

Entrant companies competing with “green” incumbents – incentives to refrain from CSR

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Abstract. The attention given to CSR has in recent years increased, so much by the public, consumers, activist groups, non-government organizations as well as by policy-makers. In the light of the persistent call for CSR, firms seem to react by increasingly engaging in activities which enhance their socially responsible image. This paper aims to examine the incentives of potential entrant firms to engage in CSR, when incumbent firms are socially responsible. We assume a market with a socially responsible incumbent and two types of consumers, conscious and unconscious. We find that refraining from CSR is a means to differentiate from the rival and soften competition.

Keywords: Corporate Social Responsibility, Entry, Differentiation

INTRODUCTION

The attention given to CSR has in recent years increased, so much by the public, consumers, activist groups, non-government organizations as well as by policy-makers. In the light of the persistent call for CSR, firms seem to react by increasingly engaging in activities which enhance their socially responsible image. According to the European Multistakeholder Forum (Commission of the European Communities, 2004, p. 7) “CSR is a concept whereby companies integrate social and environmental concerns in their business operations and in their interactions with their stakeholders on a voluntary basis.” While the EU, local governments and international organizations such as the OECD, the UN, the ILO are focusing on designing policies to promote and support socially responsible behaviour from the part of business the practice of CSR is not mandated and is left to businesses’ own devices to be socially responsible and choose whether and to what extent they will be socially responsible. So the question that emerges then is, are there incentives for business to practice CSR? What are those incentives and to what extent can they be relied upon? So much of the discussion about CSR is focused on the incentives of companies to practice CSR.

On the one hand policy-makers and academics argue that there is a business case for CSR and that business should see CSR “as an opportunity: an opportunity for enterprises themselves, for their stakeholders and for society at large” (Commission of the European Communities, 2007a, p.5) and see CSR as a long-term investment which should be part of a firm’s strategy. It has been argued (Cochran and Wood, 1984; Waddock and Graves, 1997)¹ that there is a positive relationship between CSR and financial performance. Also, it has been argued (Baron, 2001; Feddersen & Giliggan, 2001) that under the threat of boycotts or collective action against socially irresponsible behaviour, firms have incentives to pre-empt such actions by actively engaging in CSR. A lot is said about the role of consumers in inducing firms to be socially responsible. Given that there is a fraction of consumers who value products and services produced by socially responsible companies, it is argued in the literature (Arora and Gangopadhyay, 1995; Innes, 2006) that pressures from those consumers can induce companies to voluntarily practice CSR. To the same direction, it is argued that companies choose to practice CSR because they identify the benefits in the marketplace from doing that. According to Porter and Kramer (2006, p. 3) “CSR can be much more than a cost, a constraint of a charitable deed – it can be a source of opportunity, innovation and competitive advantage”. Porter and Kramer (2006) argue that firms should incorporate CSR in their strategy if they want to secure long-term prosperity, as socially irresponsible

¹ Although it is the case that the positive relationship between financial performance and CSR has been challenged. See for example, McWilliams and Siegel (2000) and Wright and Ferris (1997).

behaviour towards stakeholders (whether it is in the form of harming the environment or in the form of disadvantaging society) will reflect back to the company affecting its economic performance, brand reputation, relationship with buyers and suppliers. To the same direction with Porter and Kramer it is argued by the EU that CSR can yield benefits for the business in two dimensions, internal and external, by allowing it to create a healthy and safe work environment, increase employ satisfaction and price and thus allow it to manage its human resources better, by allowing it to adopt to change and manage natural resources better, control harm to the environment, by making it acceptable by local communities and by allowing it to have better relationships with business partners and suppliers (Commission of the European Communities, 2007a).

