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How business leaders can care about the world – profitably

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In today's world the question of third-party interests is of increasing importance as companies leave their footprint around the globe in different societies. How and to what degree should executives allow for these externalities? This article explores how companies can address the issue of third-party interests from a business perspective to the benefit of both themselves and society.

The terms "externalities" and "sustainability" abound these days in the popular media, business literature and – crucially – board discussions at companies around the world. Society increasingly expects business to take (co-) ownership of the side effects of its products and operations. For example, companies that outsource the manufacture of widgets to low-cost countries are expected to care about possible child labor abuse by their subcontractors. While such matters could for a long time be ignored, society today considers "responsible behavior" a prerequisite for giving business its implicit license to operate.

Does this mean that today's business leaders should emulate the hippies of the 1970s, calling for action on every wrong? Is this the age of the CEO who is seen to care? Or is this rather a dangerous drift that increases costs, stifles innovation and drains management attention toward issues that may turn out to be immaterial? Is society perversely eroding the ability of business to create wealth for society?

In this article we will argue that companies should indeed take externalities seriously into account, as these will continue to have a very real impact on business success. But we will also argue that companies should do so with a keen business eye, carefully considering when to take action and how to respond pragmatically.

A brief history of externalities and business

Whenever a company operates, it is likely to generate costs or benefits outside its immediate business sphere that are not reflected in the price of its products or services. This brings us to a good definition of an externality: it is a cost or benefit that impacts society but is not included in the market price of a good or service. Polluting the environment or increasing the skills base in a region are examples of a negative and positive externality respectively. When a company can pollute the environment freely, society will

bear the costs (e.g. the deteriorating health of the nearby population), while the company keeps its costs and consequently its prices lower than they would be if it had to clean up its effluents.

Clearly, society doesn't let this happen and requires companies to address such externalities. As a result of regulation, consumer pressure or other forces, companies voluntarily or compulsorily internalize the issue until it appears to be an integral part of business and sometimes is no longer even considered an issue.

It is important to get externalities right. Recent history is full of examples of companies that have been quite spectacularly wrong about concerns such as working conditions (e.g. sweatshops in sport shoes and child labor in cocoa), health (e.g. tobacco use and infant health problems associated with the sale of milk powder), biodiversity (e.g. genetically modified organisms and new products developed by agribusiness), safety (e.g. offshore oil and gas production) or livelihoods (e.g. the impact of water extraction for soft drinks on local agriculture).

As a result of regulation, consumer pressure or other forces, companies voluntarily or compulsorily internalize the issue until it appears to be an integral part of business and sometimes is no longer even considered an issue.

Conversely, other companies have been able to cement or improve their business position through careful consideration of externalities. Clorox, for example, has profitably tapped an important consumer segment in the US through the timely introduction of its Green Works line of cleaning products; it has proactively internalized some negative impacts of cleaning products, in particular ingredients whose production or discharge have adverse environmental impact or that are harmful to users. Similarly, Walmart has given a whole new meaning to its slogan "Save Money, Live Better": it is internalizing climate change by reducing greenhouse gas emissions in its operations and supply chain. Likewise, lottery operators, mining companies and other types of businesses find that changing the way they work can make them a preferred partner and may help to secure attractive concessions and contracts.

The internalization of externalities is not a new phenomenon. As the examples in the side box show, business has had to deal for centuries with societal and governmental demands to change its practices.

Historical examples of the internalization of externalities

In the past 250 years, business has had to deal with the internalization of many different issues. Slavery is an often overlooked early example of how changing norms and values result in the emergence of an externality. Although slavery had been common practice since ancient times, opposition rose slowly but unmistakably in the 17th century, culminating in the abolition of slavery.
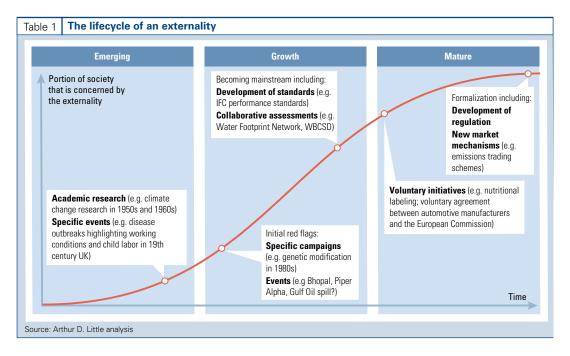
Child labor has been internalized in a similar manner. Only with the advent of state schooling during the first half of the 19th century did opportunity costs for children's time come into existence. This gave rise to increasingly progressive regulations on working conditions and school attendance for children. In the 20th century, society's scrutiny of workplace conditions became ever more stringent for all employees, resulting in improved factory safety legislation and a crackdown on sweatshops.

