The Virtue Matrix: Calculating the Return on Corporate Responsibility

by Roger L. Martin

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HBR CASE STUDY
The Coach Who Got Poached R0203A
Idalene F. Kesner

FIRST PERSON
The Trouble I've Seen R0203B
David N. James

DIFFERENT VOICE
Everything I Know About Business I Learned from Monopoly R0203C
Phil Orbanes

The 2002 HBR List: Breakthrough Ideas for Today's Business Agenda R0203D

The Virtue Matrix: Calculating the Return on Corporate Responsibility R0203E
Roger L. Martin

The Hidden Challenge of Cross-Border Negotiations R0203F
James K. Sebenius

Making Sense of Corporate Venture Capital R0203G
Henry W. Chesbrough

THE HBR INTERVIEW
Edgar H. Schein: The Anxiety of Learning R0203H
Diane L. Coutu

FRONTIERS
Predicting the Unpredictable R0203J
Eric Bonabeau

TOOL KIT
Do You Have a Well-Designed Organization? R0203K
Michael Goold and Andrew Campbell

The Virtue Matrix

Calculating the Return on Corporate Responsibility

Most companies want to be good corporate citizens. But at what price? A new tool pinpoints when it's smart business to do the right thing—and when it's not.

The images from recent meetings concerning globalization in Seattle, Davos, and Genoa might seem to suggest that only the unwashed and the unruly are pressuring business to show a greater sense of social and environmental responsibility. But it's increasingly clear that the calls are coming from mainstream quarters of society as well. Many consumers and investors, as well as a growing number of business leaders, have added their voices to those urging corporations to remember their obligations to their employees, their communities, and the environment, even as they pursue profits for shareholders.

But executives who wish to make their organizations better corporate citizens face significant obstacles. If they undertake costly initiatives that their rivals don't embrace, they risk eroding their competitive position. If they invite government oversight, they may find themselves hampered by regulations that impose onerous costs without generating meaningful societal benefits in return. And if they insist on adopting the wage scales and working conditions that prevail in the world's wealthiest industrial democracies, they may succeed only in driving jobs to countries where less stringent standards are the norm.

These dilemmas, which have long bedeviled business thinkers, were the focus of discussion among a group of executives, academics, and public-sector policy makers, myself included, who gathered recently at the Aspen Institute in Colorado under the auspices of its Initiative for Social Innovation Through Business. It would be going much too far to say that our group arrived at any solutions to these urgent problems. But prodded by our discussion, I designed an analytical tool that helps executives think about the pressing issue of corporate responsibility. Having tested and refined it with my colleagues at the institute, I'm confident that this tool, which I call the *virtue matrix,* can help executives understand what generates socially responsible corporate conduct.

You'll notice that I refer to corporate responsibility in this article as if it were a product or service. That is no accident. It's my contention that, by treating corporate responsibility as an artifact subject to market pressures, the virtue matrix reveals the forces that limit its supply and defines measures likely to increase it. Before we turn to the matrix, let's explore the drivers of corporate virtue.

Generating Corporate Virtue

By now, the story of Malden Mills and its owner, Aaron Feuerstein, is so familiar that the company name has become a sort of shorthand for corporate benevolence. The tale briefly told: In 1995, a fire destroyed Malden Mills' textile plant in Lawrence, an economically depressed town in northeastern Massachusetts. With an insurance settlement of close to $300 million in hand, Feuerstein could have, for example, moved operations to a country

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with a lower wage base, or he could have retired. Instead, he rebuilt in Lawrence and continued to pay his employees while the new plant was under construction.

"Why don't more companies act that way?" is a common reaction when people first hear the story. It is much too simplistic to reply that Feuerstein is a better person than most. Whatever Feuerstein's relative level of virtue, he had far fewer shareholders to answer to than the average CEO. Feuerstein's only shareholders are himself and several members of his family, who presumably share his willingness to sacrifice profits for the sake of the employees' well-being. (Feuerstein was perhaps too willing – Malden Mills filed for bankruptcy protection last November.) The typical CEO of a publicly held corporation, by contrast, is accountable to thousands of shareholders.

My purpose here is not to denigrate the share-owned corporation, which is a fundamental building block of democratic capitalism, but to acknowledge that its legal structure imposes certain priorities on its senior leaders. If they fail to maximize earnings for shareholders, managers risk removal by the equity holders to whom they report. Worse, failure to serve shareholders' interests puts the corporation in jeopardy of being acquired by a stronger company or losing access to capital markets. In theory at least, self-interest and self-preservation ensure that no rational executive will engage in activities that clearly erode shareholder value.

