endorsement of a product's environmental credentials is used to drive consumer demand.

Research suggests that CSR can contribute to improved customer demand in the case of SMEs. Based on case study evidence from seven European countries, Mandl and Dorr (2007) point out that particularly high employee satisfaction and publicity attributed to CSR activities can also have a beneficial outcome in terms of customer loyalty. Longo et al. (2005) report that the Italian SMEs surveyed expected consumer loyalty to be a positive result of their CSR engagement.

The competitive advantages of CSR from the customer perspective will evolve as consumer demand evolves. The rapid growth in the market for fair trade and organic goods is a good indication of changing consumer demand. According to Fairtrade Labelling Organisations International, the sales of Fairtrade-certified products have been growing at an average of 40% per year in the last five years, and in 2007 amounted to around €2.3 billion worldwide. Mainstream retailers and producers are now entering this field, which until recently was the more or less exclusive preserve of specialised fair-trade operators. Some organisations argue that the availability of more comprehensive consumer information on

the social and environmental aspects of production would further drive consumer demand for responsibly produced goods and so potentially reinforce the business case for CSR.

Although consumers are paying more attention to the social and environmental credentials of the products they buy, this is not necessarily a trend that will continue uninterrupted. The biggest risk would appear to come from inflation and a serious global economic downturn. In such circumstances it is conceivable that a significant proportion of consumers might put a greater premium on price and quality only, with less attention to social and environmental aspects. The recent increases in food prices may provide a test case in this regard.

#### 5.3.3.3. *CSR in public procurement and private supply chains*

Many enterprises, especially large enterprises, now impose social and environmental requirements on their suppliers. The growth of business interest in supply-chain partnerships such as the Business Social Compliance Initiative and the Global Social Compliance Programme suggest that the number and seriousness of CSR-related supply chain requirements will continue to increase. This creates opportunities for supplier enterprises that, through their own CSR performance, can help buyers to live up to their social and environmental commitments.

The growth of green or sustainable public procurement should similarly strengthen the competitive position of suppliers who pay particular attention to environmental issues or who are able to offer innovative environmental solutions. Several Member States are leading the way by setting ambitious green public procurement targets. The Dutch government, for example, has set a 100 % Sustainable Procurement target to be reached by 2010. The European Commission has recently proposed that, by the year 2010, 50 % of all tendering procedures should be green.

The Commission is also preparing a guide for public authorities on how to integrate social requirements in public procurement. The integration of social criteria within public procurement has lagged behind the progress made in the field of green public procurement. If more widely applied, it could also strengthen the competitive position of enterprises that pay particular attention to the social aspects of CSR.

#### 5.3.3.4. *The importance of ensuring that CSR claims are credible*

Enterprises are sometimes criticised for "green-washing", or making unjustified claims for the environmental benefits of a certain product in the hope of using a greener image to boost customer

demand. Figures from the UK would suggest that this is a growing trend: the UK Advertising Standards Authority banned 19 green campaigns between January and September 2007, double the number in the previous year. Exaggerated or unjustified claims run the risk of generating a sceptical reaction from consumers over the medium to long term. A guide to sustainable marketing produced by CSR Europe warns that “customers want, above all, to trust the companies they are dealing with, and any hint of [...] green wash can be harmful for a company’s brand”. If “green-washing” causes consumer scepticism then it may not only harm individual brands, but also undermine the potential competitive advantages of those companies that could justifiably market and advertise their products on the basis of their green characteristics.

#### 5.3.3.5. Conclusion

The competitive benefits of CSR from a customer perspective appear to be strengthening as a result of growing demand from consumers, enterprises and public authorities. It is possible that rising prices could have negative affect on this demand, however. The extent to which CSR can drive competitiveness from a customer perspective depends on the competitive strategy of enterprises. Enterprises whose appeal to customers is based essentially on low costs may have less to gain from CSR, although even some cost-cutting retailers believe that a certain level of commitment to CSR is now necessary.

#### 5.3.4. Innovation

When explaining their motivations for addressing CSR, some company representatives cite innovation as an important beneficial outcome. The fact that the links between CSR and innovation are increasingly acknowledged is a good example of how the business case for CSR is no longer just perceived in terms of potential cost savings but now also encompasses the potential for new value creation and the development of new revenue streams. The links between CSR and innovation are complex, however, and less immediately obvious than in the case of other competitiveness determinants examined in this chapter.

