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Financialisation and Corporate Responsibility: Implications for the Nature of the Firm

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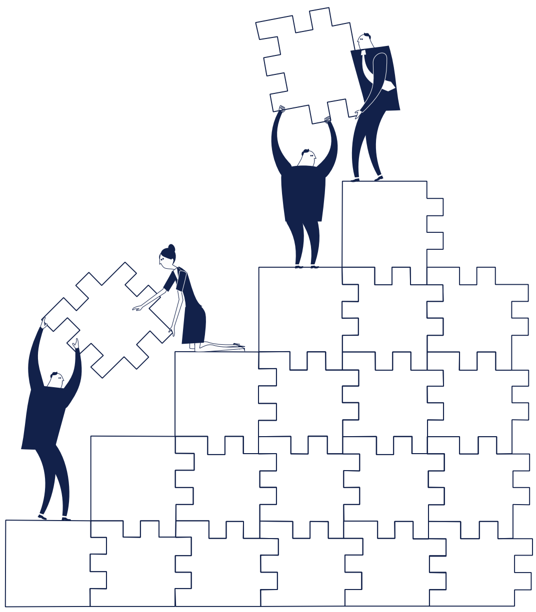

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Financialisation and corporate responsibility: implications for the nature of the firm[1]

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Introduction

In this paper we set out a series of primarily conceptual arguments. Each argument may suggest further conceptual, empirical and normative analysis.

We necessarily make a number of assumptions that we hope are reasonably clear, even where they are considered incorrect or flawed. Each assumption can be discussed further.

Reasons for acting: financialisation and corporate responsibility

We start with a general claim: firms have *reasons for acting*. We consider some key aspects of, and possible changes to, these reasons. This is of course only one of many starting points for the analysis of firms.

We can describe multiple *reasons for acting* for each firm. However, we seem to recognise that firms *ought* to take certain actions and aim to produce certain outcomes. This suggests that, to this extent at least, these reasons can be described as *ethical reasons*.

We focus on two dimensions of a firm's reasons for acting. The first concerns the *responsibility* for actions and outcomes; in general this can be described as the degree of *corporate responsibility*. The second concerns the significance of various *financial* considerations; in general this can be described as the degree of *financialisation*.

We suggest that changes to corporate responsibility and financialisation may inform a firm's reasons for acting. These changes may have more of less significant implications for the firm, and over time this may change the *nature* of the firm.

Four dimensions of value

One way to model financialisation and corporate responsibility is to use an idea of value creation. In a market situation the firm may be described as a unit of *value creation*, with value measured as *financial value*.

We suggest that this is a *partial* description of value creation. We suggest the idea of four dimensions of value comprising: narrow financial value, such as a return on shareholder investment; wide financial value, such as value created across the supply chain; external financial value, such as value measured financially but not accounted for by the firm; and, non-financial value, such as value that is not financially measureable.

Figure 1 shows a model of the four dimensions of value. This includes a representation of the 'boundaries' between each dimension. The foundations, implications and problems with the model can be discussed in more detail.

