

Conditions for value creation in the marketplace through the management of CSR issues
– A negative external effects framework

Abstract

The aim of this paper is to investigate the conditions under which certain negative externalities can be made ‘internalizable’ within corporate-led social responsibility initiatives while creating social and economic value. Our research is built on a two-step rationale. We first show that the economic theory of externality can bring some insights to strategic CSR by tailoring a framework for classifying negative externalities that can then be used as a basis for categorizing the various issues facing the socially-responsible firm. We then build on current reflections from the strategic CSR stream on value creation and CSR practices. We highlight three requisite conditions to create value on the marketplace: a willingness among some stakeholders to pay, low transaction costs, and social acceptability for the transactions made. We then cross-match these three conditions to the pre-established externality categories to sketch out in detail the strategies available enabling a business to profitably internalize its negative externalities.

Keywords: Strategic CSR, value creation, externality, willingness-to-pay, two-sided transactions

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Introduction

What conditions enable firms to create economic value in the marketplace via corporate social responsibility policies? The value creation question is a time-honored debate within the CSR research community, yet remains far from being solved. Research to date has mainly focused on the “whether” question, i.e. whether socially-responsible firms prove more profitable (Margolis and Walsh 2003; Orlitzky, Schmidt and al. 2003; Smith 2003). All these papers have in some way responding to Nobel Prize-winner Milton Friedman’s famous 1970 article stating that the sole responsibility of business was to make profits (Friedman 1970). The echo of this bitter denunciation of CSR experimentations was such that the quest for proof of responsible profitability remained the sole visible path for CSR researchers to survive the neo-classical win-lose argument (Levitt 1958; Friedman 1962; Drucker 1984; Walley and Whitehead 1994; Kapstein 2001). Consequently, at the end of the 90s, researchers started to join mainstream multinationals and CSR consultants in asserting the virtues of the triple bottom line (Elkington 1997).

Nevertheless this statement may appear counterintuitive on a number of counts (McWilliams and Siegel 2000; Vogel 2006; Davis, Whitman and al. 2008). If integrating social responsibilities carried zero costs or was even a systematically win-win mechanism of value creation, as it is purported to be in the ‘*CSR industry*’ and its ‘*business case*’ concept (Elkington 1994; Elkington 1997), the subject would long since have become hackneyed and the problems resolved by firms whose primary function is to maximize shareholder profits (Friedman 1962; Jensen and Meckling 1976; Jensen 2001). This apparent paradox inherent to

CSR is being increasingly emphasized by commentators across the board, from critical schools of thought (Gray 2001) to institutional economists (Campbell 2007) and back to sociologists researching social movements (Davis, Whitman and al. 2008).

This paper approaches the problem from a different angle, investigating the requisite conditions for profitable society-and-market-based value creation. Our arguments are not anchored on Friedman's statement but instead on another "Nobel Prize" winner, Kenneth Arrow, whose 1973 article "Social responsibility and economic efficiency" defined CSR as the capacity of firms to rectify market failures (Arrow 1973). Arrow listed different ways "the economic activity of one firm may affect other members in the economy" (1973: 303) and concluded that "The question of social responsibility takes very different forms with regard to the different items on this varied list. It is not a uniform characteristic at all." (1973: 304). He then called for a research that could take into account the variety of CSR issues and concluded that "some effort must be made to alter the profit maximizing behavior of firms in those cases where it is imposing costs on others which are not easily compensated through an appropriate set of price." (1973: 307). Starting out from this statement, we draw on externality theory to study the question of profitable social issues management. Our paper contends that this economic theory has still many insights to bring to current strategic thinking on CSR, especially the analytical grids proposed for categorizing types of market failures and thus classifying the types of externalities that companies shed onto their stakeholders.

We mirror a recent article by C. Crouch reframing the CSR dilemma in new terms: "*for any firm, reducing negative externality (...) will inevitably involve actions that will incur costs yet for which there is no payment. This issue is pivotal to CSR: how can a profit-maximizing firm be expected to engage in this kind of action?*" (Crouch 2006: 1534). Our article responds to this apparent contradiction by investigating the possibilities for a CSR-driven strategy of externality internalization while highlighting the market conditions governing its real-world

implementation. We provide insight into how far a firm can be expected to demonstrate social responsibility through the profitable internalization of the negative externalities they previously offloaded onto stakeholders, and under what conditions. We thus intend to contribute to the *Strategic CSR* thread while highlighting the conditions for an alignment between social performance and competitive advantage.

Our argument begins by setting out clear conceptual points. We draw on externality theory to synthesize conceptual ties between externalities, social issues, and CSR. Then, starting out from research published by a number of commentators, we go on to show that CSR can be defined as the voluntary internalization of negative externalities. We then sharpen the definitions set by incorporating specifics on the concept of negative externality by building a framework of externalities types (I). We go on to envision the requisite condition-sets that would enable the internalization of negative externality to benefit society and generate added market revenue for the internalizer-business at the same time. We highlight the three requisite conditions pinpointed: a willingness among some stakeholders to pay, low transaction costs, and social acceptability for the transactions made. We then cross-match these three conditions to the pre-established externality categories to sketch out in detail the strategies available enabling a business to profitably internalize its negative externalities (II).

