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K4D Briefing Note

The Commercial and Financial Case for Responsible Business Conduct and What Works for Promotion

Overview

According to the available evidence, companies that prioritize responsible business practices can anticipate higher financial returns, increased competitiveness, and greater resilience. However, certain attitudes and business characteristics (e.g., in smaller companies) may pose significant barriers on investing time and resources in responsible business practices.

Evidence from recent meta-analysis studies indicate that a large proportion of businesses have derived financial and commercial benefits from implementing Responsible Business Conduct (RBC) policy and practices. For instance, a review of over 1,000 studies published between 2015 – 2020 reveal an overall positive relationship between RBC practice and corporate financial performance, with 58% of studies showing a positive relationship, and only 8% showing a negative relationship.[1]

Despite this positive correlation, not all businesses are embracing responsible business practices. There is emerging empirical evidence that capacity, firm size, location, sector, and position in the supply chain all influence the propensity of a firm to implement socially and environmentally responsible practices and investments.[2]

This evidence brief shows that business's sustainability strategies that drive better financial performance do so through mediating factors, such as enhancing business reputation, increasing stakeholder partnerships, mitigating business risks, and strengthening innovation capacity.[3] Recent empirical literature shows optimism that investing in RBC is a way to increase competitiveness, improve financial returns on investments and firm valuation, while reducing business costs.[4] Empirical evidence also shows that RBC has potential to decrease systematic risk and improves firm value. When companies with a good sustainability profile are acquired, the market reaction is unanimously positive and a 'high-sustainability' portfolio often outperforms a 'low-sustainability' portfolio.[5] However, there are still barriers which prevent faster uptake of responsible business practices, including lack of information on different aspects of business conduct and tensions between desire to demonstrate short-term improvements in practice, (typically for shareholders) and the need for longer-term planning.[6]

Box 1: Terminology used in this summary

Responsible Business Conduct (RBC) is the preferred term used in this evidence brief, instead of corporate social responsibility. The concept of RBC is increasingly used by development donors and international institutions, such as the OECD, to describe the way in which companies adopt a business approach that makes a positive contribution to sustainable and inclusive development and avoids negative impacts.[7]

Corporate Social Responsibility (CSR) is used to explain specific responsible business activities. There is no clear definition,[8] but there is increased recognition of the different levels of CSR, referring to "reactive" or "proactive" CSR activities.[9]

Environment, Social, and Governance (ESG) describes the three main topics in the scope of RBC and includes the various criteria and standards expected for RBC practices and investments.

Corporate Social Performance (CSP) describes the level of a company's performance based on ESG criteria. It describes the outcome of companies' adoption of RBC practices by improving their social and environmental impacts.

The Commercial and Financial case for RBC

The literature points to a strong business case for RBC from a corporate perspective. Companies that were more resilient during the 2007-2008 financial crisis were found to have high corporate social performance (CSP) levels (social capital) and showed stock returns that were 4 to 7 percentage points higher than those with lower social capital during the financial crisis.[10] Empirical evidence shows that, where increased risks are associated with higher costs, better performance in Environment, Social and Governance (ESG) standards corresponds with lower loan costs and higher credit ratings.[11] Also, responsible businesses demonstrate the ability to win more and larger contracts via public procurements than other companies.[12] There is evidence that non-sustainable behaviours or doing nothing business mentality have a negative attractiveness and can deter investors.[13]

The emerging empirical evidence shows that the business case for RBC is particularly strong when stakeholders such as investors, employees, and consumers, are more likely to reward proactive RBC approaches as corporations win their trust and increase transparency.[14] This has particularly been the case in light of the emerging climate crisis and wake of the Covid-19 pandemic. Furthermore, the relationship between corporate social performance (CSP) and corporate financial performance (CFP) with an implied long-term focus is 76% more likely to be positive or neutral.[15]

Evidence from large meta-analysis found four causally relevant attributes of CSP that can explain CFP: enhancing firm reputation, increasing stakeholder reciprocation, mitigating firm risk, and strengthening innovation capacity. The findings indicate that the four mechanisms combined explain 20% of the CSR-CFP relationship, which suggests more empirical research is needed to further analyse causality.[16] The impacts of sustainability efforts are usually not immediately visible; effects may be cumulative, slow to materialise or occurring at a distance from stakeholders, which obscures causal relations.[17] Wider literature reviews on causality have concluded that the relationship between CSP and CFP are complex. Evidence has shown that political context has an influence on the strength of the relationship, the relationship tends to change over time, and that the causal link between the CSP and CFP is not always evident, with firms that perform well having more money to invest in capacities to strengthen RBC.[18]

Factors shaping the Commercial and Financial case for RBC

The most important factors that shape the business case for RBC are the extent to which a company operates in international markets or global value chains, the public visibility of the company, and when a business operates in a cooperative institutional environment.