On the one hand a lot is said about the cost of CSR, the complications involved in practicing it and the lack of knowledge from the side of business and information from the side of stakeholders regarding CSR which are clearly disincentives for firms. “CSR covers a wide variety of issues and can, for that reason, appear overwhelming or excessively complicated, especially for small business” (Commission of the European Communities, 2007a, p. 12). Practicing CSR entails a cost which for smaller companies is often higher than for larger companies. As put by the European Multistakeholder Forum on CSR (Commission of the European Communities, 2004, p. 69) smaller companies “are already operating in a very complex environment”, with many of them placing priority on staying in business than on practicing CSR. Competition with larger companies is fierce and smaller companies struggle to establish a unique competitive position in the market in order to survive. “For smaller companies in particular, even when there are net benefits in prospect, there may not be the resources available to deploy, or other more immediate pressures and competing priorities may mean that CSR is not pursued.” (Commission of the European Communities, 2004, p. 9). Rodriguez and LeMaster (2007) argue that the increased cost of regulated CSR disclosure as required by the U.S. Securities and Exchange Commission increases companies’ costs and results in companies delisting from the U.S. stock market. The authors say that although regulated disclosure increases transparency and “reduces litigation, capital costs, and propriety costs” (p. 374), it increases the additional costs of disclosure for smaller companies and this in turn results in the delisting from the U.S. market.

A lot is said about the role of consumers in pressuring firms to practice CSR. However, it is arguable that consumers have enough or good quality information regarding CSR practices by firms and thus are not in a position to scrutinise their behaviour. According to the EU the information that consumers have is often confusing and inconsistent (Commission of the European Communities, 2007b). Although Mohr et al (2001) argue that there can be pressure from conscious consumers to firms to practice CSR, they also

express concerns regarding whether consumers have the information required and urges companies and policy-makers to ‘educate’ consumers about firms’ practices. They also say that “[c]onsumers’ beliefs about CSR [...] are often inconsistent with their behaviours (i.e., not purchasing based on CSR)” (p. 69). Finally they say that “[c]onsumers are more likely to boycott irresponsible companies than to support responsible companies” (p.69). From the above it is evident that to the very least consumer pressures cannot provide an incentive to practice CSR.

With the aim to contribute to the debate about firm’s incentives to practice or to refrain from CSR this research examine the incentives of a potential entrant company to invest in CSR. We assume that CSR takes the form of a “green” license – we use the term “green” as it is an identifiable term, while it is the case that CSR could take any other form such as a community project, or charity. There is a market with an incumbent firm, which is socially responsible; it has a “green” license. An entrant firm wants to enter the market and compete with the incumbent. The market consists of two types of consumers, we call them conscious consumers – they are those who value CSR and prefer to consume the “green” product; they get a disutility from not consuming the “green” product – and unconscious consumers – they are those who will consume any product “green” or not. We want to examine the incentives of the incumbent to accommodate or deter entry. More importantly we want to examine the entrant’s incentives to obtain the “green” license or not. We find that there are circumstances under which the entrant would rather refrain from CSR and choose not to compete directly with the incumbent – not practicing CSR is a form of product differentiation – in order to avoid the incumbent’s aggressive reaction and to soften competition. So in a way we agree with McWilliams and Siegel (2001) who argue that “CSR may be a popular means of achieving differentiation, because it allows managers to simultaneously satisfy personal interests and to achieve product differentiation”² only that we show that refraining from CSR can also be a means of achieving differentiation.

THE MODEL

The market

There is a market with an incumbent firm, which is socially responsible; it has a “green” license. A potential entrant firm wants to enter the market, produce the same product and compete with the incumbent – this means that we assume that if the entrant enters the market the products of the two firms

will be homogeneous. We assume that entry entails no costs³. Also, we assume that obtaining the “green” license entails no cost⁴. We assume that both firms incur the same marginal cost c for producing the product and no fixed costs.

We assume a unit mass of consumers who are of two types, we call them conscious consumers – they are those who value CSR and prefer to consume the “green” product – and unconscious – they are those who do not care if the product is “green” or not. The fraction of conscious consumers is α and the fraction of unconscious consumers is $1 - \alpha$. Consumers enjoy a gross surplus when consuming from either firm. The conscious consumers have a preference for the “green” product and entail a disutility equal to k from having to consume the product produced by a firm that does not have a “green” license – we will call this the “other” product.

Unit demands

Here we assume that consumers have unit demands, they buy one or none. The gross surplus from consumption of the product is s .

Before entry the incumbent monopolizes the market, charges the monopoly price

$$p^M = s$$

and enjoys monopoly profits equal to

$$\pi^M = s - c$$

Consumers enjoy no surplus.

