CHAPTER 7

Community Embeddedness, Consumer Voice, Corporate Social Responsibility

Morris Altman

1 Introduction

For Tomer (Altman 2003; Tomer 1987, 1999, 2008, 2015), most firms do not realize their potential, which would occur if they were both ethical and socially responsible and maximized their productivity given their available resources. A firm that realized this specification of its potential represents what Tomer would consider to be the ideal firm. For Tomer, a socially responsible firm is closely intertwined with the notion of corporate social responsibility. He also maintained that there is a positive relationship between being ethical and, relatedly, socially responsible, and the firm's productivity. Realizing the potential embedded in this positive relationship facilitates achieving Tomer's benchmark of the ideal firm. He argues that rational firm owners and managers should make decisions that

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are consistent with the ideal firm. The latter should also involve incorporating any externalities into its decision-making process, which is part and parcel of a socially responsible firm. I would argue that the big public policy and social welfare or well-being question is: if the ideal firm is achievable, then why have most firms not realized their potential? A clear effect of firms performing below their potential is a less ethical society and a lower level of socio-economic well-being for its population.

In conventional economics, market forces would drive firms into behaving efficiently at least in terms of maximizing productivity. Tomer's prior assumption is that the latter does not typically take place in spite of the fact the ethical and socially responsible firm is the relatively more productive firm and is an achievable ideal. This view of the persistently economically inefficient firm flows from Leibenstein's (1966) x-efficiency theory, where it is argued that firms are typically not nearly as productive as they can be given their conventional factor inputs. Tomer also maintains that market forces do not drive firms into behaving ethically and in a socially responsible manner. Non-market factors are required to achieve this end.

Tomer argues that firm leaders can be nudged into making their firm more ethical firm and socially responsible by the communities in which they are embedded, by their firm's shareholders, and also by the fear of government forcing them to behave more ethically and socially responsible in the near future. In the latter case, government bureaucracies will make decisions for the firm which firm leaders might believe could be better or more efficiently made by themselves if only they can pre-empt government intervention by becoming more ethical on their own. In other words, the social and institutional environment, which includes a credible threat by government to eventually force ethical behaviour on the firm, can be expected to induce firms into behaving ethically and in a socially responsible manner. Firms can also by coached into becoming more ethical by government, by demonstrating to firm owners the benefits of being ethical or socially responsible. All of this nudging induces the firm into behaving more rationally, that is a more ethical and socially responsible manner.[1]

This chapter addresses the question of why firm decision-makers would choose not to transform their firm into ethical and socially responsible

[1] Tomer relates being ethical and socially responsible to being rational in that this contributes to increasing the firm's efficiency.

entities. In contrast to Tomer, I argue that rational firm decision-makers should *not* be expected to behave ethically or socially responsibly especially if they are motivated by profit maximization or cost minimization and if they *believe* (mental models) that efforts to become more ethical and socially responsible will make their firm less competitive. Therefore, I underline the importance of the mental models (Altman 2014; Denzau and North 1994) adopted by decision-makers with regards to the effect of being more ethical and socially responsible upon profits and average costs. This speaks to the potential importance of coaching (as Tomer puts it), which can provide decision-makers with more accurate mental models on the net economic impact on the firm of engaging in ethical and socially responsible behaviour. More, broadly, this speaks to the importance of education in affecting the mental models and, therefore, the decisions made by firm leaders.

Moreover, I argue, building upon an extended x-efficiency theory of the firm, drawing upon the original insights of Leibenstein (1966), that even when productivity and ethical behaviour is positively and causally related this does not necessarily mean that being ethical will yield higher profits and lower unit costs of production, which is implicitly assumed in Tomer's narrative. Becoming ethical and socially responsible typically incurs costs which can offset the productivity benefits of becoming ethical and socially responsible. Hence, rational profit maximizing firm decision-makers need not choose to convert their firms into ethical entities given that there is no economic (profit, cost) imperative to do so. Even if being ethical and socially responsible does not cause competitive harm to the firm, doing the right thing may not be enough to motivate rational profit motivated decision-makers to change their behaviour. This is particularly the case when decision-makers are not imbued with a strong sense of moral sentiment and empathy. And, there is no empirical basis upon which to ground the assumption that the typical firm decision-maker is imbued with a strong sense of moral sentiment and empathy.