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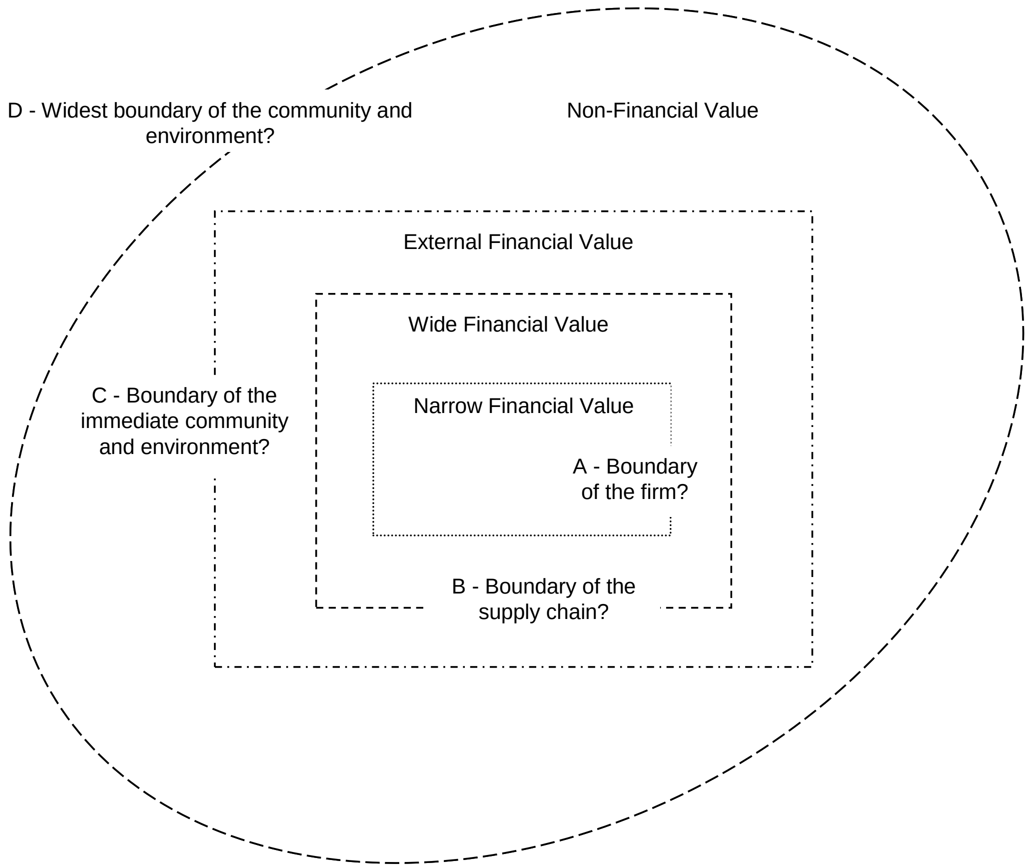
[1] This paper was presented at the Society for the Advancement of Socio-Economics (SASE), 21st Annual Meeting, July 16-18 2009, Paris, France. Minor updates have been made for the current version of the paper.

Figure 1: Four dimensions of value



The four dimensions model provides a description of the value created by all the outcomes of a firm's activities, including those outcomes that generate non-financial value. The total value created within each dimension, and across all the dimensions combined, may be positive or negative. Within Boundary A, positive and negative value is measured financially and will typically determine the success or failure of the firm in a market situation. Beyond Boundary A, positive and negative value may not be accounted for by the firm and may be only partially measured financially.

In a market situation bounded by the rule of law, firms will typically account for narrow financial value. This will inform a firm's reasons for acting. We can describe these reasons as based on two principles: *principle F*, make a positive financial return; and, *principle L*, operate within legal requirements.

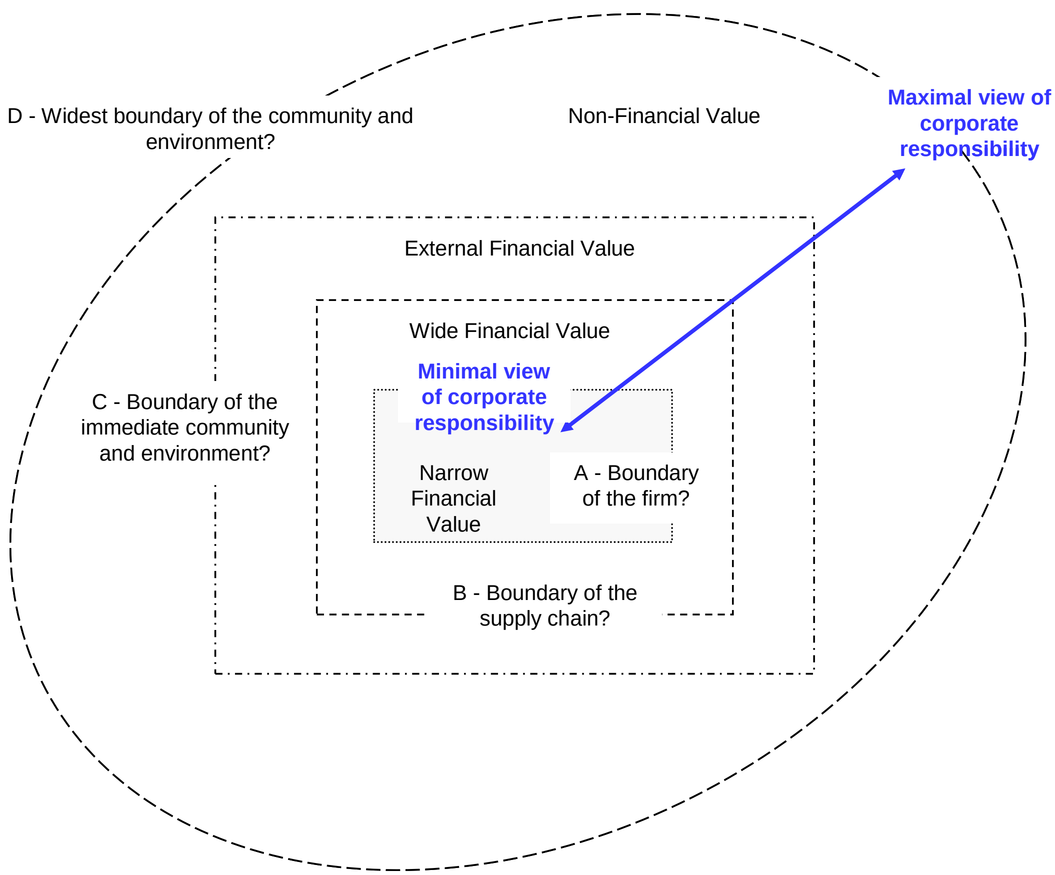
L and F describe the primary principles that firms will appeal to as reasons for acting in a market situation bounded by the rule of law.

