On the scientific contributions of

Jean Tirole

to understanding responsible finance

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This paper presents the contributions of Jean Tirole, recipient of the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2014, to the field of corporate social responsibility and sustainable finance. Among his numerous academic contributions, Jean Tirole, founder of the Toulouse School of Economics, has produced two major articles in this field with his co-author Roland Bénabou from Princeton University. Highlighting these contributions is useful because the Economic Sciences Prize Committee of the Royal Swedish Academy of Sciences only alludes to them in its presentation of the work of Jean Tirole: these contributions are too recent. Obviously, the present paper only reflects my own understanding of his thinking and does not reflect all the subtleties and richness of his contributions.

Jean Tirole's contributions enable to better understand the articulation between individual and corporate social responsibility. A first article was the object of the inaugural conference of the Research Center on Sustainable Finance and Responsible Investments (Chaire FDIR, « Finance Durable et Investissement Responsable ») in 2007.[1] A second article shows how competition for talents induces a bonus culture that might be detrimental for society as a whole.[2] This contribution was the topic of Jean Tirole's keynote address at the PRI-CDC Academic Network Conference 2013, a conference for which the Chaire FDIR animated the scientific activities.

Both of these contributions have numerous and important implications for the practice of responsible finance. These implications speak to the structure and strategies of responsible investment funds, to the governance of socially responsible firms, and to the design of their responsible shareholders' engagement policies. These implications are also discussed in this paper.

Individual and Corporate Social Responsibility

The first contribution is formulated in an article entitled "Individual and Corporate Social Responsibility". Roland Bénabou and Jean Tirole identify various economic reasons why an extended notion of corporate social responsibility might be relevant.

To understand their ideas, it is useful to start with the narrow version of corporate social responsibility as best represented by the title of a *New York Times Magazine* article by Milton Friedman in 1970: "The Social Responsibility of Business is to Increase its Profits." In a

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[1] Bénabou R. and J. Tirole, "Individual and Corporate Social Responsibility", *Economica*, Volume 77, Issue 305, pages 1–19, January 2010.

[2] Bénabou R. and J. Tirole, "The Bonus Culture: Competitive Pay, Screening, and Multitasking", forthcoming *Journal of Political Economy*.

more precise way, businesses should try and maximize the present value of profits, present and future. This assertion is valid in a setting in which markets and governments work perfectly. In this setting, laws restrict business behavior in a way that is consistent with a country's political will, and businesses, by maximizing their current value, offer their shareholders the best opportunity to obtain from markets whatever goods and services they wish, including supporting the causes that suits them related for example to environmental and social issues. In this logic, markets (for CO2 emission permits for example) or polluter-pays taxes are assumed to adequately reward the positive impacts and punish the negative impacts firms exert on society. As a consequence, firms can maximize profit, as when doing so they internalize the social costs and benefits of their acts.

Roland Bénabou and Jean Tirole present two economic arguments that suggest this view of corporate social responsibility might be too narrow.

Delegated philanthropy

A first motivation for an extended notion of corporate social responsibility (CSR) is named "delegated philanthropy." It refers to the case in which there are market and regulatory failures, due to transaction costs, capture by lobbies, or jurisdiction territoriality issues.[3] For example, in the case of environmental damages, there are missing markets for CO2 emissions because some governments have decided not to support their creation. It is impossible to force them to open and adequately regulate these environmental markets because of their sovereign status. Emblematic examples are the absence of a CO2 emissions market in the US and the very low price of permits in the European Union.

In this case, individuals might want to engage into pro-social behavior (out of pure altruism, material incentives, or image-concern) when the firms they work at, invest in or buy products from are actually generating externalities on their environment: firms will not produce enough of good externalities (e.g., employee training and safety), because they are not rewarded enough, and will produce too much of bad externalities (e.g., pollution), because they are not punished enough. It is then not the case that shareholders would like to see firms always maximize profits if firms can have an impact on the overall level of externalities. Businesses social responsibility is then to choose the appropriate mix of profits and externality production (pollution mitigation, training and safety policies…) to reflect the will of stakeholders. Delegated philanthropy in the end maximizes shareholder value: Starbucks passes through the extra cost of fair trade coffee to consumers, who are willing to pay more for their cappuccino.

