What is the business of business?

By building social issues into strategy, big companies can recast the debate about their role in society.

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The great, long-running debate about business's role in society is currently caught between two contrasting, and tired, ideological positions. On one side of the current debate are those who argue that, to borrow Milton Friedman's phrase, "the business of business is business." This belief, most established in Anglo-Saxon economies, implies that social issues are peripheral to the challenges of corporate management. The sole legitimate purpose of business is to create shareholder value. On the other side are the proponents of corporate social responsibility, a rapidly growing, rather fuzzy movement encompassing companies that claim that they already practice the principles of CSR and skeptical advocacy groups arguing that they must go further in mitigating their social impact. As other regions of the world—parts of continental Europe, for example—move toward the Anglo-Saxon shareholder value model, the debate between these points of view has increasingly taken on global significance.

Both perspectives obscure, in different ways, the significance of social issues to business success. They also unhelpfully caricature the contribution of business to social welfare. It is time for CEOs of big companies to recast this debate and recapture the intellectual and moral high ground from their critics.

Large companies must build social issues into strategy in a way that reflects their actual business importance. Such companies need to articulate their social contribution and to define their ultimate purpose in a way that is more subtle than "the business of business is business" and less defensive than most current CSR approaches. It can help to view the relationship between big business and society as an implicit social contract—Rousseau adapted to the corporate world, you might say. This contract has obligations, opportunities, and advantages for both sides.

To explain the basis for such an approach, it may help first to pinpoint the limitations of the two current ideological poles. Start with "the business of business is business." The issue here is not primarily legal: in many countries, such as Germany, companies have a legal obligation to stakeholders, and even in the United States the legal primacy of shareholders is open to very broad interpretation.

The problem with the "business of business is business" mind-set is rather that it can obscure two important realities. The first is that social issues are not so much tangential to the business of business as fundamental to it. From a defensive point of view, companies that ignore public sentiment make themselves vulnerable to attack. Social pressures can also serve as early indicators of factors essential to corporate profitability: for example, the regulations and public-policy environment in which companies must operate, the appetite of consumers for certain goods above others, and the motivation of employees—and their willingness to be hired in the first place.

Companies that treat social issues as either irritating distractions or simply unjustified vehicles for attacks on business are turning a blind eye to impending forces that have the potential to alter the strategic future in fundamental ways. Although the effects of social pressures on these forces may not be immediate, that is not a reason for companies to delay preparing for or tackling them. Even from a strict shareholder perspective, most stock market value—typically, more than 80 percent in US and Western European public markets—depends on expectations of corporate cash flows beyond the next three years.

Examples abound of the long-term business impact of social issues. That impact is growing fast. In the pharmaceutical sector, the past decade's storm of social pressures—stemming from issues such as public perceptions of excessive prices charged for HIV/AIDS drugs in developing countries—are now translating into a general (and sometimes seemingly indiscriminate) toughening of the regulatory environment. In the food and restaurant sector, meanwhile, the long-escalating debate about obesity is now resulting in calls for further controls on the marketing of unhealthy foods. In the case of big financial institutions, concerns about conflicts of interest and the mis-selling of products have recently led to changes in core business practices and industry structure. For some big retailers, public and planning resistance to new stores is constraining growth opportunities. And all this is to say nothing of the way social and political pressures have reshaped and redefined the tobacco and the oil and mining industries, among others, over the decades.

In all such cases, billions of dollars of shareholder value have been put at stake as a result of social issues that ultimately feed into the fundamental drivers of corporate performance. In many instances, a "business of business is business" outlook has blinded companies to outcomes, or to shifts in the implicit social contract, that often could have been anticipated.

Just as important, these outcomes have not just posed risks to companies but also generated value creation opportunities: in the case of the pharmaceutical sector, for example, the growing market for generic drugs; in the case of fast-food restaurants, providing healthier meals; and in the case of the energy industry, meeting fast-growing demand (as well as regulatory pressure) for cleaner fuels such as natural gas. Social pressures often indicate the existence of unmet social needs or consumer preferences. Businesses can gain advantage by spotting and supplying these before their competitors do.

Paradoxically, therefore, the language of shareholder value may in this respect hinder companies from maximizing their shareholder value. Practiced as an unthinking mantra, "the business of business is business" can lead managers to focus excessively on improving the short-term performance of their businesses, thus neglecting important longer-term opportunities and issues, including societal pressures, the trust of customers, and investments in innovation and other growth prospects.