Public concerns about the environmental impact of industrial activity have been growing ever since the industrial revolution took off. The Club of Rome's 1972 publication "Limits to Growth" postulated that economies could not grow indefinitely. Gloomy discoveries in the 1970s, such as acid rain and ozone depletion, led to an increase in research and policy development. New regulatory frameworks and agreements emerged, such as the Montreal Protocol (1987) to address the impact of CFC emissions on the ozone layer and the US Clean Air Act (1990) to reduce emissions of SO_2 and NO_x.

Since the 1980s, various industries have been taking voluntary measures to improve health, safety and environmental performance. In 1985, for example, the chemical industry launched the Responsible Care program, which is now active in 53 countries. Over the last two decades, the number of instruments, organizations and initiatives focusing on the internalization of environmental issues has grown enormously, although many externalities are yet to be addressed.

Finally, companies and their stakeholders have recently taken joint initiatives such as the Global Reporting Initiative to create an integrated approach towards the management and reporting of a broad range of externalities.

The difference between the past and today is that issues now run more quickly through the lifecycle. Whereas it took 60 to 100 years to get from the launch of the abolition movement in England to the official abolition of slavery, ozone-depleting CFCs were banned in less than 15 years.

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This historical review is instructive because it shows that externalities tend to go through three consecutive phases of a lifecycle, much as a product does (see Table 1). In the emerging stage, when an issue comes to the fore and business is asked to take care of it, this demand initially appears to be quite outrageous. In the subsequent growth phase, the issue becomes the subject of more debate, with the most proactive players in the industry taking the first measures. In the mature stage, the issue is fully internalized and often sealed by law to make sure there are no free riders. Regulation generally is the last step in internalization. By the time most businesses are convinced and have abandoned a certain practice, it is politically expedient to outlaw the practice and create a level playing field.

Table 1	The lifecycle of an externality

Emerging	Growth	Mature

Portion of society that is concerned by the externality

Becoming mainstream including:
Development of standards (e.g. IFC performance standards)
Collaborative assessments (e.g. Water Footprint Network, WBCSD)

Formalization including:
Development of regulation
New market mechanisms (e.g. emissions trading schemes)

Voluntary initiatives (e.g. nutritional labeling; voluntary agreement between automotive manufacturers and the European Commission)

Academic research (e.g. climate change research in 1950s and 1960s)
Specific events (e.g. disease outbreaks highlighting working conditions and child labor in 19th century UK)

Initial red flags:
Specific campaigns (e.g. genetic modification in 1980s)
Events (e.g Bhopal, Piper Alpha, Gulf Oil spill?)
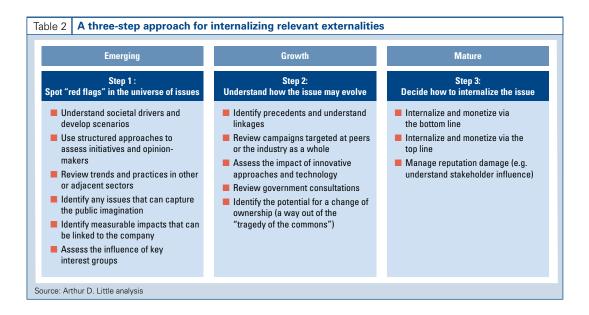
Time

Source: Arthur D. Little analysis

The difference between the past and today is that issues now run more quickly through the lifecycle. Whereas it took 60 to 100 years to get from the launch of the abolition movement in England to the official abolition of slavery, ozone-depleting CFCs were banned in less than 15 years. The higher speed can be attributed to increased information flows, the improved ability to track and measure impacts and the growing potential to link issues with brand identity.