Unlike Tomer, I do not assume irrational decision-makers (when they fail to become more ethical and socially responsible). Rather, I model why *rational* decision-makers will *not* choose to transform their firms into ethical and socially responsible firms. I also model the conditions under which rational decision-makers will chose to engage in such a transformation. Critical to this chapter is modelling the conditions under which consumers and firm stakeholders will advocate for and nudge firms towards being more ethical and socially responsible. Of significance here is the importance of mental models adopted by firm decision-makers, as well as by consumers, firm stakeholders, and government. The role of imperfect and asymmetric information in affecting decision-making is also addressed. As Tomer argues, the credible threat of government policy can also play an important role in transforming firms towards becoming more ethical and more socially responsible. But, I argue, this very much relates to whether government decision-makers believe that Tomer's ideal firms are consistent with being competitive and economically sustainable over time. There is a critical interaction between mental models, the preferences of all decision-makers, power relationships across economic agents, and the extent to which ethical and socially responsible firms are economically sustainable. Finally, I argue that the extent to which a firm is embedded in its community can affect the extent to which it behaves in a socially responsible manner. A community embedded firm, as compared to one where the firm is controlled and owned by non-local individuals and organizations, is less likely to succumb to public stakeholder pressure to behave in a more socially responsible manner.

2 Being Ethical and the Conventional Economic Wisdom

A useful starting point for addressing Tomer's narrative of the ethical and socially responsible firm is Friedman's (1970) classic narrative on what should be considered as ethical behaviour by firm decision-makers, which is very much vested in conventional economic theory. Friedman's key point is that any decision that results in damaging the firm's competitive position, reducing its rate of return, or reducing dividends paid to shareholders is a product of unethical behaviour by the firm's decision-makers, by its leadership. It represents a betrayal of the firm's stakeholders (firm owners), who the firm's decision-makers have a moral obligation to represent. These owners would typically be interested in maximizing profits. Therefore, improving working conditions, increasing real wages, reducing the firm's environmental footprint should be deemed unethical if it causes economic harm to the firm. But it is these types of behaviours that Tomer, amongst others, argue are critical ingredients of an ethical and socially responsible firm.

Friedman writes in his now classic 1970, New York Times article, how one should define ethical behaviour for firm leaders in market embedded, profit-oriented firms:

> In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom. Of course, in some cases his employers may have a different objective. A group of persons might establish a corporation for an eleemosynary [charitable] purpose–for example, a hospital or a school. The manager of such a corporation will not have money profit as his objective but the rendering of certain services.

Friedman (1970) elaborates on the above by quoting from his book, *Capitalism and Freedom* (Friedman and Friedman 1962): "…there is one and only one social responsibility of business–to use it resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."

Friedman maintains that members of a firm's executive can engage in costly ethical behaviour at their own expense, but not at the expense of the firm that employs them to maximize profits, share value, or dividends. Also, such ethical behaviour can be consistent with alternative organizational forms such as charitable organizations where non-profit maximization objectives take priority. Friedman does not mention member-owned organizations or co-operatives wherein member concerns and benefits are first priority. But I would argue that for all organizational forms, inclusive or charities and co-operatives, the firm or organization must be economically sustainable. Costs can't exceed revenue over time, unless their losses are covered by subsidies. It is also important to note that Friedman accepts the conventional view that being ethical and engaging in socially responsible behaviour incurs costs which cause economic harm to the profit-oriented firm. Tomer rejects this assumption and in so doing challenges an underlying premise of conventional economics that being profit-oriented is inconsistent with a firm being and, more broadly speaking, socially responsible.

Tomer's rejection of the conventional narrative is consistent with that of other economists who are argue that capitalism is compatible with ethical behaviour and that ethical behaviour can have positive effects on the firm's overall economic performance (M. Altman 2020). A most recent pro-ethics narrative is presented by McCloskey (1996), who argues that with the flourishing of markets there should be the flourishing of ethical behaviour within firms and society at large. This is a function of ethical behaviour (it is assumed) being embedded in bourgeois values. However, there is evidence to suggest that ethical and socially responsible behaviour is not inevitable under capitalism even though it is not damaging firms and their competitive position. It is important to explain why this is case, especially if one assumes that decision-makers are rational.[2] Why would rational decision-makers not take advantage pursuing further economic efficiencies through more ethical and socially responsible behaviour? It would appear that this would be (irrationally) equivalent to leaving big bills lying on the sidewalk (Olson 1996).