The entrant must decide whether to enter or not and whether to obtain the license or not. If entry takes place then the two firms set prices and compete for market shares. Thus this is a two stage process where in stage one the entrant decides whether to enter with a license, enter without a license or stay out of the market and then in stage two the two firms engage in price competition.

² McWilliams and Siegel (2001) do not develop any formal model of differentiation. In their paper they only discuss the prospect of product differentiation through CSR.

³ We are interested in examining the incentives to practice CSR, so we make this assumption because we develop a simple model of entry and we want to avoid making the question trivial. If entry costs are positive and products homogeneous, Bertrand competition will lead to negative profits for the entrant and entry will not occur.

⁴ Again we make this assumption in order to avoid getting into questions about whether we should include a “green” license cost for the incumbent in the analysis, or whether we should assume that the incumbent has recovered the license cost. We could assume for example that the firm obtains the license by announcing publicly that it will be “green” and to avoid being too simplistic we could assume that failing to rise up to the announcement entails a very high cost such that it does not pay to not keep the announcement. This is also more in line with the fact that small entrant companies are less likely to get into sophisticated CSR practices and commit to CSR in a formal way and more likely to announce that they will practice CSR and try to make the announcement true (Commission of the European Communities, 2007a).

Entry with a license

The entrant can choose to enter the market and obtain the license. In this case the two products will be homogeneous in every aspect and thus in stage two we will have a typical Bertrand competition model with homogeneous products, where the equilibrium is characterized by

$$p_I^B = p_E^B = c$$

and

$$\pi_I^B = \pi_E^B = 0$$

Entry without license

In this case the firms will compete for market shares. For the incumbent to be able to attract the unconscious consumers it must be

$$p_I^C = p_E^C = c$$

The two firms will split the market for unconscious consumers and the incumbent will retain the conscious consumers. Profits for the two firms will be

$$\pi_I^C = \pi_E^C = 0$$

Alternatively the two firms can split the market such that the entrant takes the whole market of unconscious consumers and the incumbent retains the market of conscious consumers. This will happen if the incumbent charges a price such that

$$p_E^{LM} - k < p_I^{LM} < p_E^{LM}$$

It suffices that the incumbent charges

$$p_I^{LM} = s$$

and the entrant charges

$$p^{EM} = s - \varepsilon$$

where $\varepsilon > 0$ is a very small number such that $\varepsilon < k$. In this case the unconscious consumers will be attracted by the entrant and the conscious consumers will be attracted by the incumbent. The conscious consumers will enjoy no surplus in equilibrium, while the unconscious consumers will enjoy a surplus equal to ε . The profits for the two firms will be

$$\pi_I^{LM} = (s - c)\alpha$$

for the incumbent and

$$\pi_E^{LM} = (s - \varepsilon - c)(1 - \alpha)$$

for the entrant.

Clearly between the two, competing for market shares or monopolizing their respective markets, both firms prefer the latter, as this allows them to enjoy positive profits. What makes the difference here compared to the ‘entry with license’ case is that the entrant refrains from CSR and differentiates its product from that of the incumbent firm. The existence of different preferences in the market with respect to CSR allows the two firms to relax competition between them and constrain themselves to the part of the market where they have an advantage in the eyes of the consumer (lower price for the unconscious consumers, “green” product for the unconscious).

Entry deterrence

Would the incumbent want to deter entry? Again we will examine this question in a simplistic way. We will assume that the incumbent can spend an amount of money D before entry occurs (in stage zero) to deter entry. For example we could assume that the incumbent spends an amount of money to educate unconscious consumers so that they prefer the “green” product. If entry is deterred then the incumbent will continue to charge the monopoly price

$$p_I^M = s$$

and get profit equal to

$$\pi_I^{MD} = s - c - D$$

So the incumbent will decide whether to deter entry or not comparing

$$\pi_I^{LM} = (s - c)\alpha$$

and

$$\pi_I^{MD} = s - c - D$$

and will decide to deter entry if

$$(s - c)(1 - \alpha) \geq D$$

This says that the incumbent will deter entry only if the monopoly profits gained in the market of the unconscious consumers exceed the cost of deterrence. So the lower the cost of entry deterrence, the less resources required for it, the more likely it is that entry will be deterred. Also, the higher the fraction of unconscious consumers in the market the higher the incentives of the incumbent to deter entry. Contrary if unconscious consumers are a small fraction of the total market then the more likely it is that entry will be accommodated and the two firms will monopolize their respective markets.