A number of studies have argued that CSR can be a route to innovation through the use of social, environmental or sustainability drivers to create new ways of working, new products, services, processes and new market space (Grayson and Hodges 2004, Little 2006). Based on an analysis of innovative SMEs in Spain, Italy and the United Kingdom, Mendibil et al (2007) find that there is a positive link between innovation performance and CSR, even if the cause and effect relationship is not entirely clear.

Some academics have questioned the positive CSR-innovation link, suggesting that some aspects of CSR could be incompatible with certain types of innovation. For example, Midtun (2007) argues that, in the case of disruptive innovation, firms have to change extremely rapidly and sometimes disappear. In this case, it may be difficult to combine competitiveness and CSR objectives.

There would appear to be three main ways in which CSR can contribute to innovation capacity and performance: innovation resulting from engagement with other stakeholders; identifying business opportunities through addressing societal challenges; and creating work places that are more conducive to innovation.

##### 5.3.4.1. Innovation resulting from engagement with other stakeholders

CSR requires dialogue and cooperation with stakeholders, both inside and outside the company. Through their commitment to CSR, many enterprises are engaging in dialogue and partnership with a range of stakeholders, such as grassroots community groups or global non-governmental organisations, with whom they would previously have had little or no direct contact. Holmes and Moir (2007) have proposed a theoretical framework for analysing how engagement with external non-profit stakeholders might drive corporate innovation. They point out that innovation outcomes might be a deliberate outcome of engagement with external stakeholders, or might be an unexpected, ancillary benefit from such relationships.

Roome and Jonker (2006) have analysed how eight pioneering companies, leading exponents of CSR in Europe, managed to bring about a high degree of integration between their performance in CSR and their performance in terms of competitiveness. They found that managers in these companies “came to appreciate that they confronted a growing array of issues that required them to seek to change the relationships they had with other actors in society.” By engaging and improving relations with external stakeholders, they created new business models that “involved the combination of ideas from outside the company with an understanding of the existing business model.”

In a case study of a Spanish SME that manufactures tools for professional and industrial use, Mendibil et al (2007) describe how in practice innovation and social responsibility appear to come together under the same approach. Strong engagement with employees and external stakeholders contributes to the innovation capacity and competitiveness model of the enterprise, even though the enterprise itself does not see a need to manage CSR explicitly as a separate concept.

Innovation is more and more understood as a collaborative exercise, and enterprises are increasingly unable to innovate effectively on their own. Concepts such as open innovation, society-driven innovation, stakeholder-driven innovation and customer-driven innovation are now commonplace. As this trend intensifies, CSR is likely to become ever more relevant to the innovation process, since CSR by definition brings enterprises into constructive relationships with a new range of stakeholders.

#### 5.3.4.2. *Business opportunities from addressing societal challenges*

There is a strong case, backed up by academic literature, for arguing that environmental management, as a part of the environmental dimension of CSR, can contribute to innovation. Rennings et al. (2006), for example, have shown a positive link between the maturity of environmental management systems and environmental process innovation. The causal link is not always straightforward, however, and Seijas Nogareda and Ziegler (2006) argue in favour of a “complex dynamic interrelationship” between green management and corporate green technology innovations.

In pioneering enterprises, CSR has involved reconsidering the purpose and role of the enterprise in society. For a number of companies, this has led to the realisation that a growing proportion of company value is likely to be created by providing business solutions to societal challenges such as climate change, the ageing population, or poverty and social inclusion. A report prepared by representatives of enterprises that are members of the World Business Council for Sustainable Development states that “the leading global companies of 2020 will be those that provide goods and services and reach new customers in ways that address the world’s major challenges” (World Business Council for Sustainable Development, 2000).

This clearly suggests that the creation of business value will lie in providing innovative solutions that help address societal challenges. Some companies now explicitly try to measure the potential public or societal value of a new product during the development process. The European Commission’s Lead Markets proposal, which aims to help European enterprises to capitalise on their innovative potential, has identified six such lead markets, all of which are related to societal benefit: eHealth, protective textiles, sustainable construction, recycling, bio-based products and markets for renewable energies.