I- CSR as voluntary internalization of externality

Definitional analysis focused on CSR appears to endorse the definition given by the European Commission in 2001 (European Commission 2001). Building on research from a panel of commentators, we propose to bolster this definition further by drawing in the widely-developed economics concept of externality (I.1). We then seek to highlight the various social and economic realities spanning the notion of externality (I.2).

I.1- Social issues management as externalities internalization

Despite the numerous debatable points involved, the European Commission's definition of CSR appears to reflect a certain degree of consensus. Thus, when understood as "*a concept whereby companies integrate social and environmental concerns in their business operations (...) on a voluntary basis*" (European Commission, 2001)¹, CSR is a cue for companies to take further steps to integrate the expectations of stakeholders impacted by the company's activities, not just during the production of goods and services phase but throughout consumer use. Through a series commitments made on social responsibility, companies pledge to make sure they generate minimal negative impact on the welfare of their stakeholders, often integrating stakeholders' expectations in order to cut down or eliminate the 'collateral damage' caused.

Economists generally use the more technical term *negative externality* to describe the "collateral damage" impacting on stakeholders falling somewhere within the company's immediate environments (Kapp 1950; Laffont 1977; Papandreou 1994; Stiglitz and E. 2002; Elsner, Frigato et al. 2006). We will not be poring over the long history of the externality concept, which from Alfred Marshall's pioneering research through to the latest developments in agency and incentive theories has spawned an array of developments (Mishan 1971; Papandreou 1994; Cornes and Sandler 1999).

In this article, we build our definition of externality on the assertions developed by R.H. Coase. It should be underlined that never, at any point in his work, did R.H. Coase use the term 'externality' – a term he considered way too off-mark and ideologically connotative (Coase 1960; Coase 1988). Coase's work is far more generic, and extends to studying

¹ Taking a more theoretical stance, this definition ties directly into the definition put forward by McWilliams & Siegel, who conceptualize CSR "*as actions that appear to further some social good, beyond the interests of the firm and that which is required by law*" (McWilliams & Siegel, 2001: 117).

“actions of business firms which have harmful effects on others” (Coase, 1960: 95). As an extension to Coase’s work, we define negative externality as any disservice that a business firm causes its stakeholders without offering compensation for the damages burdened² (Coase, 1960, 1988). We have taken this definition of externality in a conscious effort to move away from Pareto optimality-related research on competitive equilibrium and towards a more holistic approach aimed at understanding the dynamics of how a firm changes its relationships with the stakeholders forced to bear the burden of its negative externalities.

The research reported here defines CSR as the voluntary integration of the externalities companies previously offloaded onto stakeholders. It should be underlined that this is not in itself an original vision of CSR, since a number of commentators have adopted a similar view (Arcelus and Schaefer 1982; Baron 1995; Crouch 2006). C. Crouch, for instance, asserts that *“the central premise of CSR resides in companies taking ownership of the externalities they generate”* (Crouch, 2006, p. 1534). Historically speaking, exploiting externality as a concept for understanding and defining CSR is no new move, but it remains still a compelling conceptual framework, for five main reasons:

- 1- McWilliams, Siegel & Wright underlined how an uncontrolled profusion of CSR definitions has in fact counterproductively frustrated attempts to theorize and operationalize CSR research (McWilliams, Siegel and al. 2006). This barrier can be overcome by using a simple core definition of CSR – the voluntary management of externality – that encompasses the other published definitions of CSR. Any socially responsible firm would at least be expected to voluntarily make efforts to reduce the externalities previously pushed onto stakeholders. This

² This definition also mirrors the definition given by W. Kapp, who defined negative externality as *“any direct or indirect losses borne by third parties or the public in general as a result of a firm’s business activity”* (Kapp, 1950: 14).

definition carries the advantage of being consensual, simple, operationalizable, and testable.

- 2- The second advantage of tying CSR to externalities is that it clearly exposes the intrinsic predicament involved. Managing externality simply does not come free, as firms have to internalize “social and environmental costs” that are always going to affect the value creation process. A firm that is socially responsible will inevitably continue pressing towards its primary objective to create profit – a process inescapably hampered by CSR commitments (McWilliams and Siegel 2001). The internalization of externality spotlights the tension at play between the drive to maximize profit and the willingness to integrate the expectations and demands of a broader spectrum of stakeholders.
- 3- Another undeniable advantage of externality theory is that it embraces each component in an economic activity. Whereas certain theoretical frameworks rationalize economic activity strictly in terms of its market-driven dimension, externality theory also integrates extra-market-driven considerations (Kapp 1950; Callon 1998; Crouch 2006). This theoretical framework simultaneously envisions not only the exchange of goods (components integrated into economic activity) but also the exchange of social costs (components not integrated into economic activity). Externalities give a fuller holistic picture of a firm’s business activity by simultaneously integrating both economic and social factors: the firm operates within a market sphere and within a social sphere.
- 4- An important point is that externalities represent a ‘theoretical focus’ that is particularly well-g geared to understanding and exploring CSR challenges and the practices employed. Externalities simultaneously challenge both the institutional

and the organizational aspects of firms' activities³. The institutional factor comes under the spotlight since the presence of externalities gives a voice to stakeholders as they challenge firms and the free-market machinery (Hirschman 1970; Davis, McAdam and al. 2005). The organizational factor also comes under the spotlight since firms responding to changing social standards and marketplace dynamics manage to more or less successfully effect procedural and technical transformations in their production facilities and in their value chain (Ackerman and Bauer 1976; Porter and Kramer 2006). Since externalities represent the 'boundaryline theoretical focus' between the transformation of social norms, free-market mechanisms and the production process, they simultaneously harness the institutional and organizational dynamics at the heart of CSR and more generally at the interface between business and society (Donaldson and Dunfee 1999).