Elastic demands

Here we will drop the assumption of unit demands and assume that the net surplus from consumption is

$$v(p_i) = \frac{p_i^{-(\eta-1)}}{\eta-1}$$

where p_i ($i = I, E$) is the price of the product and η is the price elasticity of demand⁵, so that

$$v'(p_i) = -q_i$$

Like in the case of unit demands, before entry the incumbent monopolizes the whole market, charges a price given by

$$\frac{p^M - c}{p^M} = \frac{1}{\eta}$$

and enjoys monopoly profits. Consumers enjoy no surplus.

The entrant must decide whether to enter or not and whether to obtain the license or not. If entry takes place then the two firms set prices and compete for market shares. Thus this is a two stage process where in stage one the entrant decides whether to enter with a license, enter without a license or stay out of the market and then in stage two the two firms engage in price competition.

Entry with license

The entrant can choose to enter the market and obtain the license. In this case the two products will be homogeneous in every aspect and thus in stage two we will have a typical Bertrand competition model with homogeneous products, where the equilibrium is characterized

$$p_I^B = p_E^B = c$$

and

$$\pi_I^B = \pi_E^B = 0$$

⁵ Since the products are homogeneous there is no reason to assume different elasticities.

Entry without license

In this case the firms will compete for market shares. For the incumbent to be able to attract the unconscious consumers it must be

$$p_I^C = p_E^C = c$$

The two firms will split the market for unconscious consumers and the incumbent will retain the conscious consumers. Profits for the two firms will be

$$\pi_I^C = \pi_E^C = 0$$

Alternatively the two firms can split the market such that the entrant takes the whole market of unconscious consumers and the incumbent retains the market of conscious consumers. This will happen if the incumbent charges a price

$$p_E^{LM} < p_I^{LM}$$

such that

$$v(p_E^{LM}) - k < v(p_I^{LM}) < v(p_E^{LM})$$

In this case the unconscious consumers will be attracted by the entrant and the conscious consumers will be attracted by the incumbent. The firms will both enjoy positive profits equal to

$$\pi_I^{LM} = (p_I^{LM} - c)\alpha q_I^{LM}$$

and

$$\pi_E^{LM} = (p_E^{LM} - c)(1 - \alpha)q_E^{LM}$$

for the incumbent and the entrant respectively.

Maximizing the firms' profits w.r.t prices yields

$$\frac{p_I^{LM} - c}{p_I^{LM}} = \frac{1}{\alpha\eta}$$

for the incumbent and

$$\frac{p_E^{LM} - c}{p_E^{LM}} = \frac{1}{(1 - \alpha)\eta}$$

for the entrant. So the two firms will adjust their monopoly prices to account for their relevant market power which is measured by the part of the size of the market that has a preference on the product of each firm.

So does the inequality

$$v(p_E^{LM}) - k < v(p_I^{LM}) < v(p_E^{LM})$$

hold? Firstly consider the second inequality

$$v(p_I^{LM}) < v(p_E^{LM})$$

It turns out after some algebra that this inequality holds for $\alpha > 1/2$. The first inequality is more challenging to confirm, but performing some numerical solutions shows that it is possible for combinations of values for the variables and impossible for others (please see appendix for some examples). We can assume that our variables are such that the first inequality holds⁶.

The conscious consumers will enjoy no surplus in equilibrium, while the unconscious consumers will enjoy a surplus. The two firms' profits will be

$$\pi_I^{LM} = (p_I^{LM} - c)\alpha$$

for the incumbent and

$$\pi_E^{LM} = (p_E^{LM} - c)(1 - \alpha)$$

for the entrant.

Clearly between the two, competing for market shares or monopolizing their respective markets, both firms prefer the latter, as this allows them to enjoy positive profits. Like in the case of inelastic demands, what makes the difference here compared to the 'entry with license' case is that the entrant refrains from CSR and differentiates itself from the incumbent firm. The existence of different preferences in the market with respect to CSR allows the two firms to relax competition between them and constrain themselves to the part of the market where they have an advantage in the eyes of the consumer (lower price for the unconscious consumers, "green" product for the unconscious).