The development of low-carbon technologies is an obvious example of how addressing societal challenges can be a catalyst for innovation. Another

example involves so-called “bottom of the pyramid” business strategies, first popularised by Prahalad (2004), through which enterprises treat poorer people as valuable customers and seek to provide them with appropriate goods and services. The United Nations Development Programme reports that such approaches can lead to innovations that contribute to a company’s competitiveness. This can happen because “to meet the poor’s preferences and needs, firms must offer new combinations of price and performance”, and because “the pervasive constraints that businesses encounter when doing business with the poor – from transportation difficulties to the inability to enforce contracts – require creative responses” (UNDP, 2008). A concrete illustration of such business models is the expansion of the micro-credit market, not only in developing but also in developed countries.

Innovation to address societal challenges is an opportunity for enterprises of all sizes, including SMEs. Based on a study of approximately 50 Danish SMEs engaged in CSR practices, Kramer et al. (2007) identify a number of companies that derive a substantial and growing share of business from socially beneficial innovations. The authors conclude that environmental and other socially beneficial innovations seem to be an expanding niche well suited to SMEs. As part of its work on inclusive business, the UNDP cites two examples of Polish SMEs, one from the energy sector and one from the IT sector, that have developed successful business models by innovating to provide services to low-income groups.

The extent to which social and environmental issues are integrated into the core business strategy of an enterprise will be an important determinant of its ability to find business opportunities in responding to societal challenges. Enterprises in which social and environmental concerns are a peripheral issue or considered primarily from a public relations perspective are less likely to be able to exploit these opportunities.

#### 5.3.4.3. *CSR involves creating better workplaces, which can be more conducive to innovation*

Working conditions and the treatment of employees are an important aspect of CSR. The creation of better working environments, including placing greater trust in employees and paying more attention to employee health, well-being and quality of life, can lead to workplaces that are more conducive to innovation. The European Commission recognised this link in its 2006 Communication on innovation policy: “Innovation needs to be organised in a way that supports not only the acceptance of change but also provides opportunities in human resource management, leading to higher productivity” (European Commission 2006).

On the basis of 120 case studies conducted in the Hi-Res project, Totterdill (2004) reports that new forms of work organisation based on participation and trust can offer several potential advantages, including competitiveness through successful innovation in products, services and processes. The importance of placing trust in employees is reinforced by a study of the link between work organisation and innovation in 15 EU Member States, which found that in-house creativity and innovation is greatest when employees are given a high level of discretion in problem-solving (Arundel et al, 2007).

Work-force diversity, as an important aspect of the work-place dimension of CSR, has been shown to have a positive impact on innovation capacity. "Like-minded people make like minded decisions", whereas a broader range of perspectives, backgrounds and expertise can lead to creative thinking and more effective problem-solving (Campayne, 2008).

A European Business Test Panel organised in 2008 by the European Commission found that 56% of participating enterprises had equality and diversity practices of some kind. Of these, 63% said that their workplace diversity had contributed to innovation and creativity in the company. These results seemed to apply equally to SMEs and larger enterprises. A study by the London Business School has shown that innovation performance tends to be higher in work teams that have a gender balance (London Business School, 2008).

Work-force diversity does not necessarily bring easy gains, however. The main risks involve reduced cohesion, increased conflict, and problems of communication and participation. The quality of diversity management in a company is crucial if these risks are to be minimised and the innovation and other benefits are to be realised.

#### 5.3.4.4. Conclusion

There is evidence that certain aspects of CSR can have a positive impact on competitiveness by enhancing capacity for innovation. This relationship exists in the case of engagement with stakeholders through CSR, environmental management, and the workplace dimension of CSR, including work-force diversity. The positive relationship between CSR and innovation is strengthened by the fact that innovation is increasingly a collaborative exercise, and by the trend towards the generation of new business value from innovations that address societal problems.

### 5.3.5. Risk and reputation management

#### 5.3.5.1. CSR, reputation building and risk management

The link between CSR and strategic risk management is well established. Bowman (1980) introduced

the concept of corporate social responsibility as a means of anticipating and reducing potential sources of business risk. Heal (2005) suggests that CSR can minimise conflicts between companies, society and the environment and argues that risk management in the sense of avoidance or reduction of conflicts may be a major benefit of effective CSR programmes. Husted (2005) argues that CSR is an essential element of corporate risk management. Orlitzky and Benjamin (2001) identify different kinds of business risks CSR may reduce, such as governmental regulation, labour unrest, or environmental damage.