- 5- Finally, externality theory is one of the leading strands of economics research, which has produced numerous models and frameworks with which to classify and inventory different forms of externality, and by extension different social challenges that firms have to contend with when pledging their commitment to socially-responsible practices and policy. Defining CSR as the drive to take ownership of externalities enables us to borrow from tools and econometrics employed by economists.

It is this last point 5 that will become the focus of our research as we set out an externality classification framework designed to pinpoint the diverse cross-section of realities that a socially-responsible firm may have to contend with.

³ We refer here to the definition of institutions given by Douglas C. North: "Institutions are the humanly divided constraints that structure the political, economic and social interaction. They consist of both informal constraint and formal rules." (North, 1991: 97)

I.2- What kind of externalities firms are dealing with? A candidate analytical framework

As stated earlier, setting CSR as the drive to take ownership of externalities enables us to borrow from tools and analytical concepts developed by economists. In fact, a number of authors have attempted to specify the scope covered under the externality concept (Cowen 1988; Cornes and Sandler 1999), progressively developing, inventorying and categorizing the social realities encompassed.

Focusing in, we borrow conceptual constructs from public goods theory, which is one of the variants of externality theory (Stiglitz, 2002), to categorize the types of externality firms offload onto stakeholders. The approach outlined here consists in reversing the logic of public goods theory so that it can be repurposed to externalities as specific goods. The point here is that public goods theory as originally developed by P. Samuelson was designed to categorize goods according to whether or not they were liable to be produced by the market (see Cornes & Sandler, 1999 and Stiglitz, 2002 for groundwork). We reverse this stance but retain the same analytical categories in an effort to inventory those externalities liable to be internalized by the market.

Based on the work of Samuelson (Samuelson 1954), Cornes & Standler proposed to characterize public goods in terms of two core analytical dimensions: rivalry and exclusivity (Cornes & Standler, 1999). Running with the analytical stance outlined above, we also reintegrate these two concepts, but this time in order to categorize externalities:

- 1- **Rivalry**: An externality is rival when a stakeholder affected by the externality effect alleviates the deterioration in the welfare of other stakeholders. The first-line victim 'absorbs' all or part of the externality, as if this absorbed part gets almost 'neutralized' in some way, with the result that it can no longer cause further damage to other

stakeholders. The stakeholder finds itself forced to acquire the externality, in an acquisition that stems the spread to other stakeholders. On the flip-side, an externality is nonrival when a stakeholder bearing the burden of the externality cannot curtail further deterioration to the welfare of other stakeholders. In this configuration, all of the stakeholders find themselves involuntarily taking 'ownership' of the externality.

- 2- **Exclusivity**: An externality is exclusive when there are options for ringfencing or factoring out deterioration to the welfare of certain stakeholders. In contrast, the externality is non-exclusive when there is no way for the stakeholders to escape deterioration of their welfare. All stakeholders are exposed to the externality, and if the externality is non-exclusive, they will all suffer the burden of damage to their welfare.

The table below illustrates the different externality configurations in terms of rivalry/nonrivalry and exclusivity/non-exclusivity. We assert that externality can be shortlisted into four core categories: private externalities, club externalities, common-pool externalities and public externalities.

	Rivalry	Non-rivalry
Exclusivity	<p align="center"><u>PRIVATE EXTERNALITY</u></p> <p>Victims can be excluded, and some victims are more affected than others.</p>	<p align="center"><u>CLUB EXTERNALITY</u></p> <p>Victims can be excluded, and all are exposed to the same amount of externalities.</p>
Non-exclusivity	<p align="center"><u>COMMON-POOL EXTERNALITIES</u></p> <p>Victims cannot be excluded, and some victims are more affected than others.</p>	<p align="center"><u>PUBLIC EXTERNALITIES</u></p> <p>Victims cannot be excluded, and all are exposed to the same amount of externalities.</p>

Table 1 - *Classes of externality*

Although the boundaries defining externalities have remained fuzzy and unsatisfactory for years, research on public good theory enables us to develop a clearer organizational breakdown, as illustrated in the table below, of the different types of externality potentially offloaded by firms onto their stakeholders. The point to underline is that this class-clustering system is essentially a heuristic matrix (as for public goods) designed to capture, grasp and decipher real-world situations that, as ever, are actually far more complex:

- 1- **Private externalities:** In this configuration, the victim bearing the externality burden can be excluded or at least shielded, and therefore avoid damaged welfare. The exclusion can be assured if the firm pumps in the investment needed to evolve their production process and/or the features of their goods or services in a way that no longer offloads the externality. Technical and organizational transformations can viably exclude victims from the negative externality spin-off. The second feature lies in the fact that there is a limited number of victims, and that these victims essentially ‘protect’ other vulnerably-exposed victims. This is typical of the type of effect R.H.