3 Modelling Ethical and Socially Responsible Firms as Sustainable and Competitive Organizations

Tomer's narrative on the ethical and socially responsible or his ideal firm can be incorporated in an extended x-efficiency model of the firm (Leibenstein 1966; also Frantz 1997) which I've developed elsewhere (Altman 1996, 2001, 2005, 2006, 2012, 2017, 2019, 2020). A key point made by Tomer is that ethical and socially responsible behaviour contributes to firm productivity through its impact on the firm's level of x-efficiency. The latter refers to the extent to which the firm is maximizing productivity given its traditional factor inputs and given technology. In the x-efficiency narrative one important variable affecting productivity is the level of the quality and quantity of effort input, which is assumed, based on the evidence, to be a variable. In a sense, this is what Tomer's narrative implies wherein ethical and socially responsible behaviour serves to increase the level of effort inputs towards some optimal/maximum level. Relatively, unethical and socially irresponsible behaviour results in less of than optimal or x-inefficient levels of productivity. This runs contrary to the conventional economic wisdom that firm decision-makers, in the pursuit of profits and their self-interest to maximize their material benefits, and paying attention to competitive market forces, will assure that all economic agents within the firm will be working as smart and as

[2] As previously mentioned, Tomer assumes that decision-makers can be and often are irrational because they don't subscribe to the development of the ideal firm which is, for Tomer, the ethical and socially responsible firm.

hard as they can. A less stringent assumption stemming from this narrative is that effort inputs are fixed at some high level and not subject to change. If effort inputs are maximized or fixed, they can be assumed away as a variable input in the production function.

One way of connecting the conventional model with Tomer's narrative and x-efficiency theory is to clearly stipulate the relationship between effort inputs, the cost of inputs (one of which is the cost of being ethical and socially responsible), average costs, and productivity. Leibenstein's (1966) cost narrative is illustrated in Eq. 1 for a very simple model of the firm with one factor input. AC is average cost, w is cost per unit of input (here the cost per hour of labour), and Q/L is labour productivity (derived from Altman 1996, 2005, 2017). When effort input is reduced, labour productivity (Q/L) diminishes and this increases average costs. The reduction in productivity is a measure of an increase in the level of x-inefficiency. The increase in average cost makes the firm less competitive. Leibeinstein argues that x-inefficiency is the norm, especially where such higher cost firms are protected by imperfect (less competitive) product markets and government policy such as tariffs and subsidies. Tomer argues that being more ethical and socially responsible should make the firm more productive, and this can be related to the firm becoming more x-efficient (increasing Q/L) (see also M. Altman 2020). But ceteris paribus, this should result in lower average cost as per Eq. 1. This point is not made explicit in the Tomer narrative. My modelling raises the fundamentally important question as to why, if ethics and social responsibility is good for business, all profit-seeking firms do not converge towards ethical and socially responsible organizational forms.

$$\mathrm{AC} = \frac{w}{\left(\frac{Q}{L}\right)} \tag{1}$$

What one must recognize and incorporate into one's modelling is the fact that becoming and then remaining more ethical and socially responsible comes at a cost. In Eq. 1, this cost can be proxied by w. Hence, increasing a firm's ethical and socially responsible dimension increases w and, thereby, average cost. Only if the productivity effect of becoming more ethical and socially responsible offsets the costs of so doing will average cost not increase. On the hand, becoming less ethical and socially responsible should reduce productivity, which can actually have the net effect of increasing average cost. This fall in productivity could be the result of firm members retaliating against their firm's unethical behaviour by reducing their effort input, thereby making the firm less productive. It is possible that the productivity effect of becoming more or less ethical and socially responsible will simply offset the associated change in cost: changes in Q/L will always offset changes in w. If this latter scenario holds true, then becoming more ethical and socially responsible does not yield a competitive advantage, nor does becoming less ethical and socially responsible.