The issue of regulatory risk is important in this context. CSR may particularly help enterprises, including SMEs, to prepare for possible new regulations on social or environmental issues (Burke and Logsdon 1996, Orlitzky and Benjamin 2001). If that is correct, then CSR takes on added importance given the probability of new regulatory frameworks to promote sustainability and in particular to deal with climate change.

A growing number of companies see their commitment to CSR not just in terms of risk management but as a means of enhancing their reputation in the eyes of customers, potential employees, and regulators. This can have the effect of exposing the enterprise to greater public scrutiny, however. Company representatives often report that, by making public commitments on CSR-related issues, they in fact become more vulnerable to criticism from non-governmental organisations and other stakeholders. In the medium to long term, CSR is only likely to improve competitiveness through a better company reputation if it is deeply embedded in the company's values and operations.

The power of communication technology has in any case already made enterprises much more vulnerable to public criticism. This strengthens the links between CSR and competitiveness, since it increases the risks incurred by a lack of attention to CSR.

The nature of the knowledge economy may also increase the potential of CSR to bring competitive advantage through improved reputation. Trust, reputation and relationships are increasingly important to competitive success in the knowledge economy, not least because of the growing need to be able to collaborate with other stakeholders in order to create new value. On the evidence of narratives written by SME owner-managers, Fuller and Tian have suggested that 'in a global economy where prices will always be difficult to beat, technological innovations highly specialised and an ever greater need for collaboration, new forms of social and symbolic capital generated through responsible behaviour [...] may be features of new firms in Western society' (Fuller and Tian, 2006).

Toyne (2003) provides further evidence that the risk and reputation aspects of CSR are important for SMEs. Based on interviews with a variety of SMEs and key informants, Toyne (2003) identifies risk to reputation as a key driver for the CSR agenda of SMEs. Fuller and Tian (2006) note that SMEs may act responsibly because their legitimacy with immediate stakeholders (employees, customers, suppliers and their local 'community') is at stake in a far more direct and personal way than it is with major corporations.

#### *5.3.5.2. Human rights and risk and reputation management*

When looking at the CSR practices of leading enterprises, it is increasingly hard to distinguish between pure risk management and the realisation of new opportunities. The area of human rights provides a good example of this. Though not enough companies as yet have explicit human rights policies, most of those that do are initially motivated by risk management, in addition to moral considerations. However, the Business Leaders' Initiative on Human Rights argues that "turning risk into opportunity is a key component of a strategic approach to human rights in business" (Business Leaders' Initiative on Human Rights). It suggests that opportunities arising from corporate human rights policies can include positive impacts on stakeholder relations, minimisation of operational disruption, better relationships with society and media, a positive impact on investor confidence, and improved employee morale.

#### *5.3.5.3. The supply-chain and risk and reputation management*

The distinction between risk management and realising new opportunities is similarly fluid in the case of CSR-related supply-chain requirements. The initial motivation of enterprises in imposing such requirements may be risk management, in the knowledge that many companies have suffered reputational damage as result of non-compliance with social and environmental standards on the part of suppliers. However, many buying enterprises have realised the advantages in terms of enhancing brand value and building deeper and more sustainable relationships with suppliers. What is more, the advantages are not necessarily limited to the buyer: an analysis of the experience of Central European SMEs in the supply chain of a large IT company found that buyer requirements can be a driver for the introduction of better management systems in supplier enterprises (Danish Commerce and Companies Agency, 2008).

#### *5.3.5.4. Transparency and reporting*

The same argument also applies to the question of transparency and CSR reporting. Many companies that now issue CSR or sustainability reports initially

did so with the aim of protecting themselves from the criticism of non-governmental organisations. While they have not always been successful in that objective, they have often found that sustainability reporting can lead to other advantages, such as employee pride and morale, stronger relationships with external stakeholders, and improving their own internal capacity to measure and manage social and environmental issues. Pohle and Hittner (2008) argue that greater levels of transparency can help to anticipate difficulties with external stakeholders: 'the company that invites more eyes on its operations can pre-empt problems that would otherwise become very expensive to solve.'

#### *5.3.5.5. Conclusion*

CSR is an essential component of risk and reputation management for many companies. The business case for CSR in terms of risk and reputation management is strengthened by the fact that enterprises are more exposed to public scrutiny and criticism than in the past. This also means that there is greater pressure on companies to embed CSR deeply within their values and operations, rather than to assume it can be used as a simple public relations tool. Dealing with CSR issues such as transparency, human rights, and supply-chain requirements from a risk management perspective have led some companies to discover additional positive impacts of CSR.