Coase explores in his 1960 paper dealing with the damage imposed on a farmer's land by a cattle-raiser's straying cattle (Coase, 1960).

- 2- **Club externalities:** Some stakeholders can be shielded; the others share the exact same degree of the damage burden. The externality is generally boundaried to consumer-stakeholders and/or user-stakeholders of the goods/services creating the externality, or to stakeholders in the company's immediate environment. Take the example of airport nuisance. The externality of this economic activity can easily be avoided simply by moving out. On the other hand, the fact that some neighbors suffer from the airport nuisance does nothing to alleviate any of the damage caused to other neighbors. Club externality means consumption or production of goods or services that structurally generate collateral damage. Obviously, greater numbers of consumers and/or producers will mean higher costs tied into ring-fencing stakeholders, a mechanism that will tend to make this externality a common-pool or public externality.

- 3- **Common-pool externalities:** This is a class of externality where it proves painfully difficult to shield and exclude stakeholders, who suffer differentiated degrees of the damage burden. A classic example of common-pool externality would be an oil spill. An oil spill actually affects a limited number of victims, a handful of seaside resorts, whose value is highly dependent on their location. Some of them have to cope more directly with the oil spill damage, leaving others with less of the burden to bear. Common-pool externalities are often geographically boundaried, difficult to forecast, and essentially accidental. U. Beck gives a good description of this externality class in his work on risk society (Beck, 1986). Beck characterized these externalities as essentially non-exclusive, which means that all of us could potentially be affected or that it may be impossible to shield certain stakeholders.

4- **Public externalities:** all stakeholders suffer the damage burden in equal proportions.

CO₂ is an illustration of this kind of externality currently at work. There is no way to escape global warming, and everybody suffers the consequences of global warming in equal proportions.

Our negative externality clustering framework based on market failure theory clearly highlights how different firms have to face different CSR issues depending on the type of externality they impose on their respective environments. Firms have different realities to contend with because different industry sectors, different structural sizes and different stakeholder bases dictate different types of challenges to the processes of internalizing what are different externalities. Strategically, the CSR challenge is directly shaped by the type of externality being offloaded onto the firm's stakeholders. A firm shedding private externalities incurred by a limited number of stakeholders suffering different degrees of welfare burden does not have to deal with the same issues and challenges as a firm offloading a public externality that all shareholders are expected to cope with in equal measure. A farm shedding pesticides onto a vineyard (private externality) will not be confronted with the same degree of pressure as a cement plant shedding massive CO₂ emissions (public externality) directly fuelling global warming. In scenario one, it may prove relatively straightforward to forge a solution between polluter and polluted party, i.e. never applying pesticide treatments on windy days. In the second scenario, however, there is no viable technical solution to eliminate the externality short of shutting the cement plant down. It is these differences, which are easy to spot in real-life situations that give full meaning to questions over the prerequisite conditions to the voluntary internalization of negative externality under CSR. The key lies in identifying whether all classes of externality have the potential to be profitably internalized under socially-responsible policy and practice, i.e. identifying whether there is a creditworthy demand for each of the externality classes contoured above, as only a creditworthy demand

can enable firms to strike a balance between maximizing profit and integrating social and environmental variables.

Having made it clear that different firms will face different challenges according to whether or not they are able to exclude stakeholders (whether the externality is exclusive or non-exclusive) and take back externality ownership from certain stakeholder-groups (whether the externality is rival or nonrival), the challenge becomes to ascertain what types of externality can be made profitably internalizable for the firm, and under what market conditions.

II- Conditions for a profitable internalization of externalities on the marketplace through CSR

Which types of externality have the potential to be internalized under socially-responsible policies while creating market value? We begin by reviewing the latest endeavors of the strategic CSR stream to tackle the topic of CSR and value creation. Mobilizing the model developed by McWilliams & Siegel (2001), we show that the research so far has mainly been focusing on the “supply side of CSR” programs with a value-capture view (II.1). We shift focus to concentrate on the “demand-side of CSR” with a constructivist perspective on value creation. We look at the market conditions for a profitable internalization of externalities and propose three necessary conditions: stakeholders’ willingness-to-pay, low transaction costs, and a sufficient social acceptability of the new market (II.2). We then link these conditions to the four externality classes contoured above, and identify which categories show more potential for birthing profitable internalization via the market medium (II.3).