- Export-oriented companies tend to recognise the value of RBC practices for improving their global competitiveness, mainly due to critical external evaluations of companies' responsible production processes in the supply chain.[19]
- Businesses operating in 'highly visible' and competitive consumer markets are particularly focused on using RBC to maximise their competitive advantage and minimise disadvantages. In these markets, failure to implement RBC negatively affects businesses' reputations and decreases brand equity and value.[20] Conversely, investing in RBC might have far less or even negative financial impacts on businesses in 'less visible' industrial market contexts.[21]
- Corporate behaviours mirror the external environment.[22] In a coordinated market economy (such as Sweden and Japan) responsible business practices are more likely to be financially rewarded through multiple types of stakeholder support from related institutions. These can include employee associations, trade unions, and supplier networks, where RBC may result in higher employee satisfaction, improved productivity, organisational trust or other beneficial outcomes.[23]
- Research shows that the income level of countries is not an important factor regarding the relationship between CSP and CFP.[24]

Drivers and barriers to uptake and scaling up RBC practices

Given emerging evidence that responsible business practices are increasingly associated with better business and financial performance, it becomes obvious to ask why companies do (or do not) rapidly scale up RBC practices. The reasons to adopt or scale up RBC practices can be framed around drivers (or motives) and barriers (or challenges). Motivation is the product of how societal, business, and governmental influences or pressures drive RBC responses (see Table 1).

For example, when forces outside and inside businesses combine to provide strong incentives for RBC (such as collective stakeholder action or consumer purchasing behaviour in line with attitudes to responsible practices), it is likely to motivate companies to have a more proactive attitude towards taking up responsible business activities.

Table 1. Summary of key drivers to uptake and scaling up RBC practices and their limitations

	DRIVERS	LIMITATION
SOCIETY	Consumer pressure Civil society pressure Activist shareholders	Information asymmetries exist. Most effective for end-market, consumer-facing companies at the end of the value chain. Consumers respond more to negative stories and prefer certain ESG criteria over others. When voted on by shareholders, resolutions on social and environmental issues receive lower support than resolutions on corporate governance issues. As the objective is engaging business management, it is more effective for activists to target companies with already better governance structures, so they are not necessarily focusing on companies with the least CSP.
BUSINESS/ INDUSTRY	Management leadership and business culture Rankings, ratings, and voluntary initiatives Impact investments Supply chain actors' pressure	There is not an automatic relationship between the personal inclination of managers toward deeper sustainability and inclusion and different business models success. In liberal market economies, managers might find it more difficult to change business cultures compared with more coordinated market economies, unless supported by social capital. Contestation around how to rank/rate companies on ESG criteria. Rankings and ratings work mainly for companies in socially contested industries. Rankings and ratings can have an adverse effect as well. Voluntary initiatives provide a weak incentive for businesses, particularly as they do not contain stakeholder engagement and enforcement mechanisms. Companies and some investors are picking the 'low hanging fruits' of ESG criteria rather than forward-looking targets, metrics, and transition frameworks. Applies mostly for first-tier suppliers, but most contested activities might be outsourced further down the supply chain. Contestation of prizing in RBC in products; who is paying for it?
GOVERNMENT	Mandatory ESG goals International trade and investment agreements State ownership Public procurement	Mandatory ESG reporting requirements might increase reporting volumes, but not the quality. Enforceability can be an issue. Governments must be careful that mandatory RBC will not become an additional tax on corporations or lead to imperfect solutions by companies through box-ticking exercises. Trade and investment agreements are limited as an incentive for RBC uptake because they remain intergovernmental and do not provide direct obligations for corporations. Although there is evidence that state ownership increases CSP, in a market economy there is a limit what companies a state should own. Social public purchasing is often not embedded in law and if legislation is in place, it often overlooks regional and local authorities where a great deal of purchasing takes place. There are strategic and operational challenges, e.g. lack of technical skills and knowledge to implement social public procurement processes.