### **5.3.6. Financial markets**

Stock market effects are strongly related to all other economic effects of CSR. Since stock prices are an indicator for the general economic performance of corporations, they should, under the assumption of efficient capital markets, also reflect the discounted value of CSR practices.

#### *5.3.6.1. A positive but small link between CSR and financial performance*

There is a large body of academic literature on the stock market effects of CSR, reaching a range of different conclusions. As McWilliams and Siegel (2000) note, researchers examining the impact of CSR on financial performance have reported a positive impact (such as Ziegler et al., 2007), a negative impact (such as Wright and Ferris, 1997), and a neutral impact (such as Schröder, 2007). Since SMEs are generally not traded on the stock exchange, the literature on the link between CSR and financial markets is usually not applicable to them.

If the whole body of the existing academic literature is examined, as for example in meta-analyses by Orlitzky et al. (2003) and Margolis et al. (2007), the link between CSR and financial performance is found to

be positive but small, and in any case is not negative. The results of different studies depend to a significant extent on which specific aspects of CSR and financial performance are analysed. Orlitzky et al. (2003) find that the most powerful CSR measure in terms of effect on financial performance is reputation indices. This suggests that firm reputational aspects are amongst the most important drivers of the competitiveness effects of CSR.

Margolis et al. (2007) report that the association is strongest for the specific cases of charitable contributions, environmental performance, and revealed misdeeds (i.e. public announcements of actions that indicate socially irresponsible behaviour). The association between corporate performance and charitable contributions may relate to the reputation effect as found by Orlitzky et al. (2003), while the association with revealed misdeeds may relate both to reputation effects and to risk management. The link between environmental and financial performance may relate to environmental innovations besides reputational or risk management issues. Bird et al. (2007) have similarly found a link between market value and environmental performance, but also found that markets rewarded companies that met minimum requirements with regard to diversity and were the most pro-active in the area of employee relations.

Margolis et al. (2007) also looked at 14 studies analysing the association between corporate transparency and financial performance. The link was not strong, but the overall conclusion was that financial markets do react positively to company disclosures regarding socially responsible behaviour.

Although there is a certain positive correlation between CSR and financial performance, this in itself does not explain the causal link. Margolis et al. (2007) addressed this question in their meta-analysis, and found that although there was no financial penalty for CSR, the link from prior financial performance to subsequent CSR was at least as strong as the reverse.

#### 5.3.6.2. *Socially Responsible Investment (SRI)*

CSR performance may lead to better access to finance if investors and analysts take account of such performance. The recent growth in Socially Responsible Investment (SRI) is especially relevant in this regard. SRI funds include social and environmental criteria, as well as economic criteria, in investment decisions. The SRI market is young, but has been growing strongly for several years. The European Social Investment Forum (EUROSIF) estimates that the broad European SRI market represents 15-20% of total funds under management in the EU.

Many financial market experts assess the market potential of SRI very optimistically. In a recent poll

amongst 297 financial market experts conducted by the Centre for European Economic Research (ZEW; Oberndorfer, 2007), more than 70 per cent of all the respondents assumed a growing or at least a constant market share for SRI.

Generally, the growth of the SRI industry, combined with more robust methodologies for incorporating social and environmental aspects, should in time mean that enterprises with strong CSR policies gain competitive advantage in terms of access to finance on the international markets. This effect would be even stronger if mainstream funds and analysts (as opposed to just the SRI industry) took account, or greater account, of CSR criteria in their investments and valuations.

#### 5.3.6.3. *Mainstream investors and analysts*

There is some evidence that mainstream analysts and investors are attaching more importance to social and environmental issues. The UN Principles for Responsible Investment, launched in 2006, now have over 350 signatories, who between them manage assets worth about €8.2 trillion. A study of fund managers with over €7.6 trillion of assets under management, including more than half of the world's leading 20 fund managers, found that investment skills and research associated with the SRI industry are becoming more mainstream (Horton and Kember 2008). However the authors of the study also note that "the industry as a whole is a long way from best practice: although asset managers increasingly accept that ESG [environmental, social and governance] factors can influence investment returns and risks, most have yet to develop the corresponding competencies systematically across their organisation."