II.1- Economic value creation and strategic CSR

The view of McWilliams & Siegel is that CSR practice can be analyzed as a supply-and-demand model (McWilliams & Siegel, 2001). Firms better able to balance CSR-supply and

CSR-demand are more likely to build socially-responsible practices and internalize their externalities. This balance can be shaped and established by heavily leveraging market expectations and primarily those of the core audience, consumers (CSR-market demand), and by allocating the organizational resources (CSR-supply) that can enable the firm to make profit. This kind of win-win scenario, where the winners are the firm and the firm’s environment, will reflect a scenario where costs are cut or where either product market or production inputs secure differentiability. A scenario that features the two sources of competitive advantage (Porter 1985; Rumelt 2003) so extensively explored in the strategic CSR literature. The table below provides a non-exhaustive listing of papers researching the investment strategies businesses have deployed in order to strike new tradeoffs on CSR-related variables and the tied-in value-creation mechanisms:

Competitive advantage	Mechanism	Source
Costs	<ul style="list-style-type: none"> - Efficiency savings - Rebound effect-driven improvement in production processes - Opportunity costs on sidestepping future regulatory sanctions - Synergy with HR missions (motivation, turnover...) 	(Porter 1990; Porter and Van Der Linde 1995; Esty and Porter 1998) (Hart 1995) (Turban and Greening 1997) (Russo and Fouts 1997) (Nehrt 1998; Klassen and Whybark 1999) (King and Lenox 2002) (Smith 2003) (Reynaud 2005) (Branco and Rodrigues 2006) (Orsato 2006)
Differentiation	<ul style="list-style-type: none"> - New products - New markets - Lower reputation risk on goods markets and productive inputs markets (capital+ recruitment) - Attractive pull for investment 	(Davis 1973) (Fombrun 2000) (Orsato 2006) (Porter and Kramer 2006) (Branco and Rodrigues 2006)

Table 2: *Mechanisms of value creation through pro-CSR approaches*

The published research cited above has significantly fleshed out the “CSR supply” issue, poring through various differentiation strategies firms can opt to deploy, in conjunction with

the best-gearred investment strategies. Nevertheless, there are still grey areas plaguing the link between strategic CSR to value creation. First off, there has been little in-depth analysis on the market forces-driven approach to CSR and internalizing externalities. The postulate implicitly sketched out is that there is demand among consumers and that firms need recognize and or promote this demand if they hope to strike a new socially virtuous and economically profitable balance. However, the reality is that we actually have little grasp on how this market-driven CSR approach actually is shaped.

Second, refocusing explicitly at Michael Porter's conceptual framework for competitive advantage, the above-cited research struggles to shake off an overarchingly naturalistic vision of economic value. This translates into a pervasive conception of some kind of existing value that needs to be shared more 'fairly' between the firm's different stakeholders. Porter illustrates this line of reasoning by using a well-worn metaphor in neoclassical economics circles: you'll never find a \$10 note on the ground, as someone driven by his own greed will always pick it up before you do (Porter and Van Der Linde 1995: 98). We defend in this paper that a more constructivist and open-ended view on economic value would generate key insight into the processes of marketplace value creation. To illustrate our line of thought, let's go back over Porter's metaphor on the \$10 note. M. Porter claims this money can never be found lying on the ground due to the maximization of profit-generating functions in an economy geared to the neoclassical paradigm. Exploring deeper, our touchstone is that the very criteria defining value itself are not universally shared but are actually social constructs. The key idea that we defend here is this: the issue is not how to lay our hands on that \$10 bill; the real issue is to understand that the worn-out piece of paper lying there on the ground is actually a banknote and that a great amount of stakeholders can benefit from this paper without impacting the utility of the other users.

M. Porter recently authored a paper revisiting the potential business benefits that can be created for firms adopting sustainable development strategies. The paper discussed the “business case” as a possibility. The article went on to embrace the concept of “shared value”, defined as a “*society-oriented benefit that can create value for the firm*” (Porter and Kramer 2006: 8). This notion is key groundwork to addressing the issue of co-building value and market demand for CSR-oriented investment. Our research topic could be reformulated in the following terms: what set of conditions would enable the creation of a shared value syndicating both firm and stakeholders around the internalization of negative externalities? It is precisely this question that we set out to address by investigating the conditions to be harnessed together in order to create a market-driven demand capable of counterbalancing the investment budget required to internalize negative externalities.

II.2- Prerequisite conditions to market-driven demand for CSR

Our research suggests that three requisite sets of conditions are needed before firms voluntarily taking ownership of negative externalities can successfully become operational practice: stakeholder willingness to pay, low transaction costs, legitimacy of the transactions. We start out by tightening up the McWilliams and Siegel framework, detailing the various marketplace configurations liable to create profitable returns on the investment plough-in needed for external effects to be internalized (a). We then show that for marketplace demand to emerge, the transaction cost have to be low (b) and the transactions involved in leading the externality internalization project have to be socially acceptable (c).

a- Stakeholder willingness to pay for the internalization of externalities

McWilliams and Siegel clearly underlined that one of the pivotal conditions that could drive firms to internalize the externalities they previously offloaded onto stakeholders is that the firm has to have options for offsetting all or part of the organizational and transaction costs

related to the internalization of “*social and environmental costs*”. This implies that there has to be business opportunities available enabling the firm to offset these extra costs and thus orchestrate some degree of stability in their value creation chain. Our vision is that there are two ideotypical scenarios underpinning the emergence of a CSR demand that would enable a firm to gain profitable return on the investments it channels into internalizing its negative externalities:

1- Simple transactions: In configuration 1, the beneficiary under the internalization of negative externalities is ready to pay to improve his situation. This is kind of scenario outlined by R.H. Coase in his seminal 1960 paper (Coase, 1960). Coase, working within a straightforward polluter-polluted model, envisioned the option that the polluted party could provide the producer economic compensation to incentivize internalization of the externality. Stakeholders would table their own negotiations, after which the victim could subsequently be led to finance the internalization if it proved an economically cheaper option than the welfare-related damage suffered. This solution hinges on the firm bargaining with the externality-impacted stakeholders to reach consensus on an amount of compensation to be paid by one party to the other. This financial compensation can be employed either to directly improve the welfare of the stakeholder or to reimburse the firm for costs incurred in actions led to curb or eliminate the externality.