Entry deterrence

Would the incumbent want to deter entry? If entry is deterred then the incumbent will continue to charge the monopoly price

$$\frac{p_I^M - c}{p_I^M} = \frac{1}{\eta}$$

and get profit equal to

⁶ If it does not then the incumbent will lose the whole market, so in this case the preferable choice for the incumbent is to deter entry so long as the cost of entry deterrence does not exceed monopoly profits.

$$\pi_I^{MD} = p_I^M - c - D$$

So the incumbent will decide whether to deter entry or not comparing this profit with

$$\pi_I^{LM} = (p_I^{LM} - c)\alpha$$

and will choose to deter entry if

$$(p_I^{LM} - c)\alpha - (p_I^M - c) \geq D$$

This says that the incumbent will deter entry only if the monopoly profits gained in the market of the unconscious consumers exceeds the cost of deterrence. So the lower the cost of entry deterrence, the less resources required for it, the more likely it is that entry will be deterred. Also, the higher the fraction of unconscious consumers in the market the higher the incentives of the incumbent to deter entry. Contrary if unconscious consumers are a small fraction of the total market then the more likely it is that entry will be accommodated and the two firms will monopolize their respective markets.

When the incumbent isn't "green"

It is interesting to consider what happens when the incumbent isn't "green", when in other words the incumbent does not have the "green" license and does not practice CSR. In this case the entrant has incentives to obtain the "green" license even if obtaining the license entails some cost. Both with unit and elastic demands the entrant will want to avoid producing a product that is homogeneous in every aspect with that of the incumbent and will choose to differentiate its product by making it "green". By making its product "green" the entrant will now attract the conscious consumers and the incumbent will keep the unconscious. The incumbent's decision to deter entry or not will now be determined by the gains in the market of the conscious consumers. The entrant will have incentives to obtain the "green" license even if that entails a cost, so long as profits are non-negative

$$\pi_E^{LM} = (p_E^{LM} - c)\alpha q_E^{LM} - L \geq 0$$

where L is the cost of obtaining the green license and q_E^{LM} is one in the case of unit demands.

CONCLUSIONS

We have presented a simple model of entry and competition with the aim to examine a potential entrant's incentives to be socially responsible. We have shown that an entrant firm has incentives to refrain from CSR in order to avoid fiercely competing with the incumbent. What matters in our model is not the size of the company (since if we turn things around – when the incumbent is not "green" – we see that the roles are reversed); so what drives our results is not really the size of the firms (smaller compared

to larger firms). Our results depend on the sequence of choices – the entrant firm chooses the level of CSR after it has observed the incumbent’s engagement in CSR. What drives the results is the existence of different types of consumers in the market and the potential for the firms to differentiate their products.

When the incumbent is “green”, the entrant chooses not to be “green”, CSR acts as a differentiation device and allows the firms to split the market in two with the incumbent selling its product to those consumers who value CSR and the entrant selling its product to those consumers who do not have a preference for CSR. What is interesting is that the consumers who care about CSR end up with no surplus, while those who do not care about it are left with positive surplus. So in a sense conscious consumers pay for their “green” conscience. It is interesting that when the incumbent is not “green” the entrant has incentives to be “green”. This again is due to the fact that CSR is used a means to differentiate from competition.

The results suggest that since there are incentives to refrain from CSR, policy-makers should offer more incentives in order for new, entering companies to engage in CSR. The results also suggest that with a large pull of conscious consumers and the threat of entry from a “green” potential entrant, incumbent firms have more incentives to preempt their rivals and become the “green” firms themselves. About educating consumers to value CSR, the model would have to be more sophisticated to give some insights.