If we take history as a guide, should business react to every externality and be ready to internalize it at some point? Our experience indicates that not all externalities go into the growth stage and, even if they do, they may do so at different speeds. As a consequence, the crucial decision for executives is: when do I switch from merely monitoring an externality to making it an operational business responsibility?

How to internalize what's relevant at the right time

In today's business environment, companies have to deal with a myriad of issues raised by interest groups, investors, government bodies and others all vying for attention. While it is impractical to consider all of these, waiting to be regulated is not an option either. So it is critical to identify which externalities will matter, and which won't, and then to act. There is a robust, three-step approach for doing so (see Table 2).

Table 2 | A three-step approach for internalizing relevant externalities

Emerging	Growth	Mature
Step 1 : **Spot "red flags" in the universe of issues**	**Step 2:** **Understand how the issue may evolve**	**Step 3:** **Decide how to internalize the issue**
■ Understand societal drivers and develop scenarios ■ Use structured approaches to assess initiatives and opinion-makers ■ Review trends and practices in other or adjacent sectors ■ Identify any issues that can capture the public imagination ■ Identify measurable impacts that can be linked to the company ■ Assess the influence of key interest groups	■ Identify precedents and understand linkages ■ Review campaigns targeted at peers or the industry as a whole ■ Assess the impact of innovative approaches and technology ■ Review government consultations ■ Identify the potential for a change of ownership (a way out of the "tragedy of the commons")	■ Internalize and monetize via the bottom line ■ Internalize and monetize via the top line ■ Manage reputation damage (e.g. understand stakeholder influence)

Source: Arthur D. Little analysis

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Step 1 – Spot red flags in the universe of issues

The first step is the continuous spotting of "red flags", i.e. warnings that something previously treated as mere noise may soon be a prominent feature in the annual report, so to speak. Red flags can include:

- **The exposure of questionable practices by others in the same or related sectors.** An example is Trafigura's concealment of the true nature of hazardous waste transported to the Ivory Coast, which raised the issue of cross-border controls. Other examples are major accidents or disasters such as BP's Deepwater Horizon oil spill in the Gulf of Mexico.

- **Public attention to leading practices by forerunners.** For example, the garden centre retailer B&Q surprised the industry when it announced plans to go peat-free with composts, which forced its peers to follow suit quickly.

- **The emergence of issues likely to capture the public imagination.** For example, campaigns on child labor have often focused on products such as footballs or chocolate, where children are also consumers.

- **Public attention to the (perceived) link between a company activity and an environmental issue.** For example, palm oil production or soya growing have long been associated with the loss of rainforest and biodiversity (even though these issues have been internalized only slowly, as commodity markets make it difficult to trace the sources of raw materials).

Step 2 – Understand how the issue may evolve

Once you have identified red flags, you can use a structured roadmapping approach to identify what actions to take as the externality evolves. To understand how the underlying issue may evolve, the management can do the following:

The first step is the continuous spotting of "red flags", i.e. warnings that something previously treated as mere noise may soon be a prominent feature in the annual report, so to speak.

- **Review pathways experienced by others.** Once external parties (interest groups, media, regulators, etc.) have covered easy-to-address companies, others can expect to be targeted. Fortunately, the latter can learn from the experience of the former. For instance, single-point source polluters are easy to address, control and manage, but in many cases non-point source polluters (e.g. fertilizer nitrate run-off from agriculture) can expect to be targeted next. Another example concerns carbon reduction schemes: they initially focused on big energy users (e.g. the Carbon Reduction Commitment in the UK involves a trading scheme only for companies using more than 6GWh per year), but attention is currently shifting to less energy-intensive sectors.

- **Determine the performance potential of new technology.** Newly emerging technologies may allow a previously unmanageable issue to be addressed and thus raise expectations about what companies should do about it. For instance, the availability of biometric identification technologies has enabled governments to identify "fake" employees who otherwise would continue to be paid with taxpayers' money.

- **Determine the performance potential of new measurement methods.** As with new technology, new ways to measure and understand issues may raise expectations about the actions companies could and should take. For example, the use of geographic information systems enables the mapping of factors affecting local health. Once these factors are identified (e.g. a nearby polluter), the companies linked to these factors could be targeted.