2- Two-sided transactions: In configuration 2, a third party is ready to finance the welfare safeguarded through the internalization of an externality that someone else experiences as negative. Pivotal to this configuration is that there has to be differentiation between externality-impacted victims and the agents set to create value through the internalization process, which equates to building a 3-factor model where the factors are all three agents: a polluter, a polluted party, and a third party free of the

externality loop but ready to pay for it to be internalized. This scenario spawns a two-sided transaction (Rochet and Tirole 2003; Eisenmann 2006). The first is between the firm and the stakeholder bearing the externality burden. The outcome sought is either to reduce the negative impact on the stakeholder via a transformation of the production process, or to provide financial compensation for the damage suffered. The second transaction occurs between the firm and a third-party stakeholder who is ready to finance and compensate the additional costs generated in transforming the value creation chain or the financial compensation paid to the front-line stakeholders. This scenario is based on the supposition that there would be a third-party stakeholder with a sufficient ‘willingness-to-pay’ to improve the situation of someone else (Lankoski 2000; Jackson and Nelson 2004; Reinhardt 2005; Lankoski 2006; Elkington and Hartigan 2008). There is an array of real-world examples stretching from fair-trade business to organic cotton textiles and back to socially responsible investing.

In both cases, the decisive factor pivotal to market creation is the stakeholder or consumer’s level of willingness-to-pay. If it proves greater than the internalization costs, then the first condition precluding value creation in the marketplace via the internalization of externality has already been met. The diagram below illustrates our analysis of CSR demand.

b- Low transaction costs

That said, the existence of a stakeholders’ willingness to pay alone cannot be expected to guarantee that market forces-led externality management is a valid and profitable solution.

The free market is in fact a misnomer, as markets are not, in fact, free; there will always be ‘*transaction costs*’⁴ (Coase 1937) some of which can be too heavy for markets to build

⁴ Generally defined as the amount of resources allocated to organizing and safeguarding business deals. There are, in general, three types of transaction costs: the costs stemming from the search for the fairest price, the costs

(Coase, 1988). The money pumped into market research, winning contracts and tracking their execution can, as in many other marketplaces, act as a barrier to establishing a profitable compromise on negative externalities. The amount of transaction costs may mean that the market cannot be organized, even though there may be stakeholders ready to input funding to curb the welfare damage burden on themselves or on other stakeholders. Overlooking the transaction costs issue as a factor in attempts to establish a compromise of externality ownership between firms and stakeholders would automatically place us in a world that R.H. Coase claims has no real-world economic foundation (Coase 1988; Coase 1996). Thus, if our goal is to embed trade transactions as part of the externality internalization process, then transaction costs have to be factored in.

Furthermore, transaction costs prove particularly high in two-sided transactions, i.e. where a third-party stakeholder pays to improve the welfare of another stakeholder. This is because, as stated above, there is one set of transaction costs between the firm and externality-impacted stakeholder and a second set of transaction costs between the firm and the third-party stakeholder.

Over and above the existence of a creditworthy demand and low transaction costs, there is a third and final requisite condition to the emergence of a market-led solution on externality management: the social acceptability of the business transactions connected with the externalities.

c- The social acceptability of transactions on external effects

In the best-case scenario where a creditworthy demand was paired with low enough transaction costs for the agents to enter negotiation, there is still a third condition-set that

of contract negotiations, and the costs of making sure that the contract terms are complied with and followed (Coase, 1937, 1988, pp. 38-39; Fox, 2006).

would need to be met: transactional legitimacy, or in other terms, the transactions led to finance the internalization solution and/or compensate the stakeholders' welfare damage burden would have to be socially acceptable (Esping-Andersen 1985; Kuttner 1997).

The emergence of business transactions designed to internalize externalities raises a number of ethical issues. This a point that resonates in a number of debates centered on the economic assessment of social and environmental damage. The search for compromise and its corollary the commoditization of the living world in order to come up with figures to serve as a basis for stakeholder transactions cannot but raise questions. This system of 'sinister accounting' ties directly into highly delicate moral and ethical issues that directly challenge the social acceptability of any market forces-driven solution for handling negative externalities. There are many situations where stakeholders would be likely to consider the '*market for virtue*' as immoral, claiming that certain rights are non-negotiable. Business transactions designed to internalize externalities, inevitably, are tightly governed by a much wider institutional infrastructure, which may in some cases prove dissuasive enough to block the solution for reasons of moral or political unacceptability. The Nike and child labor casefile provides a salient illustration of the dynamics involved in economically-possible but socially-unacceptable solutions. It is not difficult to imagine Nike funding training programs for minors employed in Nike sweatshops, based on the rationale that these children would at least benefit from skillsets and training that would otherwise be way beyond their reach given the financial poverty of their parent families who depend on derisory salaries just to survive. The costs incurred in training these underage workers would be offset onto consumers, but western democracies would virulently condemn any form of child labor. In short, the transactions could not be instrumentalized since they would be judged socially unacceptable.