The drivers and barriers for RBC uptake and upscaling vary according to sector, country context and business characteristics. For example, due to higher spill-over effects, larger and more visible businesses for end-consumers might feel more pressure from civil society actors and activist shareholders.[25] However information asymmetries exist, for example towards consumers. As a result of this unequal access to information for stakeholders, transparency and accountability measures should be improved to ensure that more businesses can be held accountable.[26]

Attitudes and behaviours within a business can be important barriers too, particularly in relation to recruiting and developing relevant skills for RBC officials who can invest time and money in RBC and reach out to all stakeholders.[27] In this context, company size matters most, as smaller-sized companies might lack the resources, capacity, and time for stakeholder engagement. The return on RBC investments might not occur in the short term, disincentivising their pursuit.[28] Smaller companies in general also feel less pressure from outside investors and stakeholders who might demand more transparency and accountability.[29] However, good leadership and less complex management and ownership structures can allow smaller companies to potentially more easily adapt their business models, enter niche markets, and develop or pilot innovative stakeholder engagement models more rapidly.

Other key barriers or challenges include:

- Although there is a positive trend towards valuing social and environmental standards by certain groups of shareholders and investors, in general, shareholders, financial markets and other investors remain focused on **short-term profit maximisation**.[30]
- For many companies, **upfront cost factors** (despite long-term gains) may hinder RBC practices, particularly for investing in meaningful engagement with stakeholders and building the required skills and internal structures to do this effectively.[31]
- Social barriers can be associated with **low public awareness and acceptance of RBC initiatives.** Consumers are not always willing or able to pay a premium price for more responsibly-made products.[32]
- RBC frameworks and assessment methods tend to focus on cost and risk reduction and optimisation of efficiencies in the shorter term (quick fixes). There is less focus on creating value and resilience in the longer term, which is more difficult to measure. This often leads to **intentional selectivity of sustainability issues** and stakeholder engagement, resulting in mixed corporate responses.[33]
- The **lack of universally agreed measurement systems and standards** to assess the benefits of RBC practices hinder progress. For example, indicators used in sustainability reports and indexes are not standardised, which makes comparability difficult and makes it difficult for investors to decide which company to invest in.[34]
- Even when RBC standards converge into common international RBC guidelines, they have historically been only "soft law" (i.e. not mandatory), with a **lack of enforceability** through "hard law".[35]

Covid-19 pandemic and RBC responses

The drivers and barriers for businesses to adopt and scale up RBC practices change in response to crises. Some early studies show that companies with high levels of responsible business commitments were valued more by shareholders during the Covid 19 pandemic. RBC was conducive to improving stock returns during the pandemic. Investors particularly approved of higher standards for both employee and environmental protection responsibilities in these companies.[36] Companies with higher levels of responsible business commitments in general kept their ESG standards and priorities high during the pandemic, such as building stewardship relations with employees, suppliers, customers and communities.[37]

Overall, the pandemic created opportunities for RBC, as follows:

- At the peak of the Covid-19 pandemic several surveys found that consumers were changing their purchasing habits towards more sustainable products. The optimistic view was that a "window of opportunity" for RBC had been created due to the pandemic because of increased demand for sustainable consumer products.[38]
- ESG principles came to the fore of shareholder activist agendas with the prospect of more government regulations to disclose ESG impacts of investments.[39] In particular, the 'S' in ESG has seen much more attention, with activist shareholders taking into account how companies have dealt with their employees, suppliers, and customers.[40]
- The pandemic has increased government action to support business by addressing some acute problems in global value chains (GVCs) and the business environment. Although there is no evidence available as yet on how this has impacted on RBC, there are some indications that it has shaped new forms of dialogue, public-private relations, and more mandatory regulations.[41]
- The lessons of business responses to the pandemic is that there must be significant commitment and buy-in by management and owners of companies if

Box 2: Multistakeholder initiatives

Government support to multistakeholder initiatives (MSIs) falls into the category of facilitation, by promoting peer pressure, dialogue and other collective action among companies. MSIs are a platform for establishing and promoting RBC standards as a guide for corporate behaviour and increasing awareness of responsible business activities and trust amongst different stakeholders.[53]