In 2007 Goldman Sachs published details of GS SUSTAIN, a methodology for integrating social and environmental issues into company valuation. Goldman Sachs believes it can be more confident in its predictions of improving returns or industry leadership for those companies which appear to be best managed, as signalled by a strong score on environmental, social and governance issues. The GS SUSTAIN framework also facilitates the identification of emerging industries and companies that Goldman Sachs believes are well placed to address the structural issues facing major industries in terms of significant global themes such as alternative energy, environmental technologies, biotechnology, and nutrition. It is notable in this respect that GS SUSTAIN appears, in effect, to be identifying industries and companies that are best placed to help resolve important societal challenges.

#### 5.3.6.4. *Measurement and communication*

Methodological difficulties and access to reliable and comparable information can hamper the ability of

investment analysts to take full account of social and environmental issues. Some investors, especially but not only from the SRI sector, believe that company disclosure of social and environmental performance should be standardised and perhaps made obligatory. For companies, balancing transparency on non-financial indicators with the need to protect strategic information from competitors can be a complex task.

Substantial work is being undertaken to improve metrics and communication in the area of non-financial performance. The European Alliance on CSR is aiming to produce a framework of metrics and strategies for the management and communication of key areas of non-financial performance, highlighting the link with financial performance. Other relevant work in this area has been undertaken by the UNEP Finance Initiative and the Enhanced Analytics Initiative.

This is part of a wider trend towards the better measurement, valuation and disclosure of intangible assets and intellectual capital. According to surveys from 2004 and 2007, more than three quarters of board members and executives acknowledge that financial indicators alone are not enough to identify companies' strengths and weaknesses (Deloitte 2007). The European Federation of Financial Analysts Societies is a strong proponent of action in this area, pointing out that companies which do not systematically analyse their intellectual capital have an insufficient understanding of what really drives their value creation.

The World Intellectual Capital Initiative has recently been launched under the auspices of the OECD to promote the management and reporting of intellectual capital at company level and to promote international dialogue on this issue. The Enhanced Business Reporting Consortium, which is part of this initiative, aims to develop a voluntary, global disclosure framework for the presentation of the non-financial components of business reports, including key performance indicators. Although intangible assets cover substantially more than just CSR-related issues, such issues are nevertheless often a subset of intangible assets. Pressure for and progress towards better measurement, valuation and disclosure of intangible assets will therefore also affect the measurement, valuation and disclosure of CSR performance.

#### 5.3.6.5. Conclusion

Research indicates conclusively that there is a positive but small correlation between CSR and financial performance. The nature of the causal link is not clear, however. The growth of the SRI industry provides opportunities for better access to finance for

companies that perform well on CSR. There is also evidence that mainstream investors and analysts are paying greater attention to CSR-related issues and more generally to intangible assets and intellectual capital. This is likely to increase the profile of CSR issues in the financial valuation of enterprises.

## 5.4. Competitiveness effects of CSR at macro and sector level

### 5.4.1. CSR and competitiveness at macro level

The European Commission sees CSR as an important part of the European Strategy for Growth and Jobs. If more European businesses are more socially and environmentally responsible, this should help Europe as a whole to meet its objectives under the growth and jobs strategy. These objectives include making Europe more competitive, as well as objectives such as social inclusion. A greater commitment from European enterprises to CSR can also help Europe to better combine competitiveness objectives with the overarching goal of sustainable development.

Some Member States also frame their policies to promote CSR at least partially in the context of improving national competitiveness. The CSR strategy published by the Danish Government in 2008 seeks to strengthen the international reputation of Denmark as a country renowned for responsible growth, which should in turn help to uphold its strong position in the global competition for competent labour, investment and market shares.

One of the main ways in which CSR could contribute to national and regional competitiveness in the EU is by generating higher levels of trust in business on the part of society. CSR practices that are credible, and that are recognised as such by citizens and other stakeholders should help to address the trust gap between enterprises and other stakeholders in society. Conversely, if the CSR practices of enterprises are perceived not to be credible, i.e. to be more public relations than real substance, then this could in the longer term actually compound the problem of the trust gap.

Higher levels of trust in business on the part of society could positively affect macro-level competitiveness in a number of ways. It could, for example, make it easier to reach political agreement on measures to reduce unnecessary administrative burdens on business. The possibilities for reaching social and political consensus on such measures should be greater if enterprises are perceived to share the values of the societies in which they operate and are seen to address societal challenges as well as creating wealth through their own commercial success.