II.3- Externality types and conditions for marketplace value creation

We can now move on to the third tier of our argument. We have demonstrated that CSR and the internalization of negative externalities is not an all-inclusive but multicontextual issue, as there are several different category-sets. We then surfaced the different condition-sets needed to enable externality internalization programs to emerge within firm-led frameworks. One requisite is that there has to be a creditworthy demand in order to offset the investment ploughed in by firms, and another is that the transaction costs have to be low enough to enable agents to enter into negotiation and frame the optimal level of internalization. The third and final requisite condition is that the transaction arrangements settled have to be socially acceptable. The final hurdle now is to cross-match the externality classes to the market-driven value creation conditions in order to begin to understand fully-deployable business strategies for firms geared to the externalities they are offloading.

- **Public externalities**

To recap, victims cannot be excluded, and all victims share the same degree of welfare damage. The victims cannot be excluded because neither the technology nor the investment funds needed can be viably mobilized to protect them. The only way to eliminate the externality is to forcefully shut down the business, resigned to the losing access to the goods and services produced. Stopping short at abandoning the activity wholesale, what internalization management solutions are available to businesses offloading a public externality?

The firm is obliged to open negotiations with the externality victims to hammer out a financial compensation package (to offset the externality). This is only conceivable as an option if the transaction costs are low enough. At the same time, the firm also has to contend with having to engineer new technologies and/or processes liable to eliminate or at least reduce its

externality burden in the future. This solution may bear fruit in the long term, but in the more-or-less immediate timeframe the firm cannot hope to significantly cut the number of victims. The picture therefore is that any firm seeking to intelligently manage a public externality has to find the resources to compensate the victims *and* invest in new technology engineering. The crux of the issue therefore boils down to whether market-driven demand can extend to compensating victims and at the same time funding the necessary investments.

The simple answer is: probably not. Given that bargaining would have to be led with every single victim, the process would involve spiraling transaction costs. Furthermore, it is difficult to envisage a situation where it is the victims who are expected to pay the firm to minimize its public externality. After all, how could the victims win out in a cost-benefit analysis on paying the firm, whereas by very definition there are no technical measures to feasibly protect them from the externality effects? This would amount to victims paying the firm to offer them a financial compensation package. There is no hope for a simple transaction in situations involving a public externality. What about two-sided transactions? Options do emerge, as consumers (who are equally victims of the public externality) may, within the bounds of their resources, be ready to overpay in a move to cover the costs of compensating the other victims and drumming up the investments necessary to bring in fresh technology and processes. However, in the real world, this willingness to pay could never hope to finance the firm's internalization solution, as the sums involved (transaction costs and structural costs) would be way outside their bracket.

Firms generating a public externality therefore find themselves in a very uncomfortable position, having to contend with rising social pressure on one side from all the members of a entire community of externality victims all seeking financial compensation, and on the other side, a consumer willingness to pay that fatally falls short. Subsequently, there is no market-driven demand strong enough to cover the additional structural and transactional costs that a

public externality internalization project would generate. There is no market capable of simultaneously creating social value and economic value. Consequently, this form of externality can only be handled through political measures. The consumer-citizen is forced to reassess the trade-off: protect their welfare but forego the original good that creates the externality, or else consume the good but risk exposure to significant welfare deterioration.

- **Common-pool externalities**

In this configuration, victims cannot be excluded, but their welfare is affected to differing degrees. As with the public externality, the victims cannot be excluded because neither the technology nor the investment funds needed can be viably mobilized to protect them. Where the situation changes is that certain victims are more directly impacted by the externality. Internalization demand will therefore be weaker, but more targeted. What kind of internalization management strategy can the firm generating a common-pool externality offer?

The firm is finds itself is obliged to open negotiations with the first-line externality victims to bargain a financial compensation package (to offset the externality). This is only conceivable as an option if the transaction costs are low enough. At the same time, the firm also has to contend with having to engineer new technologies and/or processes liable to eliminate or at least reduce its externality burden in the future. Again, as with the public externality, the picture is that any firm seeking to intelligently manage a common-pool externality has to find the resources to compensate the victims *and* invest in new technology engineering. Will the firm innovate a market-driven demand capable of compensating victims and at the same time funding the necessary investment?

If transaction costs are too high, the firm can opt to negotiate with the first-line victims in order to bargain a compensation package. However, as with public externalities, there is no

rational reason why victims should be expected to pay a company to get the same sum back as compensation. At this juncture, the firm may turn to consumers to drum up compensation-package and internalization-investment funds, but again, there is little chance that willingness to pay would stretch to covering the additional structural and transaction costs involved.

This situation also clearly spotlights the social acceptability issues involved with firms leading transaction agreements with the front-line victims. There is an overriding sense that victims are being sacrificed to defend the welfare of consumers, which itself raises heavy ethical and political issues. Even if a firm was able to realistically offer a compensation package, the solution would come flagged with social justice issues that would surely prove too problematic for a market forces-led solution. In situations involving a common-pool externality, it is highly unlikely that the marketplace can simultaneously create social value and economic value, as the firm is too vulnerable to political risk.