Second, another reason for an extended notion of CSR has to do with intertemporal (long-term) profit maximization, and the potential disconnect between short-term and long-term/sustainable profits. This disconnect might be due to poorly designed managerial incentive schemes that are too tilted towards short-term performance. But it can also be an inherent feature of appropriate incentive contracts for risk averse or impatient managers. Moreover, shareholder meetings and boards of directors make tenure renewal decisions on a regular basis, which induces managers to focus on short-term performance that is most likely to affect their career outlooks.

This notion of CSR is motivated by the fact that short-term profit maximization often creates negative externalities on stakeholders: loss of franchise value leading to worker

[3] These economic and legal frictions have important implications, discussed below, for the design of the engagement policy of socially responsible investors.

layoffs, accumulation of off-balance-sheet liabilities or the taking of environmental gambles leading to bankruptcies, etc. This second notion of CSR is also consistent with shareholder value, but in the economist's traditional sense of intertemporal profit maximization.

Finally, the article discusses the informational requirements for responsible behavior to actually promote the interests of society, and not just being well-meaning.

Win-win approach: Curbing the Bonus Culture

A second article by Roland Bénabou and Jean Tirole, entitled "The Bonus Culture: Competitive Pay, Screening, and Multitasking", identifies the economic conditions that may trigger or worsen a conflict between short- and long-run performances. A conflict may arise when business managers have to perform different types of activities in order to generate corporate profits: some activities translate into short-term profits and are easily measurable while others translate into long-term profits but are only imperfectly observed. In this case, shareholders emphasize more short-term performance because it enables to provide stronger managerial incentives.

If competition to attract talented managers is not fierce, shareholders are cautious not to give too high short-term bonuses because they realize that these might induce managers to focus too much on short-term oriented activities (such as presenting attractive financial ratios) at the expenses of long-term oriented ones (such as accident prevention, honoring implicit contracts with employees, product safety, pollution mitigation and investing to increase energy savings). However, when there is intense competition to attract the best employees, firms rely more on short-term bonuses because these are more attractive to the best employees and thus enable to separate between good and bad managers. While each firm by assumption design its managerial compensation contract so as maximize its own profit, the resulting equilibrium involves schemes that are too short-termists for all firms. Bonuses are too prevalent.

One can draw numerous implications from the analyses of Jean Tirole in terms of socially responsible investments, corporate governance and engagement policies.

Implications for socially responsible investments

Corporate social responsibility calls for long-term shareholders. Such long-term horizon gives incentives and credibility for shareholders to choose responsible business strategies, corporate governance and managerial compensation contracts. Socially responsible investors would thus benefit from displaying low portfolio turnover and exerting engagement. Moreover, to the extent that socially responsible investors want funds to ensure that firms are doing good on their behalf, responsible funds should clearly indicate what are the main externalities they are focusing on. This is naturally the case for example in pension funds that are administered by employee representatives or in thematic funds that invest in renewable energies. Finally, depending on the psychological motivations that drive demand for responsible investments, funds might have an interest to down play their potential financial advantages (in an attempt to not blur inferences about investors' true altruistic motivation) and to increase their salience (in order to boost the image-concern driver of investors' demand).

Implications for corporate governance

In the win-win logic, corporate governance should reflect a firm's multiple objectives. Corporate responsibility officers should be present at high levels in the organizations and in

the board of directors in order to communicate information and provide incentives based on long-term performance. To do so adequately, a formal system of measurement of extra-financial performance should be put in place. In addition to objectivizing firms' performance in terms of externalities, such a formal system of corporate responsibility measurement and governance may also be useful to prevent managerial entrenchment, as analyzed by Giovanni Cespa and Giacinta Cestone.[4] It would indeed provide firms with the commitment to protect stakeholders even when responsibility-oriented executives are replaced.

Implications for shareholder engagement

In terms of shareholder engagement, socially responsible investors' policies should reflect the market and regulatory failures that are at the root of firms' externalities. For example, socially responsible funds should be more demanding when firms have a cost-effective and direct impact on externalities, and firms are active in countries that do not respect the norms issued by international political bodies. Moreover, policies coordinated across various funds to engage a large number of companies are called for in order to curb externalities at the level of the whole economy. This is for example particularly important for issues, such as CO2 emissions reductions and salary caps, that involve a risk of free riding by firms to try and increase their competitiveness with respect to their pairs.

[4] Cespa G. and G. Cestone, "Corporate Social Responsibility and Managerial Entrenchment", *Journal of Economics & Management Strategy*, Volume 16, Issue 3, pages 741–771, Fall 2007.