It is also possible that a better image of business in the eyes of society will help to create a more entrepreneurial mindset amongst Europeans. It is probably harder to encourage more young people to become entrepreneurs if the pervasive attitude towards the achievements and impacts of existing enterprises is ambiguous. In its 2006 Communication on entrepreneurship education in 2006, the Commission suggested that emphasising the notion of “responsible entrepreneurship” could help to make an entrepreneurial career a more attractive proposition to young people (European Commission 2006).

It seems reasonable to assume that the generation of trust through credible CSR practices may also help to create social capital in national and regional economies. If so, then CSR could also contribute to competitiveness at a macro-level through a reduction in transaction costs.

Taken as a whole, the CSR practices of enterprises can also contribute to labour market integration and to skills development, both of which are identified in the Growth and Jobs Strategy as being important for European competitiveness. Companies contribute to labour market integration through employee diversity policies, which also have the effect of helping to offset the potential negative competitiveness consequences of the shrinking working age population. The investments made by many enterprises in the skills development of their employees is also an important aspect of the work-place dimension of CSR, and may have positive implications at the macro level in terms of helping to create and maintain a European work force with the skills to compete in the globalised economy.

This chapter argues that CSR can contribute to the innovation performance of companies. If so, then CSR may also improve macro-level competitiveness by being a driver for improved innovation performance in a given nation or region as a whole. It has also been suggested that regions in particular, by actively developing a reputation for CSR and sustainable business, may be able to increase their attractiveness as an investment location (European Commission 2007).

In spite of the validity of these arguments, the links between CSR and competitiveness at a macro level are difficult to measure. Isolating the cause and effect relationship between different aspects of CSR and different determinants of competitiveness is significantly more complicated at macro level than it is even at micro (firm) level. There has been little research into whether the aggregated CSR practices of individual companies do actually have a measureable effect on the determinants of national and regional competitiveness in the ways suggested above. It will in any

case always be dependent on a critical mass of companies engaged in CSR in the economy under study, although the size of that critical mass is uncertain and also invites academic investigation.

In spite of the difficulty of measuring the cause and effect relationship between CSR and competitiveness at national and regional level, there is evidence of a positive relationship between the two. AccountAbility has established a Responsible Competitive Index, which measures the tendency of a country towards responsibility and sustainability, and then plots that against the Growth Competitive Index of the World Economic Forum. The 2007 edition of this exercise found a strong correlation, as have previous editions (MacGillivray et al., 2007). AccountAbility has carried out a similar exercise at regional level in the United Kingdom, and also has found a correlation between levels of responsibility and traditional indicators of regional competitiveness (MacGillivray and Mackie, 2005).

#### 5.4.2. CSR and competitiveness at sector level

The links between CSR and competitiveness can also be considered from a sector perspective. The competitiveness challenges facing certain sectors coincide at least partially with the strategic CSR issues specific to that sector. There are a number of examples of this:

- Chemicals: The High Level Group on the Competitiveness of the European Chemical Industry has identified opportunities for the industry in four fields: climate change, natural resources, renewable energy production and the ageing society. The chemical industry therefore has the potential to play a key role as a provider of solutions to major societal problems. As well as the opportunities for revenue generation this creates, the chemical industry might also improve its reputation in society and its exposure to regulation if it fulfils this potential.
- Mining: Two important strategic issues facing the mining industry are access to land and the attraction of high-quality and suitably qualified workers. Both these factors are influenced by public perceptions of the industry, especially on issues such as its environmental performance and health and safety, which are also key CSR issues for the sector. The mining industry has also suffered from the perception of corruption, and the Extractive Industries Transparency Initiative is a response to that.
- Information technology: Leading IT companies are cooperating to promote e-skills and digital literacy in Europe through the European Alliance on Skills for Employability and the e-skills Industry Leadership Board. The companies involved are motivated

- by a number of considerations, including their own strategic interest in helping to ensure that Europeans have a high level of IT knowledge and skills.
- Tourism: The quality of tourism products and services is very closely linked to the training and behaviour of employees, the state of the surrounding physical environment, and good and close relations with the local community in any given tourism destination. Each of these issues is high on the CSR agenda of tourism enterprises, but very often they cannot be addressed by any one enterprise acting on its own.