Appreciating that decision-makers, firm leaders have some choice as to whether or not to become more or less ethical and socially responsible and remain economically sustainable, allows us to address a number of important theoretical and policy issues raised in Tomer's narrative. From a theoretical perspective, one can explain why there is no economic imperative for firms to become more ethical and socially responsible (M. Altman 2020). Moreover, to the extent that firm leaders have some choice with regards to becoming more or less ethical or socially responsible, one can better identify why a firm would choose to be relatively unethical and less socially responsible and what type of polices can shift a firm to a more ethical and socially responsible equilibrium. Some of these points are illustrated in Diagram One.

Average cost is mapped against the level of ethical and socially responsible behaviour and related firm characteristics. Acon represents the conventional economics-Friedmanite view of the world. Increasing the extent to which the firm is ethical and socially responsible results in increasing average costs. This damages the firm's economic position, and it would be unethical for firm leaders to do so when the firm leaders are responsible to firm owners, unless the firm owners are happy to absorb these additional costs (owners have a preference for being more ethical and socially responsible). Also, ceteris paribus, one would expect that such high cost firm would fail to compete unless supported by government. What is consistent with Tomer's narrative as well as that of McCloskey is ATM, wherein average costs decrease as the firm becomes more ethical and socially responsible. Tomer makes the case, as discussed above, that the more ethical and socially responsible firms are or should be more productive (in part by reducing the extent of x-inefficiency), and this increase in productivity more than offsets any associated costs of becoming more ethical or socially responsible. If this were the case, then any rational firm decision-maker would choose to become ethical and socially responsible. Moreover, these more progressive firms would be more cost competitive and should drive out of the market the less ethical and socially responsible firms.

As McCloskey argues the spread of capitalism should coincide with the eventual dominance of progressive firms—there is a form of ethical imperative towards an ethical and socially responsible capitalist society. However, an unequivocal ethical imperative does not appear to exist—there appears to be no such dynamic equilibrium. This particular point is illustrated in line segment ad, wherein there exist different levels of ethical and socially responsible behaviour consistent with a unique average cost (based on Altman 1996, 2009, 2017, 2020). Along ad, one has a type of multi-equilibrium with respect to different levels of ethical and socially responsible behaviour and related characteristics consistent with a particular average cost. Past point d (and c) further increases in ethical and socially responsible behaviour will increase average costs (dBE), which is consistent with the conventional economic model. However, if increasing the extent to which the firm is ethical and socially responsible induces technical change (M. Altman [2020], this shifts our average cost curve from BE to BETC, and this illustrates an increase in the multi-equilibrium possibility set. There is no ethical imperative here, but there is a range of ethical and socially responsible possibilities which may or may not be taken up by firm leaders. Therefore, choosing not to transform their firms into Tomer's ideal (ethical and socially responsible) firm would be consistent with rational profit maximizing behaviour (Fig. 1).

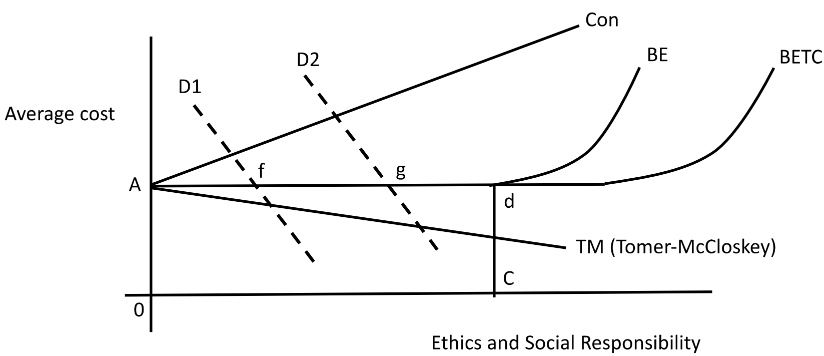

Fig. 1 Ethics, social responsibility and X-efficiency

4 Determining a Firm's Ethical and Socially Responsible Equilibrium

Given the possibility that being more or less ethical (up to a point) will not damage a firm's economic position, there are multiple factors that could induce firms to be more ethical and socially responsible. I would highlight the importance of mental models in determining decision-makers choices given their preferences. I would also underline the importance of the quality of pertinent information available to consumers with regards to the extent to which producers of goods and services are ethical and socially responsible. Also, of importance, is the ability of consumers to understand the available information on the extent to which firms are ethical and socially responsible. This is especially important in the real world of bounded rationality where information is costly and asymmetric and the deception of consumers is a very real possibility. This supplements Tomer's focus on coaching and credible threats as a means of inducing firms into becoming more ethical and socially responsible.