The second point that the "business of business is business" outlook obscures for many companies—the need to address questions about their ethics and legitimacy—is related to the first. For reasons of integrity and enlightened self-interest, big companies need to tackle such issues, with both words and actions. It is neither sufficient nor wise to say that it is for governments to set laws and for companies simply to operate within them. Nor is it enough simply to point out that many criticisms of businesses are unmerited or that those throwing the mud ought also to examine their own practices and social responsibility. Irrespective of whether the criticisms are valid, their cumulative effect can shape the strategic context for companies. It is imperative that businesses seek to lead rather than merely react to these debates.

Moreover, in certain parts of the world—particularly some poor developing countries—the rule of law and basic public services are notable by their absence. This reality can render the "business of business is business" mind-set positively unhelpful as a guide for corporate action. If companies operating in such an environment focus too narrowly on ill-defined local legislation or shy away from broad debates about their alleged behavior, they are likely to face mounting criticism over their activities as well as a greater risk of becoming embroiled in local political tensions.

Is CSR the answer? If only it were. The point is not to criticize the many laudable CSR initiatives undertaken by individual companies or to dispute the obvious need for businesses (as for any other social entity) to act responsibly. It is rather to examine the broad prescriptions proposed by groups and activists involved with CSR. These prescriptions commonly include stakeholder dialogue, social and environmental reports, and corporate policies on ethical issues. This approach is too limited, too defensive, and too disconnected from corporate strategy.

The defensive posture of CSR springs from its origins. Its popularity as a set of corporate tactics was driven, in large part, by a series of anticorporate campaigns in the late 1990s. These campaigns were in turn given impetus by the antiglobalization protests mounted around the same time. Since then, companies have been drawn to CSR by nice-sounding if vague notions such as the "triple bottom line": the idea that companies can simultaneously serve social and environmental goals as well as earn profits. Companies have seen CSR as a way to avoid nongovernmental-organization (NGO) and reputational flak and to mitigate the rougher edges and consequences of capitalism.

Developing countries must rethink how to attract and regulate investment. See "The truth about foreign direct investment in emerging markets."

This defensiveness starts the argument on the wrong foot—certainly as far as business leaders should be concerned. Big business provides huge and critical contributions to modern society. These are insufficiently articulated, acknowledged, or understood. Among them are productivity gains, innovation and research, employment, large-scale investments, human-capital development, and organization. All of them are, and will be, essential for future national and global economic welfare. Big business also supplies investment vehicles that are likely to be central to the provision of pensions in the aging countries of the Organisation for Economic Co-operation and Development (OECD). In developing countries, meanwhile, the entry of multinational companies through foreign direct investment has often contributed critical capital, technology, skills, and other poverty-reducing economic spillovers. It is no coincidence that developing countries place such emphasis on attracting big business and the investment it can bring to their economies.

CSR is limited as an agenda for corporate action because it fails to capture the potential importance of social issues for corporate strategy. Admittedly, companies undertaking a stakeholder dialogue with NGOs will be more aware, in advance, of potential issues. But tracking NGO opinion is only part of the process of understanding the range of social pressures that can ultimately affect core business drivers such as regulations and consumption patterns.

An obvious next step for companies, having understood the possible evolution of these broad social pressures, is to map long-term options and responses. This process clearly needs to be rooted in the development of strategy. Yet typical CSR initiatives—a new ethical policy here, for example, or a glossy sustainability report there—are often tangential to it. It is perfectly possible for a company to follow many prescriptions of CSR and still be caught short by seismic shifts in the socially driven business environment. One of the compounding problems is the fact that many companies have chosen to root their CSR functions too narrowly, within their public- or corporate-affairs departments. Although such departments play an important tactical role, they are often geared toward rebutting criticism and tend to operate at a distance from strategic decision making within the company.

A **contract** has two sides, and business must acknowledge that in return for the ability to function, it is subject to rules and constraints

In the limitations of both CSR and of the "business of business is business" thinking lie the outlines of a new approach—as relevant for Chinese, German, and Indian companies as for US and British ones. Three main strands stand out. The first is a helpfully simple prescription: businesses should introduce explicit processes to make sure that social issues and emerging social forces are discussed at the highest levels as part of overall strategic planning. This point means that executives must educate and engage their boards of directors. It also means that they need to develop broad metrics or summaries that usefully describe the relevant issues, in much the same way that most companies analyze customer trends today. The risk that stakeholders—including governments, consumer groups, lawyers, and the media—will mobilize around particular issues can be roughly estimated by studying the known agendas and interests of these parties. For example, the likelihood that the obesity debate would rebound on food companies was partly predictable from the growing expenditures of governments on obesity-related health problems, the inevitable media focus on the issue, plus the interest of some lawyers in finding fresh corporate targets for litigation. By the time businesses seriously engaged with the question, they were in a defensive posture, merely struggling to catch up with the public debate. In the future, companies will need to be much better at understanding and anticipating such issues.