- **Assess the meaning of new approaches for assigning ownership.** As long as an issue remains shared between many parties, it is likely to remain an externality. This is the traditional "tragedy of the commons". But initiatives may be set up that assign ownership of the issue to individual companies. For example, the Marine Stewardship Council (MSC) established the Chain of Custody certification program for sustainable fishing: each company that takes ownership and/or processes the product is required to obtain its own Chain of

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Custody certificate in order to apply the MSC ecolabel. If there is any break in certification in the supply chain, products will not be eligible to carry the ecolabel.

Step 3 – Decide how to internalize the issue

Once you have concluded that an issue has a high likelihood of internalization or that the externality clearly is in the growth stage, you should determine how the issue can affect the financial performance of your company and, consequently, how you should manage it. You can internalize via the bottom line or the top line.

Internalizing via the bottom line

An emerging issue can be internalized by monetizing it. This means that you change your operations internally to deal with the issue (e.g. invest in pollution abatement equipment); then account for the net internal cost of dealing with the issue (e.g. also take into account the financial benefit of reduced energy consumption); and finally adjust the prices of your products to obtain a risk-adjusted return.

An emerging issue can be internalized by monetizing it. This means that you change your operations internally to deal with the issue.

Such monetization of an issue occurs frequently when an industry has decided to promote self-regulation and thus avoid more costly government regulation. Self-regulation can happen through the setting of strict rules or guidelines for business practice. By demonstrating to legislators that it can police itself and internalize the costs of environmental impacts, an industry may be able to avoid costly government intervention. For instance 67 of the world's banks have signed up to the Equator Principles based on the IFC performance standards. This has driven large infrastructure projects to prepare costed mitigation plans to address a wide range of issues such as impacts on community health, biodiversity, water quality.

Monetization can also occur at individual company level. For example, infrastructure projects often run into delays or cost overruns as a result of external concerns or demands popping up during construction (e.g. pressure to stimulate local employment or to address the impact of the project on local livelihoods). Smart companies anticipate these

issues and incur the upfront costs of internalizing them rather than run the risk of running into permission problems or getting entangled in costly local campaigns against the project. For example, a wind farm developer may offer a cash payment to people living nearby in exchange for them signing a waiver that they will not complain about excessive noise from the turning turbines.

Internalizing via the top line

An issue can also be internalized by turning it from a potentially costly problem into a revenue-generating opportunity. For example, a green design approach to product development, components or packaging may allow both the internalization of the cost of eco-design and a surge in sales to environmentally concerned customers. For companies such as Philips or General Electric, the sales performance of green products has paid back the cost of voluntarily internalizing negative environmental externalities.

Companies can also take external affairs initiatives related to externalities to gain market share with existing services and products. For instance, a major European public transport provider puts significant effort into lobbying for public transport franchises to include minimum environmental requirements above and beyond the engine emission standards put in place by the European Union. It is doing so because it knows that its competitors are still struggling to meet the regulatory minimum, while it has already decided to meet the stricter requirements.

Externalities to deal with today and tomorrow

While we do not possess a crystal ball, we endeavor, on the basis of our research and experience, to speculate about externalities that business may have to deal with in the coming years. The table below summarizes a number of emerging (negative or positive) externalities, by industry, which could have a major impact and hence warrant close monitoring or, in some cases, the first steps towards internalization. To calibrate these emerging externalities properly, we have also included a number of externalities that are already being recognized and/or internalized, i.e. that are in the growth or mature stage.