One reason why a firm's leaders would choose to remain relatively unethical would be the mental models that they adopt or with which they are instilled, to made rational business decisions (Altman 2014). If one believes in the conventional theory of the firm, then being ethical and socially responsible is a costly proposition, yielding, higher average costs, lower rates of return, and lower dividends, and even lower share values. Even if this mental model is a false mental model, an incorrect representation of reality, it can still drive firm leaders to make decisions that are socially sub-optimal and as well as being sub-optimal from the perspective of the firm's employees (Altman 2014). In this case, improving the information set available to firm leaders with regards to the economic viability and sustainability of more ethical and socially responsible firms and improving their understanding of this information can result in their adopting more truthful mental models. This would shift the demand by rational profit maximizing firm leaders for more ethical and socially responsible firms.

This underlies the potential importance of business education for business leaders affecting their demand for more ethical and socially responsible firms. This type of education can be incentivized through government action (such as coaching), but also by the type of education provided by universities and their business schools and economics departments. Tomer argues that government can coach firm leaders on the benefits of becoming more ethical and socially responsible. Of course, this overlaps with the overall importance of education in affecting firm leaders' and owners' decision-making through its impact on the decision-makers' mental models. I would also argue, that of critical importance, is government support for firms willing to invest in the start-up costs required to make their firms more ethical and socially responsible.

Providing firm leaders with a more truthful mental model can shift the firm's equilibrium position towards point d along line segment Ad in Diagram One. One can illustrate this point with a leader's demand curve for a more ethical and socially responsible firm shifting from D1 to D2, moving the firm from equilibrium f to g. This would be the case for firm leaders, decision-makers, and owners as well, who have a preference for their firm being more ethical and socially responsible if this causes no harm to the firm's bottom line and, of course, its competitive position.

Note, that in this case there is no change in the preference function of firm leaders. They actually prefer more ethical and socially responsible firms. But this preference is only realized when their mental model changes, in this case as a function of more accurate information and business education. This is an important point, since I am not arguing that individuals' preferences have to change if one is transitioning to more ethical and socially responsible firms. In this case, it the change in mental models, which is motivated by education and coaching that changes the demand for more ethical and socially responsible behaviour within firms. It is not the change in the preferences of decision-makers.

But this shift in the demand curve will not occur even if firm leaders are informed by correct mental models if they don't have a preference for more ethical and socially responsible firms. This can relate to the utility that some firm leaders might obtain from having more power (which yields positive utility) relative to their employees and society at large, which they might perceive diminishing in the context of a more ethical and socially responsible firm. If firm leaders and owners have such a relative power related preference function, the fact that their firms becoming more ethical and socially responsible has no negative impact on their firm's competitiveness and profitability, is of no consequence. Their preference function yields a socially sub-optimal equilibrium. It is this socially sub-optimal equilibrium that serves to maximize the utility of such firm leaders and owners. In this case, for firms governed by such decision-makers, one would have to go beyond education to transform firms into more ethical and socially responsible entities even if it is common knowledge that being ethical and socially responsible is economically sustainable in a competitive market economy.

It is when one is stuck in such a sub-optimal equilibrium that methods of nudging firm leaders and owners to transform their firms into becoming ethical and socially responsible becomes critically important. Going beyond the importance of false and true mental models in affecting decision-making, one should consider the points raised by Tomer on the significance of consumer behaviour and social factors affecting decision-making as well as the fear of government intervention as motivating factors in driving more ethical and socially responsible behaviour.

One way to model the role of consumer behaviour is to assume that firm decision-makers are narrow profit maximizers and that they also have a strong preference to maintain their relative positioning with respect to their employees and the wider community. They are happy to maximize their utility at some sub-optimal, relatively low level ethical and socially responsible equilibrium. But consumers with a preference for ethical products can express their preference for the output of firms producing more ethically and socially responsibly by purchasing such output. This requires that consumers can identify this output. This point is critically important in the real world of imperfect and asymmetric information (Akerlof 1970; H. Altman 2020). If this is achievable and the output of ethical and relatively non-ethical firms sells at the same price point, this provides a competitive advantage to the relatively more ethical and socially responsibly firms. Actualizing pro-ethical consumer preferences incentivizes the most unethically oriented firm decision-makers to transform their firms into more ethical and socially responsibly entities. Otherwise, their firms' market share, profits, dividends, and share value will diminish. In this case, the unethically oriented preferences of certain business leaders can't be actualized in a sustainable manner. Market forces will force their firms into becoming more ethical and socially responsible.