Multistakeholder initiatives (MSIs) do not automatically ensure good CSP. MSIs need rule coverage, efficacy, and enforcement to work well.[54] Challenges relate to how to manage the platform to ensure input legitimacy, how to choose members and how to have open communication. Members need time and must make considered effort to build trust and manage the platform, as there will be a variety of cultures, values, languages and relationships across the membership.[55]

Another challenge is how to enhance the function of output legitimacy. Time is required for output legitimacy to be certified and become useful in society.[56] As such, the actual problem-solving ability of an agreed-on standard is one of the most relevant issues for output legitimacy. This is not just a matter of the standard's capability itself, but it also depends on how companies accept and respond practically, and simultaneously how stakeholders monitor and evaluate responsible businesses in the market.

In summary, it is not only the legitimacy of MSIs that matters, but external monitoring and evaluation systems for responsible companies in the market, as well as organisational efforts to incorporate responsible business standards into managerial processes. Governments could support MSIs to address some of these challenges.

improved practices and results are to follow. This means more strategic positions and roles for stakeholders, with stakeholder engagement becoming more the norm.[42]

At the same time, there is emerging evidence that the pandemic has created or exaggerated existing challenges. During any crisis, businesses' first response is to keep business afloat, while rethinking the opportunities and costs of responsible business practices. In summary:

- The pandemic has weakened responsible business practices and due diligence systems, posing additional risks to workers – particularly vulnerable groups.[43]
- The pandemic was for some industries more devastating than for others, which means that decisions on RBC practices would vary between companies.
- The pandemic, but even more the war in Ukraine shows that companies need to act quickly in response to pressures from society, industrial peers, and governments to disinvest in Russia.

Although sustainability is increasingly on the radar of consumers, some population groups might lack awareness or interest, or lack the financial means due to economic hardship and uncertainties created by the pandemic (and other crises) to make more sustainable consumption choices.[44] This will trigger different responses by businesses, but also governments might respond differently, such as the 2022 resolution by the Florida state in the USA to bar the state's US$186 billion pension fund from considering ESG factors when making investment decisions.[45] However, more evidence is needed on how different stakeholders respond to specific crises, such as the cost-of-living crises and climate emergencies.

Furthermore, key RBC standards will need to be updated to explicitly deal with the recent crisis of COVID-19 and emerging security risks, such as the Russian invasion of Ukraine in 2022.[46]

What Works for RBC Promotion: Implications for policy

Governments can play an essential role in incentivising business and addressing the challenges companies face when deciding whether to adopt and scale up responsible business practices.

- Recent empirical literature shows that a more active role by government through regulations and enforcement is necessary to create a level playing field to ensure transparency, quality, and compliance within sectors and supply chains.[47]
- Governments can also play a crucial role as facilitators, for example, in stimulating dialogue, raising awareness among key stakeholders, sharing information and supporting training.[48] As a facilitator, government has a role in incentivising and bringing together business and societal stakeholders (e.g. in multistakeholder settings, see Box 2). It can also support monitoring by civil society organisations, raising awareness of RBC amongst business associations, and enhancing business engagement and endorsement of champions.[49]
- Governments can set a positive example as responsible buyers of products and services through public procurement practices, as service providers (e.g. in public education and health sectors), and as business owners for companies where the state has a significant share.[50] Governments also play an

important role in passing RBC enhancing legislations. For example, through the Modern Slavery Act, RBC is helping to stop slavery and human trafficking in businesses and supply chains.[51]

There is emerging evidence that mainstreaming RBC-related government policies and programmes is highly relevant to incentivise companies to increase their social and environmental values (e.g. via tax, trade, and procurement).[52] There is also growing interest by governments and donor agencies to partner directly or indirectly with companies – especially in private sector engagement programmes. This arrangement provides opportunities to restrict partnerships to those companies that comply with a certain level of RBC practice, reporting, and due diligence while including grievance mechanisms and active ESG monitoring.

Conclusion

More evidence is needed to understand what works better for RBC promotion for specific firms in certain market contexts. RBC can create business opportunities for companies and possibilities to increase both their financial and social performance, but governments have to step up and be more proactive to ensure positive impacts. By doing so, RBC can better align with supporting achievement of the Sustainable Development Goals (SDGs) and related policies and strategies. Only then can RBC realise its potential and contribute to more sustainable and inclusive economic growth and development at both a national and global level.

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