Both the second and third strands of the new approach reflect the idea that there is an implicit contract between big business and society or indeed between whole economic sectors and society—the contract that is the subject of this article. Detractors have often successfully portrayed the contract as a one-way bargain that benefits business at society's expense. The reality is much more complex. The activities undertaken by business have clearly brought social benefits as well as costs. Similarly, however, there are two sides to a contract, and business must acknowledge that in return for the ability to function, it is subject to rules and constraints. At times, the contract can come under obvious strain. The recent backlash against big business in the United States can be seen as society seeking to shift the terms of the contract as a result of popular perceptions that business has abused its power. Similarly, in Germany at present, business is struggling to defend itself against charges that its contract with society is fundamentally unbalanced.

The second strand requires companies not just to understand their individual contracts but also to manage those contracts actively. To do so, companies can choose from a range of potential tactics, such as more transparent reporting, shifts in R&D or asset reorganization to capture expected future opportunities or to shed perceived liabilities, changes in approaches to regulation, and, at an industry level, the development and deployment of voluntary standards of behavior.

Some companies and sectors are already experimenting with such approaches. Nonetheless, there is scope for much more activity, provided it is aligned with corporate strategic goals. Reshaping conduct on an industry-wide and increasingly global basis may be particularly important, given that the perceived misdeeds of one company can rebound on its sector as a whole.

An important point to remember is that companies, depending on their circumstances, will have quite different tactical responses, so off-the-shelf or simply nice-sounding solutions may not always be appropriate. Transparency offers a good example. It is easy, but wrong, to say that there can never be enough of it. What might be good for a pharmaceutical company trying to restore the consumers' trust could be damaging for a hedge fund manager. A voluntary code of practice for a retailer naturally would be very different from that of a copper-mining company.

This observation leads me to the third strand of the new approach for business leaders: they need to shape the debate on social issues much more consciously by establishing ever higher (but appropriate) standards of integrity and transparency within their own companies and by becoming much more actively involved in external debates (such as those in the media) on issues that shape the social context of business.

A starting point may be for CEOs to articulate publicly the purpose of business in terms less dry than shareholder value, although that should continue to be seen as the critical measure of business success. However, it may be more accurate, more motivating—and indeed more beneficial to shareholder value over the long term—to describe the ultimate purpose of business as the efficient provision of goods and services that society wants.

This is a hugely valuable, even noble, purpose. It is the basis of the contract between business and society and the basis of most people's real interactions with business. CEOs could point out that profits are not an end in themselves but a signal from society that a company is succeeding in its mission of providing something people want—and doing so in a way that uses resources efficiently relative to other possible uses. From this perspective, the creation of shareholder value or profits is the measure, and the reward, of success in delivering to society the goods and services we desire, which is the more fundamental business objective. The measures and rewards reflect the predominant values of the relevant society.

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By moving away from a rigid focus on the term shareholder value, big business can also make clear to broad audiences that it understands the trade-offs inherent in its social contract. The debate between business and society is essentially one about how to manage (and reach agreement on) those trade-offs. What might this point mean specifically? There is no shortage of big social issues today that directly affect many big businesses and require new debate. These issues include ensuring that aid organizations and trade regimes successfully promote the development of Africa and other poor regions, whose economic liftoff would present a major potential boon to global markets as well as to international security; promoting a more sophisticated and sensitive approach, by both companies and governments, to balancing the societal risks and rewards from new technologies; spearheading dialogue on the health care and pension challenges in many developed countries; and supporting efforts to resolve regional conflicts.

Obviously, the relevant issue must be matched to the specific business. Some companies and business organizations have taken strong public stances on these and similar issues. But in general, high-level, concerted corporate activism is more notable by its absence. Business leaders shouldn't fear taking a more forward role advocating the idea of a contract between business and society. Public receptiveness to active business leadership on issues such as these may be a lot greater than some might be inclined to think. Despite the poor image and bad press of big business in recent times, polls suggest that people retain a belief in its ability to provide a positive contribution to society.

More than two centuries ago, Rousseau's social contract helped to seed the idea among political leaders that they must serve the public good, lest their own legitimacy be threatened. The CEOs of today's big corporations should take the opportunity to restate and reinforce their own social contracts in order to help secure, for the long term, the invested billions of their shareholders.

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Ian Davis is the worldwide managing director of McKinsey & Company. This article was originally published as "The biggest contract" in the May 26, 2005, issue of the *Economist*. Copyright © The Economist Newspaper Limited, London, 2005. All rights reserved. Reprinted by permission.