In the extreme, if all consumers had pro-ethical preferences, under the conditions outlined above, with ethical firms producing at the same price point and the same average cost as relatively unethical firms, all unethical firms will go bankrupt or be transformed into ethical and socially responsible organizations. If the consumers would be willing pay a somewhat higher price for the output of the more ethical firms (where they produced at a higher average cost), this would only strengthen the hand of the more ethical and socially responsibly firms (Altman 2016; M.

Altman 2020). However, to the extent that being ethical and socially responsible dramatically increases average costs then it is less likely that most consumers would be able or willing to make such a sacrifice in real income. But this is an empirical question.

Given the above, one reason for the lack of convergence towards firms becoming ethical and socially responsibly would be the consumers not having in hand easily available, understandable, and trustworthy information on the extent to which the goods and services they are wanting to purchase are being produced by relatively ethical or unethical firms. Imperfect and costly information serves to protect relatively unethical firms and those that are not socially responsible from the wrath of pro-ethical consumer preferences. This would represent a form of market failure wherein consumers are not able to realize their pro-ethical product preferences on the market. Government can help correct this market failure by legislating for 'ethical' product labels so that consumer can discriminate between firms with respect to how ethical and socially responsible they are. This enhances the extent to which consumers objectively can exercise freedom of choice in the market.

Also related to significance of consumer preferences affecting the extent of a firm's ethical practices and the extent of its socially responsible behaviour is the increasing importance of the ESG (environmental, social, and governance) related consumer activist groups. These groups can more effectively lobby corporations to change their behaviour than individual consumers. This can be done by affecting investments in the firm and by lobbying against the purchase of goods and services produced by firms that lobbies deem to be 'dirty' firms. This has been of particular importance with regards to corporations whose investments and/or outputs impact on the environment. In other words, ESG lobby group can affect a firm's profitability by impacting both investment in the corporation and consumer demand. A profit-oriented firm can be expected to adjust its behaviour in the face of such lobbies to secure its profit targets and, relatedly, its position in the market. There is strong evidence that firms are investing heavily to meet ESG targets and that such investments have not harmed these firms bottom line, especially with regards to value creation (Henisz et al. 2019; Mooney 2021; Williams 2021). These investments also help maintain firms' market share.[3] ESG lobbying is just another

[3] However, there is no clear and unequivocal evidence that firms' bottom line is necessarily improved if they invest significantly in ESG. Much depends on how consumers

important instrument available to affect the extent of a firms ethical and socially responsible behaviour and even that of firms dominated by the most narrow profit-oriented considerations.

Community embeddedness can play an important role in incentivizing firm leaders and owners in to becoming more ethical and socially responsible. In this case, I would argue that even if firm decision-makers are narrow profit maximizers and have a strong preference to maintain their relative positioning with respect to their employees and the wider community, they might modify their behaviour (choices) towards a more ethical and socially responsible behaviour, if this increases their firms' competitive position in the community within which they are embedded. This narrative is most pertinent with regards to the issue of negative externalities and where the firm is more dependent in local-community markets and financial support. In this case, community awareness of how ethical the firm is, is of critical importance. Also of significance is the bargaining power, the community has relative to the firm.

Community embeddedness as a factor affecting firm behaviour also becomes more significant when firm leaders and owners reside in the community where their firm is located (Clark and Soulsby 1998). In this scenario, locally domiciled leaders' and owners' utility would be affected by local dissatisfaction with a firm generating negative externalities within its community. This would be especially the case when community members understand that firms internalizing negative externalities will not negatively impact these firms' competitive position. If firm leaders are domiciled external to where their firms are located there may be no loss in utility associated with the firm refusing to internalize negative externalities.