But corporations don't operate in a universe composed solely of shareholders. They exist within larger political and social entities and are subject to pressures from other members of those networks, be they citizens concerned about environmental pollution, employees seeking to strike a balance between work and family, or political authorities protective of their tax bases. When the interests of shareholders and the larger community collide, management typically (and quite rationally) sides with shareholders. The almost inevitable next step is for management to come under fire for favoring the narrow interests of shareholders over the broader interests of the community – or to put it another way, for failing to meet the demand for social responsibility.

The interests of shareholders and those of the larger community are not always opposed, of course. Corporations often willingly engage in socially responsible behavior precisely because it enhances shareholder value. They choose to undertake philanthropic activities such as supporting local museums or soup kitchens because management believes such activities create goodwill among customers in excess of their price tag. Likewise, companies provide day care and exercise facilities because the improved productivity and retention rates generated by those perks outweigh their cost. And a growing number of companies such as the Body Shop, a global skin- and hair-care retailer, make corporate virtue part of their value proposition: Buy one of our products, the Body Shop tells its customers, and you improve the lives of women in developing countries, promote animal rights, protect the environment, and otherwise increase the supply of social responsibility.

There's a second class of socially responsible corporate conduct that generates shareholder value by keeping a business on the right side of the law. For example, company compliance with worker safety regulations and sexual harassment statutes serves shareholders' interests by keeping a company free from legal sanctions and by safeguarding its reputation.

Clearly, then, shareholder value and social responsibility are not necessarily incompatible. Whether their activities are dictated by choice – supporting charities and cultural institutions, for instance – or by compliance – adhering to laws and regulations – corporations can and do serve shareholders' interests while also serving those of the larger community. For the purposes of this article, such forms of corporate social responsibility are termed *instrumental* – that is, they explicitly serve the purpose of enhancing shareholder value. At any given moment, instrumental practices, backed by either laws and regulations or social norms and conventions, make up most of the supply of responsible corporate behavior.

Another set of activities, however, increases this behavior but is not guaranteed to do the same for shareholder

The Virtues of the Virtue Matrix

The virtue matrix supplies a conceptual framework for addressing questions about corporate responsibility, including:

- What drives the market for responsible corporate behavior?
- What creates public demand for greater corporate responsibility?
- Why does globalization heighten anxiety about corporate responsibility?
- What are the barriers to increasing responsible corporate behavior?
- What forces can add to the supply of corporate responsibility?

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value; in fact, these activities may diminish it. The motivation for such activities is not instrumental – that is, impelled by the clear purpose of enhancing shareholder value – but *intrinsic:* A company's leaders embark on a course of action simply because they think it's the right thing to do, whether or not it serves shareholder interests.

Some intrinsically motivated actions turn out to benefit shareholders as well as society. Henry Ford believed he ought to pay his workers enough to afford to buy the cars they produced. That policy appeared to place him at a disadvantage, since the wages and job security at his plants were well in excess of the norms in the auto industry at the time. But his decision ultimately benefited Ford Motor Company by making it an attractive employer and by stimulating demand for its products. At the same time, Ford's move benefited society by raising the bar for pay and labor practices across the auto industry. (Ford wasn't all corporate virtue, unfortunately. Among other things, he used lethal tactics in breaking the 1937 strike at the Rouge plant in Dearborn, Michigan, and he was anti-Semitic.)

Some intrinsic activities, like Feuerstein's, benefit society at the shareholders' expense. Others, however, unless widely adopted, are both detrimental to shareholders and ineffectual in establishing socially beneficial norms. For instance, the leaders of a chemical producer may believe that investing heavily in greenhouse-gas reduction is the right thing to do. But if the producer's rivals refuse to follow suit, the company may undermine its own cost-competitiveness without significantly lowering overall greenhouse-gas emissions. Similarly, a large exporter may balk at paying bribes to foreign officials to win sales. But if its offshore competitors persist in the practice, the company and its shareholders are put at a disadvantage while the norms that countenance bribery in the first place remain unchanged.

In retrospect, of course, it is fairly easy to determine whether a particular corporate action benefited shareholders, society, both, or neither. But corporate leaders don't have the aid of hindsight when making their decisions. They can, however, use the virtue matrix as a framework for assessing opportunities for socially responsible behavior.

How the Matrix Works

Let's now take a look at the exhibit "The Virtue Matrix." The matrix is composed of four quadrants. The bottom two quadrants make up the foundation of the matrix, the top two its frontier.

The lower two quadrants of the matrix are what I call the *civil foundation.* The "common law" of responsible corporate behavior, the civil foundation is an accumulation of customs, norms, laws, and regulations. It promotes conduct that is socially responsible and enhances shareholder value. In the left quadrant is conduct that corporations engage in by *choice,* in accordance with norms and customs. The right quadrant represents *compliance* – responsible conduct mandated by law or regulation. A dotted line divides the choice side of the civil foundation from the compliance side, indicating that the boundary between the two is porous. Some activities that enter the civil foundation through the left quadrant eventually become so widespread that the norms are enshrined in laws or regulations. For example, only a handful of companies once offered health care benefits to employees' dependents. Because the goodwill engendered among employees and customers exceeded the cost of the benefits, more companies copied the practice. Eventually, government regulations required most companies offering health benefits to extend them to employees' dependents as well.