EXTENSIONS AND FURTHER RESEARCH

Heterogeneous products

The obvious extension to the above model is changing the assumption of homogeneous products. In the above we have assumed that the products of the two companies the incumbent and the potential entrant are homogeneous in all their characteristics and the only form of differentiation between them comes from whether they are produced from a firm which practices CSR or from a firm which does not practice CSR. The next step of this research is to assume heterogeneous products. With heterogeneous products competition between the two firms is relaxed and we expect that the potential entrant will have more incentives to practice CSR (since for example with heterogeneous products the case where the entrant will obtain the “green” license will not lead to zero profits for the two firms). We would like to assume that differentiation between the two firms will take the form of horizontal differentiation and add

a second dimension to Hotelling's unit line model to account for the different preferences of the consumers relative to the "green" license.

Continuous preferences and CSR levels

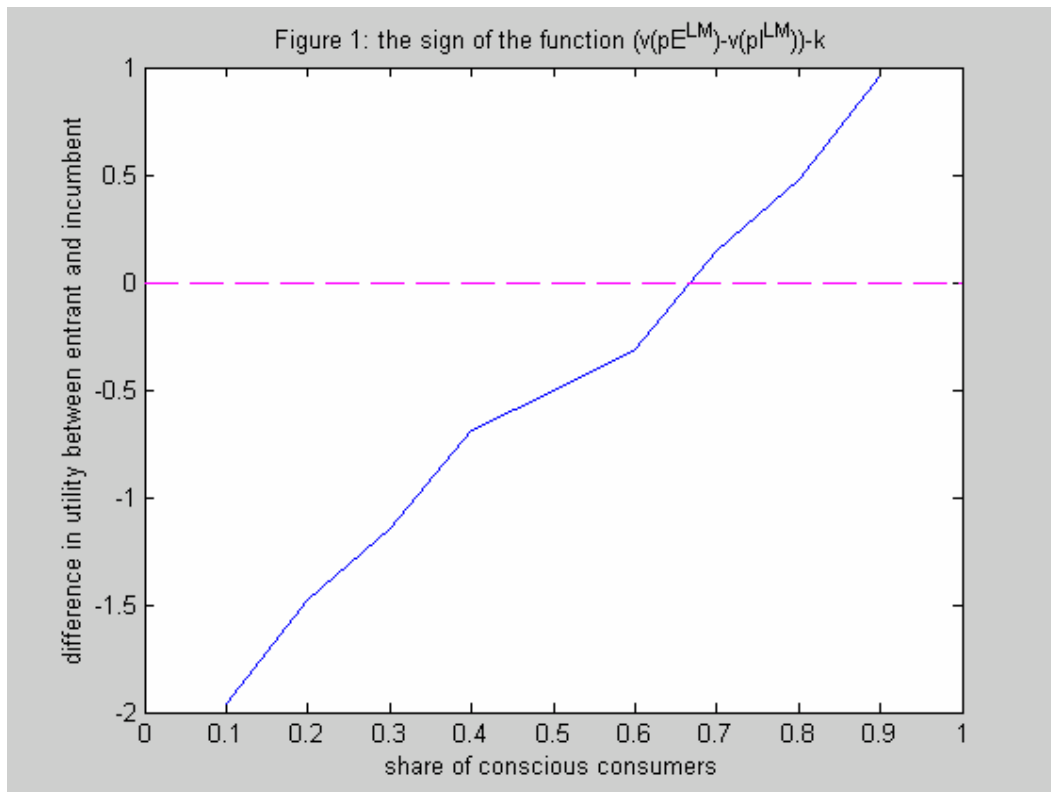
In our model above consumers are either conscious or unconscious and preferences for higher or lower (positive levels) of CSR are ignored. One other assumption is that CSR is either practiced at a specified level (the "green" license) or not practices at all. Between the two extremes there is a whole range of CSR levels that the firms may choose to practice. One interesting extension of the above model would be to assume a continuous of consumer preferences and allow the firms to choose their level of CSR from a continuum of choices. One could then examine the way in which CSR levels are affected by consumer preferences. It would be interesting to examine both the level of CSR that the potential entrant would choose to practice given a "green" incumbent as well as how this would change for different levels of CSR from the side of the incumbent or how the incumbent's choice of CSR would change with the expectation of entry.

