Social Arbitrage

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A significant trend in recent years is the growth in resources allocated to something called Corporate Social Responsibility (CSR). Typically included under this rubric are corporate expenditures made to fund a wide range of philanthropic causes and social initiatives, over-comply with environmental standards, and promote the existence of such corporate expenditures to various constituencies. Despite the dramatic increase in expenditures by corporations on CSR and an ever growing body of academic research and thought pieces in the popular press, there appears to be little agreement among academics and others as to the role played by CSR in the modern business firm, the economic and social justification for CSR, or the connection between CSR expenditures and financial performance. There is not even a consensus on what CSR is!

There are many open questions concerning CSR. Do corporations benefit financially by doing good? How does CSR affect firm value? How are CSR-related value effects impacted by a firm's circumstances? Is there a direct conflict between maximizing shareholder value and social value? Explanations and justifications offered for CSR run the gamut from the utopian to the cynical. These include socialist redefinitions of the modern corporation, single-bottom line justifications rooted in cost savings and brand management, and claims that CSR is basically a rip off of shareholders' money.

While a review of this literature is well beyond the scope of this article, a small sampling of extant theories is instructive and sets the stage for my later discussion. I offer four stylized contenders:

- Despite the elegant arguments of Adam Smith, Milton Friedman and others, some argue that profit maximization is not the proper objective of the business corporation. Instead, corporate executives should seek to maximize a broader measure of corporate well-being, which includes not only financial claimants, but also employees, customers, communities, governmental officials, the environment, and even society as a whole;
- CSR expenditures are targeted towards a firm's existing and potential customers, and like advertising, create shareholder value through brand enhancement;
- Investors view corporations and not-for-profits as equally competent suppliers of charity-related "good works" and choose to delegate their philanthropic decisions to corporate executives rather than making direct charitable contributions. In this view, corporate philanthropy is offset by reductions in charitable giving by individuals;
- Managers of corporations exploit investment in CSR for their private benefit, seeking to enhance their own reputation and social status at the expense of shareholders.

In this short article, I do not take a position on CSR, but instead focus on one aspect of CSR that I call social arbitrage.

In economics, an arbitrage opportunity is said to exist when two otherwise identical goods sell at different prices. This allows risk free profit by simultaneously buying the cheap good and selling the expensive one until prices converge. An absence of financial arbitrage would result in money being left on the table, a situation that nature appears to abhor as intensely as it does a vacuum. The financial vacuum created by price disparities is filled by financial arbitrageurs constantly on the hunt to find and exploit such profit opportunities.

By analogy, I posit the construct of the social arbitrageur on the hunt to find and exploit corporate money sitting on the table available to create social value. Social arbitrageurs gravitate to and exploit these opportunities, they do not create them. The money is put on the table by corporations seeking to deflect the wrath of social activists (not social arbitrageurs) as manifest through the political process. To be clear, I am not talking about social activists extorting money from corporations (although that does happen). Social arbitrage opportunities are generated by social activists working through the political process with the objective of damaging (or in some cases destroying) the corporation without seeking to be paid off.

Probably the most extreme case of social arbitrage is the situation faced by large U.S. tobacco firms. If you access the web site of a large U.S. tobacco company like Philip Morris USA or R.J. Reynolds Tobacco Company, the presence of CSR is immediately obvious (check out the websites of U.S. beer or oil companies for a similar effect). With a couple clicks of the mouse, you will find that these companies spend significant sums of money on a vast range of community involvement initiatives, environmental issues, and youth smoking prevention programs. These companies also maintain CSR groups within the firm to manage the firm's myriad social initiatives. These employees, among others, are social arbitrageurs. To see this, follow the money.

How do these expenditures generate shareholder value? How could value be created by endeavors like youth smoking prevention programs which appear to destroy demand for the company's products? It is not a brand enhancement story where CSR expenditures are targeted towards a firm's existing and potential customers. It is just not plausible that tobacco companies support local community initiatives to sway smokers over to their tobacco products. Then who is the target of these expenditures?

Lets explore the financial reality. The financial statements of Altria Group, Inc. (the parent of Philip Morris USA) reveal that of total 2004 revenues of $89.6 billion, $17.5 billion derives from domestic tobacco sales and $39.5 billion from foreign tobacco sales. From the $17.5 billion in domestic revenues, payments of $4.6 billion were made to the states in 2004 as part of an overall tobacco settlement. These payments are made annually and eventually rise to $6 billion annually in the year 2016 and thereafter. R.J. Reynolds Tobacco Company reports that in fiscal year 2004 total federal, state and municipal excise taxes on cigarettes were $20.1 billion. Despite the massive amount of cash diverted from tobacco sales by the government, in 2005 Reynolds American Inc. (the parent of R.J. Reynolds Tobacco Company) saw its stock price increase from $75 a share to over $90, and Altria Group, Inc.'s saw its price increase from $57 to over $70 a share!

It is clear that both shareholders and the government have good reason for domestic tobacco companies to thrive. But this cash flow is constantly challenged by a phalanx of anti-tobacco lobby groups (i.e., the social activists). It is my contention that the tension between the government's desire to keep tobacco money flowing and the social activists to destroy tobacco creates the space that is filled by social arbitrageurs, and that much of the CSR spending at U.S. tobacco companies is targeted to the politicians, providing them with a buffer to hold off the activists. Social arbitrageurs with a desire to do good exploit this opportunity.

While this view of CSR is far from utopian, a social arbitrageur would argue: tobacco money is money, doing good is doing good, and money creates opportunities for doing good.