The civil foundation is not drawn to scale. It is deep and robust in prosperous, advanced economies, whereas in poorer, less developed economies it is likely to be shallow and fragile. As we shall see, much of the anxiety over globalization stems from the differing dimensions of the civil foundations of richer and poorer countries.

Perhaps the most significant aspect of the civil foundation is its upper limit – that is, the line separating it from the frontier quadrants. It is not fixed. Rather, in robust economies it tends to move upward over time, as new social benefits become norms or even legal requirements. But the civil foundation can shrink as well as expand. Pressures on less healthy economies can weaken the norms, and in some cases even the legal enforcement, that support the civil foundation. For a case in point, consider Russia immediately following the collapse of Soviet rule. Regulations governing working conditions, child labor, and the like were largely unenforced, and legal authorities, far from protecting state assets, participated in their wholesale looting. As a result, commercial enterprises, which had been subject to at least minimal discipline by Soviet authorities, became vehicles for the enrichment of a handful of plutocrats. Only in the past few years, as foreign financiers have conditioned their investments on a modicum of responsible corporate behavior, has Russia reestablished the semblance of a civil foundation.

The top two quadrants of the matrix, the *strategic* and *structural frontiers,* encompass activities whose motivation tends to be intrinsic and whose value to shareholders is either clearly negative or not immediately apparent. The strategic frontier includes activities that may add to shareholder value – become instrumental – by generating positive reactions from customers, employees, or legal authorities. Actions that fit in this quadrant, though risky, are generated by the conscious choice of the corporation's senior management, as part of their profit-making strategy. Socially responsible corporate practices in the strategic frontier tend to migrate to the civil foundation as other companies imitate the innovator until the practice becomes the norm. An example of such a practice is

Prudential Insurance's introduction, in 1990, of viatical settlements–contracts that allow people with AIDS to tap the death benefits in their life insurance policies to pay for medical and related expenses. The move generated so much goodwill that competing insurers soon offered viatical settlements as well. Very quickly, corporate behavior that had seemed radical became business as usual throughout the insurance industry.

The upper right quadrant of the matrix, the structural frontier, houses activities that are both intrinsically motivated and clearly contrary to the interests of shareholders. The benefits of corporate conduct in this quadrant accrue principally to society rather than to the corporation, creating a fundamental structural barrier to corporate action. Aaron Feuerstein's actions following the fire at Malden Mills were a classic case of conduct on the structural frontier. By continuing to pay his employees, Feuerstein spared them considerable hardship and relieved the state and city of the costs of unemployment insurance and welfare payments. But his generous act decreased his own wealth and that of his fellow shareholders. Unlike Prudential's actions, Feuerstein's conduct probably won't become the norm in corporate America.

The strategic and structural frontiers are separated by a wavy line, which is intended to suggest that some actions are not clearly beneficial or detrimental to shareholders. For instance, Procter & Gamble had a strict policy of refusing to pay bribes to win foreign business long before the Foreign Corrupt Practices Act banned such conduct. While this may have placed the company at a disadvantage compared with its rivals, Procter & Gamble's improved reputation among consumers in the United States and elsewhere likely offset that harm.

When Prudential allowed people with AIDS to tap the death benefits in their life insurance policies to pay for medical expenses, the move generated so much goodwill that competing insurers soon offered viatical settlements as well. Very quickly, corporate behavior that had seemed radical became business as usual.

On the whole, though, actions that fall between the strategic and structural frontiers tend to gravitate, by default, toward the structural frontier. If the corporate consensus is that a particular activity will not accrue to shareholders' benefit, no one corporation is likely to take the initiative to disprove that assumption. Thus, executives' commendable concern for their shareholders' wealth can sometimes stifle innovations in corporate social responsibility.

Having toured the virtue matrix, let's use it to analyze the issues confronting senior executives when they consider their corporations' social responsibilities. The first to tackle is why the public clamor for more responsible corporate conduct never seems to abate.