Also, it would be interesting to assume a setting with two entrant firms, one entering after the other. This would come closer to more realistic situations where an incumbent firm is faced with the threat of entry from a number of potential entrant firms. We could then examine so much the incentives of the incumbent to engage in CSR as well as the behaviour of the entrant firms. It would be interested to see whether the first entrant's behaviour with respect to CSR would change in the light of the threat of the new entry.

APPENDIX

Here we will use two graphs to demonstrate that there exist values of marginal costs, elasticity of demand and disutility of consuming the “other” product for which the inequality holds and values of marginal costs, elasticity of demand and disutility of consuming the “other” product for which it does not.

For the two figures below we have assumed specific values for the marginal cost of production and the elasticity of demand – $c = 2, \eta = 1.6$ – and we have allowed the share of conscious consumers α to vary between zero and one. For the first graph the disutility of the conscious consumers from consuming the other product is assumed to be $k = 0.5$ while for the second graph it is assumed to be $k = 2$.



In Figure 1 we can see that there are values of α for which

$$v(p_E^{LM}) - k - v(p_I^{LM}) > 0$$

which says that our inequality is not satisfied and thus prices are such that the incumbent loses the conscious consumers for those values of α . So with for these α s the market is not split in two local monopolies.

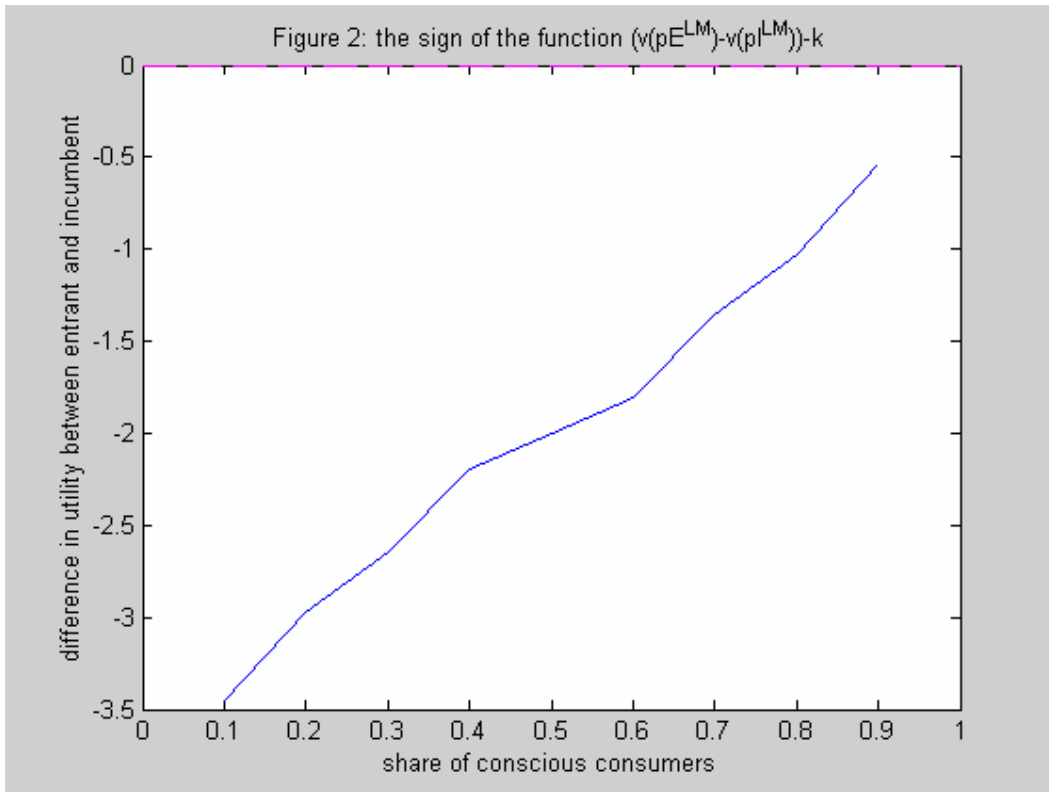


Figure 2 is an example where the inequality

$$v(p_E^{LM}) - k - v(p_I^{LM}) < 0$$

holds for all values of α which means that prices are such that the incumbent always retains the fraction of conscious consumers. Combining this with $\alpha > 1/2$ gives us the range of α s for which the market will be shared in two local monopolies.

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