We can use this model to describe how the degree of corporate responsibility and financialisation may inform a firm's reasons for acting.

Minimal-maximal spectrum of corporate responsibility

Figure 2 shows a minimal-maximal spectrum of corporate responsibility across the four dimensions of value. Movement along the minimal-maximal spectrum suggests that firms take on increasing responsibility for the outcomes of their actions.

Figure 2: Minimal-maximal spectrum of corporate responsibility

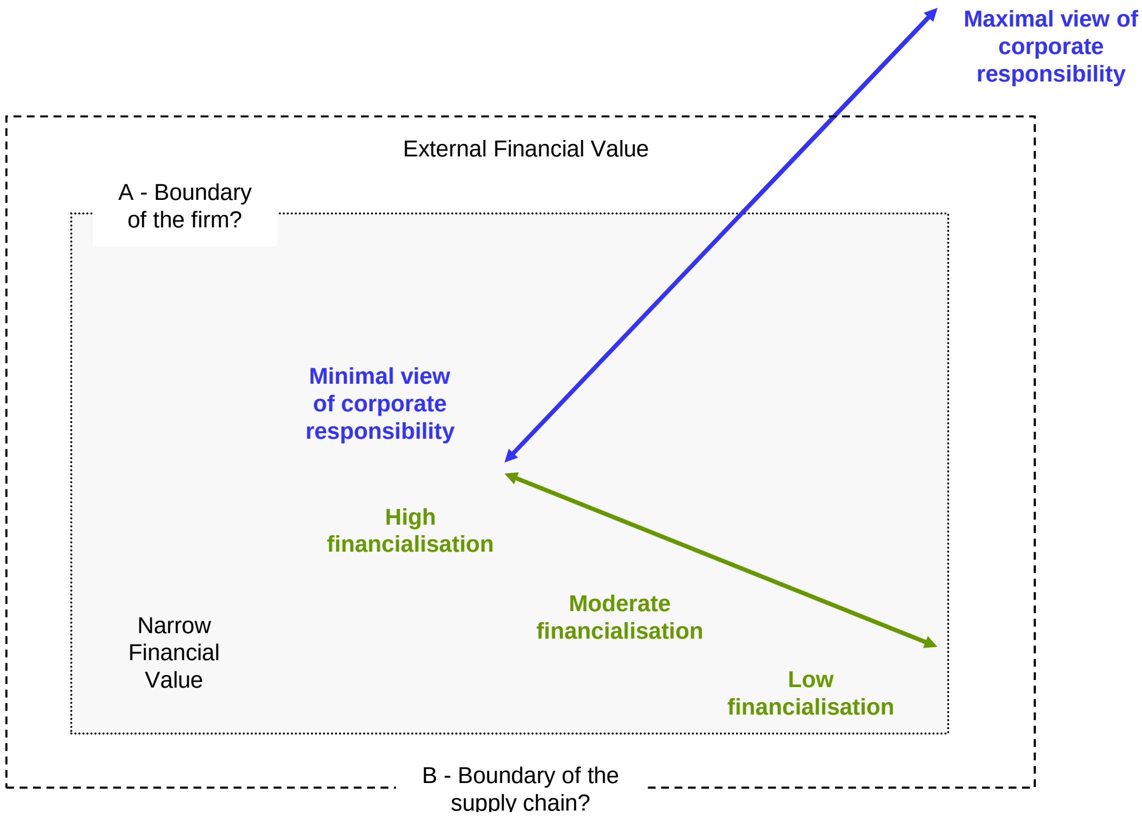


In order to consider the minimal-maximal spectrum in more detail, and to consider the degree of financialisation, we focus primarily on narrow financial value and Boundary A. Further dimensions and Boundaries can be discussed.