The domicile of firm leaders and owners can also be important in deciding whether or not to shut down a firm that's competitive but only marginally so. Here too, the firm leaders and owners' utility can be negatively affected when shutting down a marginal firm if they are domiciled locally. In theoretical economics, there is a shut-down rule, but there is also a point at which a rational profit maximizing firm decision-maker is indifferent to keeping the firm open or shutting it down. It is at this point of indifference where the location of firm leaders (the community

react to the knowledge that firms are not performing ethically and in a socially responsible manner. And this depends on the information consumers have in this domain and how well they understand this information.

embeddedness of a firm) can play an important role in determining if a marginally competitive firm is shut down.[4]

Tomer place some weight on firm leaders and owners changing their behaviour under the credible threat of government intervention with regards to the ethical practices inside their firms and the extent to which these are behaving in a socially responsible manner. This would suggest the importance of government making explicit what are acceptable dimensions of relatively unethical practices and the limits to behaviour that is not relatively social responsibility and what are the consequences on not enacting suggested government provisions. It is important that this notion of credible threat needs to be operationalized to be meaningful in relation to specific policies and incentive environment. Moreover, it is important to recognize the efficiency costs that might flow from any centralized bureaucratic provisions imposed or recommended for firms and localities in general where individualized provisions might be more effective and efficient. Still, the credible threat argument can be important where the preferences of decision-makers are not predisposed to more ethical and socially responsible behaviour.

5 Conclusion

John Tomer argued that the ethical and socially responsible firm is the ideal firm, and it should be more productive than the less ethical and socially responsible firm. Hence, rational decision-makers should choose to transform their firms into more ethical and socially responsible organizations. Since this choice is typically not made, firm leaders' behaviour is not quite rational (quasi-rational perhaps) and society ends up with sub-optimal x-inefficient outcomes. Hence, Tomer argues that firms should be nudged into being transformed into more ethical organizations through coaching (largely by government) and through the credible threat of government intervention if firm leaders do not undertake this transformation on their own.

[4] In the short run, where price is less than average variable costs, the firm should shut down. But when price equals average variable costs, and this calculation is never precise and is subject to change even in the short run, firm leaders may or may not shut down the firm. The firm leaders might be indifferent to shutting down the firm if their utility is unaffected by their decision. However, if utility is affected by the domicile of the decision-maker, this can tip the shutdown decision in favour of keeping the marginal firm open and giving it time to restructure itself into becoming a more profitable entity.

I build on Tomer's core arguments, embedding them in an x-efficient behavioural theory of the firm narrative with rational decision-makers. I also introduce the notion of mental models and the importance of informed consumer choice as additional key determinants of the extent to firm which firms become more or less ethical and socially responsible. This compliments Tomer's emphasis on coaching as a determinant of the extent to which a firm is ethical and socially responsible. Finally, I introduce the notion of how community embeddedness can positively influence rational decision-makers towards transforming their firms into more ethical and socially responsible organizations.

Unlike in Tomer's narrative, I present a multiple equilibrium model wherein both ethical and unethical firms are competitive even though the ethical and more socially responsible firm is more productive. This productivity advantage is often counterbalanced by the increased cost of being more ethical and socially responsible. This helps explain why, even within the framework of rational decision-making, Tomer's ideal firm need not dominate the marketplace. In this case, changing the mental models of decision-makers such that there is an appreciation of the competitiveness of the more ethical firms can serve to shift the decisions of decision-makers with a preference for more ethical and socially responsible behaviour towards transforming their firms. Even decision-makers who prefer ethical firms will not move in this direction if their thinking is dominated by mental models that predict that more ethics and social responsibility are very bad for business. This focus on mental models compliments Tomer emphasis on coaching whereby coaching affects which mental model is adopted.

But I also introduce the importance of consumer demand in driving firms into becoming more ethical and socially responsible when consumers are provided with accurate and easily accessible information on the ethical and socially responsible pedigree of firms (their supply chain) selling goods and services. This would be the case even when firm leaders have a strong preference for not transforming their firms into more ethical and socially responsible organizations. If the market demands more ethical and socially responsible firms, then even very profit-oriented and very anti-communitarian firm leaders are incentivized to transform their firms. Otherwise, their firm might very well earn the wrath of the market, making them less profitable and even unprofitable. Community embedded can play this same role.

Overall, Tomer's ideal firm can be realized when profit maximizing or profit-concerned decision-makers have the ability and the incentive to transform the firms under their charge into Tomer's ideal, ethical, and socially responsible firms. But decision-makers must also have an accurate understanding of how being ethical and socially responsible affects their firms' bottom line and competitive position.

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