The implication of these examples is that in certain industries joint action by enterprises and other stakeholders to address CSR issues can simultaneously help to address factors affecting the competitiveness of the sector. Research into the links between CSR and competitiveness in the financial, IT and pharmaceutical industries suggests that collaboration between different stakeholders is key to successfully combining innovation, responsibility and competitiveness (MacGillivray et al., 2007).

There is, however, potential for tension between the competitiveness interests of individual enterprises and the competitiveness of the sector as a whole, since sector-wide action might reduce the opportunities for leading enterprises to differentiate themselves through CSR. Draper (2006) acknowledges this tension but suggests that a comprehensive approach to promoting CSR at sector level can improve the CSR performance of the sector as a whole and still allow leading enterprises to differentiate themselves. The Commission aims to further study the link between CSR and competitiveness at sector level through support for a number of multi-stakeholder, sector-based CSR programmes in 2009-10.

### 5.5. Conclusion

This chapter has examined the affects of CSR on 6 different determinants and indicators of competitiveness at firm level: cost structure, human resources, customer perspective, innovation, risk and reputation management, and financial performance. It has also examined possible links between CSR and competitiveness at macro-level and at the level of individual industrial sectors. The following general conclusions can be drawn:

1. CSR can have a positive impact on firm-level competitiveness in the case of all 6 determinants examined. However, the strength of that impact, and the extent to which it is relevant to all companies, varies. The business case for CSR is specific to different sectors, sizes and circumstances of companies.
2. The strongest evidence of a positive impact of CSR on competitiveness appears to be in the cases of human resources, risk and reputation management, and innovation. Positive links between CSR and competitiveness also exist but appear less strong or not so generally applicable in the case of cost structure, the customer perspective, and financial markets.
3. The business case for CSR is not static and is getting stronger. Many of the factors affecting the business case for CSR are themselves dynamic and are intensifying. This is true of employee expectations, consumer awareness, trends in private and public procurement, expectations of future regulation, the nature of innovation processes, and the importance that financial markets attribute to social and environmental issues. Additionally, some new factors have been identified that were barely part of this discussion a few years ago. This is the case, for example, of innovation performance.
4. The business case for CSR is increasingly based on value creation. As the practice of CSR has evolved, enterprises have begun to explore creative solutions to maximise their positive impact, as well as introducing measures to minimise their negative impacts. While the origins of the current attention to CSR lie in value protection (primarily risk and reputation management), leading businesses have found that it can also lead to opportunities for new value creation.
5. The strength of the business case for CSR in any given enterprise is still dependent on the competitive positioning of the company. There are enterprises with competitive strategies that require no more than legal compliance in social and environmental fields, and where exceeding legal compliance might incur costs that undermine competitiveness. This is more likely to be the case for enterprises whose competitive positioning is primarily based on low cost.
6. However, for an increasing number of enterprises in a growing number of industries, CSR is becoming a competitive necessity – it is something that they cannot afford not to do.
7. CSR needs to be part of core business strategy if it is to be a competitive differentiator. In this way CSR can also help to strengthen the European social model. The factors affecting the link between CSR and competitiveness are multifaceted and themselves reflect fundamental shifts in the environment in which business operates. Enterprises in which CSR remains a peripheral concern, mainly confined to public relations

functions, are likely to miss opportunities for competitiveness gains. It has been suggested that the European Commission's definition of CSR should be adapted to reflect the importance of strategy, so as to read: "CSR is a concept whereby companies integrate social and environmental concerns in their strategic decision-making processes, in their business operations and in their interaction with their stakeholders on a voluntary basis" (European Academy of Business in Society, 2007).

8. For most of the competitive determinants examined, there is evidence that the impact of CSR is as relevant to SMEs as it is to larger companies. This is certainly true with regard to human resources, and also regarding reputation management and innovation.
9. There are strong reasons for believing that CSR can have a positive impact on competitiveness at European, national, regional and sector level. The overlap between competitiveness and CSR at macro and sector level may be greater than is often acknowledged. More research is required, however, in order to measure and analyse the ways in which CSR might enhance competitiveness at the macro-level and sector levels.
10. The findings of this chapter support the argument that CSR can make a valuable contribution to the goals of the European Growth and Jobs Strategy, and should encourage more Member States, in cooperation with other stakeholders including employers' organisations, to promote CSR as part of their national reform strategies. The Commission will continue to provide political impetus and practical support to all stakeholders engaged in CSR.

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