Low-moderate-high spectrum of financialisation

Figure 3 shows a spectrum of low-moderate-high financialisation within Boundary A. This spectrum suggests a movement from creating value from primarily *financial* outcomes to creating value from primarily *tangible* outcomes.

Figure 3: Minimal-maximal spectrum of corporate responsibility and low-moderate-high spectrum of financialisation



We recognise that the assumptions, arguments and models suggested so far are subject to a series of criticisms that will reveal errors and flaws. We use the analysis so far to make some observations about the implications of financialisation and corporate responsibility for the firm.

Comments on corporate responsibility

We will first make some initial comments on corporate responsibility.

Movement along the minimal-maximal spectrum within Boundary A

Movement along the minimal-maximal spectrum within Boundary A suggests changes in corporate responsibility that maintains as relatively constant the market and legal situation.

The degree of movement possible within Boundary A may be determined by the degree of *informality* of principles L and F as reasons for acting. For example: legal informality may result from issues of legal interpretation; financial informality may result from incomplete information about potential financial returns; and, both may result for information asymmetry between agents.

The informality of F may also suggest a range of *market opportunities,* all of which produce a positive financial return and are compatible with the acceptance of varying degrees of corporate responsibility[2].

Varying *definitions* of F may indicate aspects of informality. For example, the *maximisation* of shareholder value and making a *positive* return to shareholders may provide different reasons for acting; the latter may be described as *satisfying* shareholder value.

Movement beyond Boundary A

Movement beyond Boundary A may suggest changes to the nature of the firm. Where the firm takes responsibility for outcomes beyond this Boundary, this may suggest *changes* to L and F as principles.

It is important to note at this point a difference between the two principles L and F. L is based on the idea of the rule of law. Any change in this principle would require a wider change in the role of the rule law. This is unlikely within liberal democratic political systems. We can discuss situations where this is possible.

F as a principle is central to the arrangements underpinning market economies. However, F may not have the same foundational role as L in liberal democracies, although this view may be disputed. The existence of various *hybrid* types of firm may support this view[3].

On these views, change to the content of L does not change L as a *principle*. However, change to the content of F may change the principle *itself*. If F is defined as a return on shareholder investment (or a similar definition), then taking account of outcomes that do not contribute to shareholder value may change the definition of F.

Movement *beyond* Boundary A may also suggest that L and F are not the only principles appealed to as reasons for acting. This keeps L and F constant and suggests *further* principles. We can describe the *bundle* of such principles as *extended corporate responsibility* (ECR)[4].

It may be argued that movement beyond Boundary A is not possible in a market situation. Taking into account outcomes beyond Boundary A is then a matter of public policy, regulation and legislation.

Movement of Boundary A

The movement of Boundary A suggest at least two kinds of change.

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[2] For example, consumers may express preferences for products that take into account different degrees of environmental impact.

[3] For example, an institutional arrangement may continue to be described as a firm even if it is wholly or partially owned by the state or receives financial support from agents other than financial investors and customers. Of course, it may be argued that these arrangements produce institutions that may *not* be described as firms.