- **Club externality**

In this configuration, all the victims suffer the same welfare deterioration, but they can be excluded. Technological and organizational solutions make the victims subtractable, and these solutions are affordable. Yet although, from the outside, this situation appears fairly simple to resolve, we are about to see how the picture is far more complex from the inside, where the line dividing victim and consumer blurs.

In terms of internalization offer, the firm can craft mechanisms either to exclude or financially compensate the victims. It will weigh up the two options, and run with the least costly mechanism. The key point is to ascertain who the members of the club are. Two potential storylines: either the victims were nonconsensually dragged into the club where they are now unwillingly exposed to the externality, or else the victims opted into the club, fully aware that

they were also opting to remain exposed to the externality. This is the juncture at which victim and consumer overlap, and this confusion spawns significant ambiguities.

If the members were ‘conscripted’ into the club, the firm can deploy an internalization program to protect them, offsetting the costs onto the market. If the transaction costs remain affordable, the firm may choose to negotiate directly with the victims. If the solution provides the victims with the greatest benefit, they may decide to finance the investments committed by the firm under its externality internalization program. Consumers, too, may also be roped in to finance compensation packages, investment funding, or both. This time, the situation means that a market can emerge to finance the investment component. In other words, the marketplace will have engineered a situation where social value and economic value can be created side-by-side.

If the victims make a conscious decision to enter the club, consequently repositioning themselves in the camp of consumers of the good(s), then things get more complicated. Excluding the victim would equate to excluding a consumer. The victim therefore has to overpay to financially compensate self-inflicted damages. This is a setting where it makes no sense at all to exclude the victim, as the firm would be cutting away its revenue base. The only solution that remains open, then, is compensation.. This solution equates to the firm openly admitting that to consume its products is to deteriorate the welfare of its customers. The firm finds itself having to raise funds to compensate its own consumers – a scenario that, although theoretically impossible to rule out, remains highly improbable. The only way forward for the firm is thus to retain its consumers and protect its victims – who in this situation happen to be exactly the same people. A relatively absurd situation, true, but one that accounts for a number of real-world social consumption patterns, including cigarettes, alcohol, medicines, fast food...

- **Private externality**

In this configuration, the victims can be excluded, and some victims suffer heavier welfare deterioration than others. As with club externalities, there are two internalization strategies: compensate or exclude the victims. The firm will run with the least costly mechanism.

Driving demand are two potential sources of finance. If the transaction costs are affordable and if the solution provides the victims with the greatest benefit, they will finance the firm's investment effort to exclude themselves from the externality. Consumer resources may also be roped in.

This is the situation where a market-driven solution to externality management remains the most plausible – although the solution still hinges on reasonable transaction costs and on the firm bargaining socially-acceptable transactions with victims. The firm's strategy looks clearly signposted: educate consumers so that they become aware of the externalities tied into using the goods and services, and invest to exclude as many victims as possible.

The following table recaps on firms' CSR strategy options according to the externalities they push on:

	Rivalry	Non-rivalry
Exclusivity	<p>PRIVATE EXTERNALITY</p> <p>Educate consumers and invest to exclude victims</p>	<p>CLUB EXTERNALITY</p> <p>Cover risks and educate consumers</p>
Non-exclusivity	<p>COMMON-POOL EXTERNALITY</p> <p>Sacrifice some victims for the collective well-being</p>	<p>PUBLIC EXTERNALITY</p> <p>No way out on the marketplace</p>

Table 3: *CSR Strategies and externality classes*

Conclusion

This article is a first walk-through designed to address the market conditions underpinning the CSR business case, which many authors have taken as a direct assumption for CSR strategy: that there are business opportunities for internalizing externalities.

Pursuing on from K. Arrow's work, we began by demonstrating that the CSR paradigm is host to a diverse cross-section of social and economic realities, as different firms push on different classes of externality. Victims bearing the externality burden can be excluded in some cases, but not in other cases where there the technological and financial resources needed are simply way out of reach. The externality may affect all community members equally, whereas in other settings only a fraction of group members bear the externality burden. We identified four ideal-type of externalities: private externalities, common-pool externalities, club externalities and public externalities. These differing real-world patterns of business-induced externalities mean that different firms will face different CSR challenges.

We moved on to stop and question the value-creation condition-sets liable to usher in socially-beneficial internalization and whilst remaining profitable for the firm at the source of the externality. This process was completed by extending the McWilliams and Siegel framework to detail the requisite conditions that would enable the emergence of market-driven solutions for financing externality internalization. There are three critical baseline conditions: stakeholders with willingness to pay, low transaction costs, and socially-acceptable transactions agreed between the firm and the victims shouldering the externality.

We completed this three-tier analysis by cross-matching externality classes against the requisite conditions for creating market value liable to generate social and private-sector benefits side by side. Clearly, the only externality category that can potentially be solved into

a CSR-based externality internalization solution is the ‘private’ externality class – and only if all three condition-sets outlined above are met.

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