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Table 3	Examples of emerging externalities	
Industry	**Externalities in growth/mature stage**	**Externalities in emerging stage**
Agriculture	• Depletion of aquifers and groundwater • Impacts on animal welfare • Increasing resistance to antibiotics use	• Eutrophication from fertilizer run-off • Energy use for transporting food • Contribution of meat to reduced biodiversity
Fast-moving consumer goods & retail	• Depletion of water sources for surrounding communities • Contribution of food packaging to waste and pollution • Reduction of biodiversity due to sourcing of raw materials • Detrimental working conditions to drive down costs	• Management of obesity • Provision of wellness, not just food and drinks • Local sourcing of food ingredients • Value of the standing forest and pricing biodiversity and ecosystem services • Concern over high-fructose corn syrup due to different metabolic pathways v-a-v sugar
Finance	• Increased risk in the financial markets due to overextension of credit lines • Decreasing social cohesion due to backlash on excessive salaries and bonus schemes • Investments by pension funds in unsustainable businesses • Positive effects of lending services on employment and GDP	• A "flash crash" on the financial markets induced by algorithms using high-frequency trading • Temporary food shortages caused by speculation on the financial markets • Increased investment risks due to a lack of transparency in end-application of funds • Positive economic impact of enabling the offshoring of money
Manufacturing	• The financing of warlords through the sourcing of "blood minerals" • Global warming through the energy/greenhouse gas footprint of products • Exposure to toxic/hazardous substances • Detrimental working conditions at suppliers' sites caused by low-cost sourcing	• End-of-life impact from products (e.g. inefficient disposal of plastics, hazardous emissions from incineration) • Better environmental performance of new technologies coming on-stream • Scarcity of rare materials through raw materials use • Hawaiian beaches covered by plastic waste because of the long life-span of plastics
Telecom/broadcasting	• Internet addiction induced by spending too much time online • "Islands of quality" caused by tiered quality of network services • Increases in child obesity due to advertising of food products • Increased social inequality because of a "digital divide" in emerging markets • Improved access in remote areas to banking services through online services • Health concerns related to exposure to electromagnetic fields	• Social exclusion due to inability to access online services • Online privacy breach through the unauthorized installation of cookies • Job creation and increase in gross value added by investment in Next Generation Access Network (NGAN) infrastructure • Reduction of natural resources usage and increased productivity driven by embedded connectivity • Stress created by technology enabling employees to be "always on" • Decreases in social skills by reliance on social networking online
Transport	• Global warming related to fossil energy use • Economic impact of efficient transport provision • Local impacts (noise, emissions, etc.) of transportation	• Enabling integrated urban planning through intelligent transport systems

Industry	Externalities in growth/mature stage	Externalities in emerging stage
Extractive (energy, mining)	• Global warming through greenhouse gas emissions related to fossil energy • Social exclusion through inward migration of workers and camp followers • Local environmental impacts of extraction (air quality, water quality, land take, etc)	• Higher costs due to regulatory oversight and additional safety measures to counter calamities like the Gulf oil spill • Water use and local pollution from alternative fossil fuels (tar sands, shale gas) • Societal and biodiversity costs of opening up areas for exploitation
Utilities	• Global warming through greenhouse gas emissions related to fossil energy • Increases in fossil-based energy cost to subsidise energy sources • Impact of nuclear waste on future generations • Impacts on broader ecosystem through water use	• Deteriorating grid resilience due to intermittent renewable energy production • Concerns of smart meters being a "spy in the home"

In general, we predict that governments will be much more assertive in the decade to come. With governments having saved the world from financial ruin, with China being a successful state-led economy, and with climate change and other matters of sustainability requiring a strong government hand to guide the market, companies should prepare to incur higher costs and regulatory burdens related to safety, legislative compliance and more sustainable operation.

Insights for the executive

An externality is an indirect cost or benefit that accrues to society as a result of a company producing a good but that is not included in the market price of the good. Society often requires companies to address such externalities - that is, to internalize the issue that gave rise to the indirect cost or benefit – until it is an integral part of business and sometimes is no longer even considered an issue. A classic example is the replacement of CFCs, which were used as refrigerants and propellants, by substances that no longer contribute to the depletion of the ozone layer.

Looking at the fate of some companies subjected to heavy criticisms from stakeholders and the general public is enough for us to understand that companies should take externalities seriously. The first step for a company is to spot "red flags" that serve as an early warning of emerg-

ing externalities. Once a significant externality is identi-
fied, the company can develop roadmaps describing the
actions it should take as the externality evolves. To do so,
the company can review the experiences of peers that
have recently been scrutinized by their stakeholders for a
particular externality. Additionally, new technologies may
provide ways of tackling externalities that stakeholders had
hitherto accepted as unavoidable. The company can also
leverage expertise from associations and non-governmen-
tal organizations that strive to educate both companies and
the general public in ways to identify, manage and internal-
ize externalities.

Insights about the likely path the externality will take en-
able companies to develop business cases evaluating the
monetary impact of alternative ways of internalizing the
externality. Using the business case, companies can then
proceed to decide whether to accept the hit to the bottom
line, to use the externality in marketing efforts and/or to
make an effort to avoid the externality altogether.

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