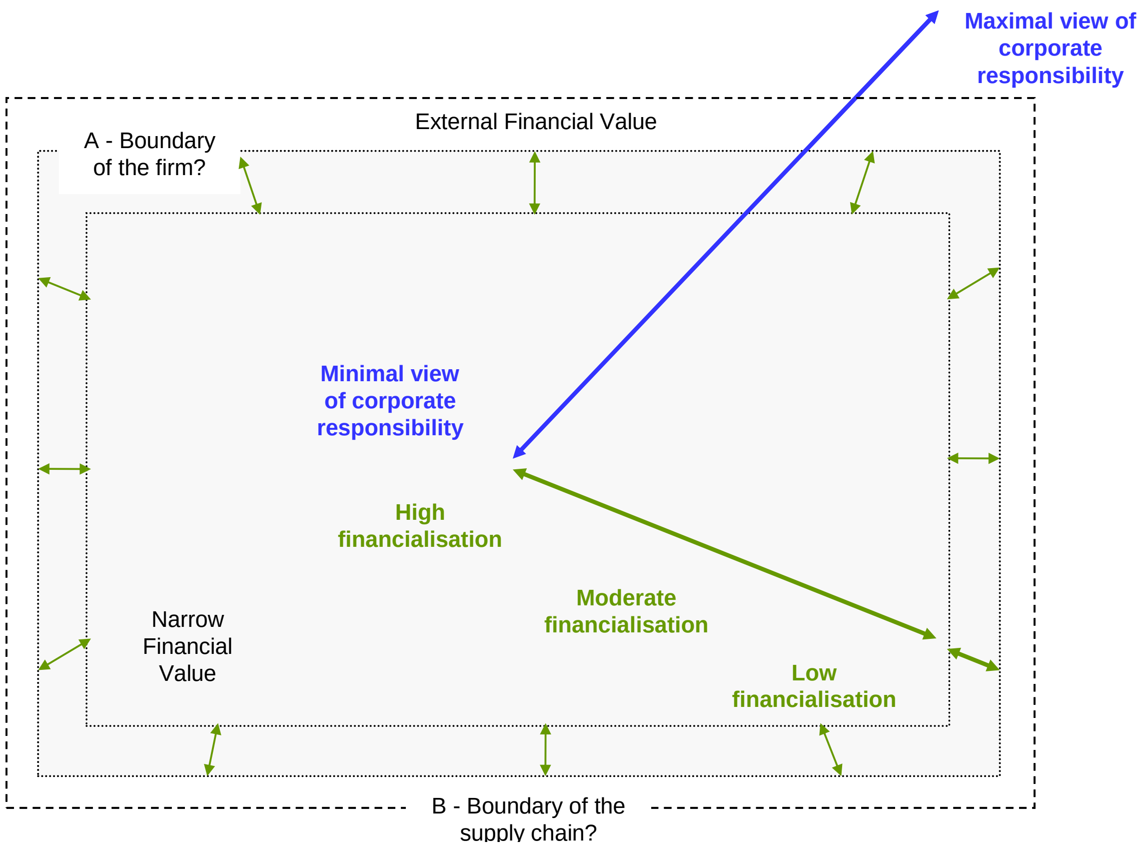
[4] There may be a range of possible further principles such as human rights (HR), environmental impacts (E), working conditions (W), and others. Each will require a clear definition and, in many cases, clear standards. We can discuss the idea of these principles further, including the issues of ordering and prioritisation.

First, changes in the content of legislation and regulation have the effect of changing the boundary of the firm. In this case, the nature of the firm as appealing to L and F as principles remains unchanged.

Second, changes to preferences expressed in the market may produce a move *along* the minimal-maximal spectrum, rather than a change to the boundary of the firm. However, relatively consistent changes to preferences will change the *whole* market context within which *all* firms operate, and suggests the movement of Boundary A.

Figure 4 shows the movement of Boundary A

Figure 4: Movement of Boundary A



Comments on financialisation

We next make some initial comments on financialisation.

The identification of financialisation as a reason for acting provides a more detailed analysis of F. Within Boundary A, all firms create narrow financial value measured by making a positive financial return to shareholders (or a similar definition).

Movement along the low-moderate-high spectrum of financialisation

Movement along the low-moderate-high spectrum of financialisation suggests that a range of reasons for acting may be described under principle F, and suggests change to the relative significance of financial arrangements for the firm's reasons for acting.

Low financialisation suggest that firms focus on the production and sale of relatively tangible products, both goods and services, as the means to create value. Value is *measured* financially but the firm's reasons for acting are significantly 'productionist'[5]. These firms tend not to consider financial operations as a relevant source of profitability. These firms may be predominantly self-financing with limited active involvement in capital markets.

Small and medium sized firms may be at this point on the low-moderate-high spectrum. This may be the dominant territory of traditional firms that operate in the context of productive systems.

Moderate financialisation suggest that firms see financial operations as a necessary complement to productive operations and as a potential source of profitability. Competitive investments in financial operations may create value but with low potential to put the existing value at risk.

Large sized firms may be at this point on the low-moderate-high spectrum. This may be the dominant territory of firms operating in both the context of both productive systems and financial systems.

High financialisation suggests that firms rely more significantly on financial transactions as the means to generate value. These firms tend to see financial operations as one of the main sources of profitability. Significant investment in financial operations may not only not create value but may put existing value at risk.

These firms tend to be actively engaged in corporate capital market restructuring and may require greater external financing. The firm's reasons for acting may also prioritise shareholder value over other stakeholders interests. This may be the dominant territory of firms operating in the context of financial systems.

There are a range of factors that may indicate movement along the low-moderate-high spectrum of financialisation and inform a firm's reasons for acting, for example the nature and extent of the portfolio of financial instruments used in the operations of the firm[6].

Within Boundary A, all firms are seen as creating narrow financial value. The low-moderate-high spectrum suggests limiting cases of financialisation. At the 'high' end of the spectrum firms may be described as points of *financialised* value creation. At the 'low' end firms may be described as points of *productionist* value creation.

[5] From Andersson, T. et al. (2007), "Financialized accounts: A stakeholder account of cash distribution in the S&P 500 (1990-2005)".
[6] Other factors include: the intensity of financial operations, for example the number of financial transactions per day; the magnitude of financial transactions, for example as a percentage of all investments; the extent to which a small number of owners or shareholders account for a large proportion of ownership or shares; the range and the degree to which the firm's operations occur in a currency other than its base currency; and, the extent to which the firm uses agents in its supply chain as financial sources.

Movement beyond and movement of Boundary A

Movement *beyond* Boundary A suggest change to L and F as principles. This suggests that a firm's reasons for acting may include a view of value creation in addition to financialised or productionist value creation. This will require further analysis.

Movement *of* Boundary A suggests changes to the legislative/regulatory context or relatively stable changes to the market situation. The model *suggests* that this will tend to affect low financialised firms to a greater extent than high financialised firms. This may be consistent with the effect of these changes on a firm's operations and products. However, the model does not appear to allow for other effects and requires further development.

Corporate responsibility and financialisation

Finally, we will make some observations about the interaction of corporate responsibility and financialisation based on the analysis so far.

The model suggests that increasing financialisation may be associated with a reduction in the scope of corporate responsibility. As a firm's reasons for acting become *more* concerned with financial means of creating value, the firm may become *less* concerned with the direct outcomes of it's activities.

It will be interesting to analyse these effects for firms whose products range from tangible goods to more intangible services including financial services. In the latter case, less concern for direct outcomes may include the consequences of, for example, consumer credit.

Movement along the minimal-maximal spectrum may suggest that firms take into account the *reasons* of a wider group of stakeholders in addition to shareholders. This may require further analysis of reasons that are *internal* and *external* to the firm. A *high* level of financialisation suggests that value creation for *shareholders* has a greater priority than value creation for other *stakeholders*.

The minimal-maximal spectrum may be used to analyse the market pressure for changes to the extent of corporate responsibility. This pressure may come from the reasons of at least two groups of market agents: consumers and investors. Both consumers and investors may include explicit corporate responsibility concerns and requirements as part of their buying and investment decisions. Other agents that can discuss also so be discussed.

Firms closer to 'low financialisation/maximal corporate responsibility' may be more responsive to *consumer* concerns. Consumers may make buying decisions on the basis of corporate responsibility issues raised by products for example, product provenance, working conditions, and environmental impacts.

Firms closer to 'high financialisation/minimal corporate responsibility' may be less responsive to consumer concerns and more responsive to *investor* concerns. For example, banks and institutional investors may have explicit corporate responsibility requirements as part of their investment portfolio. This may result in the selection of firms based on an extended view of corporate responsibility. Higher financialisation may then *increase* the responsiveness of firms to extended views of corporate responsibility as a result of investor reasons for acting.

In some cases the investor may take a ‘high’ financialisation view of the firm, but expect the firm to take a *less* financialised view of its own activities based, for example, on the corporate responsibility preferences of consumers. This may suggest a movement of Boundary A where these consumer preferences have a relatively consistent effect in the market over time.

On the other hand, high financialisation may *reduce* direct sensitivity to views about corporate responsibility. The diffuse nature of financial markets may disconnect the firm from consumer buying decisions and the effect of its outcomes on stakeholders. Value may be created primarily or significantly through financial transactions rather than directly through the production and sale of products.

Consumers and investors may take different views of the firm. Investors may to see the firm as a unit of *financialised* value creation. In this sense investors may hold a view of the firm closer to high financialisation/minimal corporate responsibility. Consumers may see the firm as a value creator through the *products* that it produces. In this sense customers may hold a view of the firm closer to low financialisation/maximal corporate responsibility.

Concluding remarks

We close this paper with these initial and speculative observations about corporate responsibility and financialisation. We hope we have developed a series of arguments that stimulate further analysis of these issues, and welcome the opportunity to continue the discussion.