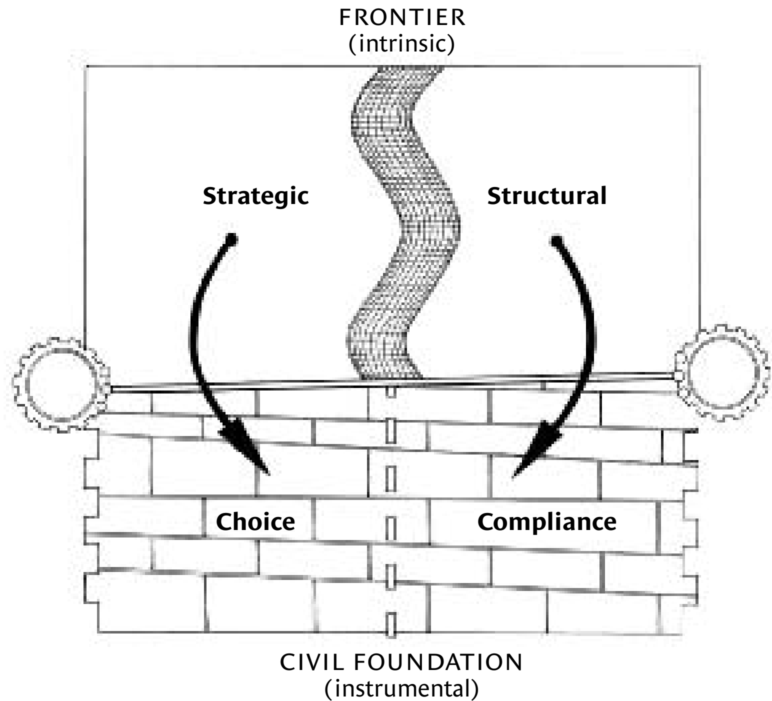
Why Good Deeds Get Punished

Without a doubt, some companies are near-paragons of socially responsible behavior. They support worthy causes in the communities in which they operate. Their workforces are diverse, their workplaces family friendly. They go well beyond the minimum safeguards required by environmental regulations. Yet many citizens, interest groups, and media commentators complain that these very companies are insufficiently attentive to the common good. What explains the public's perception that, at any given time, there is an undersupply of corporate social responsibility?

In a sense, companies are victims of their own good deeds. Consider again the civil foundation. The corporate behavior that falls into the lower quadrants of the virtue matrix may have originated on the strategic frontier, but today it is either mandated by law or enforced by custom and tradition. Thus, complying with environmental law or providing on-site day care wins corporations little credit in the public mind today. Such conduct is less a responsibility than a duty – companies are, as the British would say, "no better than they ought to be." For a company to earn public credit for its behavior, it has to engage in activities that reside in the frontier. That is where the public sees obvious social or environmental benefits to be gained, but little corporate willingness to realize them. At any given time, only a few companies are operating on the strategic frontier.

The picture is even worse on the structural frontier. No consortium of energy producers has come together to formulate and execute a strategy to reduce greenhouse-gas emissions. Pharmaceutical manufacturers have not yet crafted a plan to halt the worldwide spread of HIV infection. Media companies have failed to take concerted action to stem the tide of vulgar trash that too often passes for children's entertainment. There are compelling commercial, scientific, and political reasons why these initiatives have not come to pass, but the inability or unwillingness to deliver these obvious benefits creates a powerful public sense that corporations are not doing enough.

The Virtue Matrix



The virtue matrix depicts the forces that generate corporate social responsibility. The bottom two quadrants of the matrix are the *civil foundation,* which consists of norms, customs, and laws that govern corporate practice. Companies engage in these practices either by *choice* (they choose to observe norms and customs) or in *compliance* (they are mandated by law or regulation to comply). Behavior in the civil foundation does no more than meet society's baseline expectations. Because it explicitly serves the cause of maintaining or enhancing shareholder value, this behavior can be described as *instrumental.*

Corporate innovations in socially responsible behavior occur in the *frontier,* the matrix's upper two quadrants. The motivation for these innovative practices, at least initially, tends to be *intrinsic:* Corporate managers engage in such conduct for its own sake, rather than to enhance shareholder value. Behavior that both benefits shareholders and adds to the supply of social responsibility falls into the *strategic frontier:* It is intrinsically motivated behavior that coincidentally advances the corporation's strategy. The *structural frontier* houses actions that benefit society but not shareholders, creating a structural barrier to corporate action. As the matrix's downward-pointing arrows suggest, behavior in both frontiers can migrate to the civil foundation – from the strategic frontier through widespread imitation of the successful innovator, or from the structural frontier through collective action or government mandate. This migration ratchets up the civil foundation. But the foundation can be ratcheted down if a critical mass of companies abandons a socially responsible practice.

Does Globalization Kill Virtue?

Globalization only heightens public anxiety over corporate conduct. Many people seem to think that corporate virtue declines as international economic activity expands. An analysis using the virtue matrix suggests that the source of the skepticism has to do with the variations among the civil foundations of countries at differing stages of economic and political development.

A country's civil foundation – thus its supply of corporate virtue – tends to grow in concert with its overall economic development. In general, corporate social responsibility in economically advanced countries is generated by deep, solid civil foundations supporting relatively smaller strategic and structural frontiers. The civil foundations of countries with developing economies, by contrast, are relatively shallow and weak, and their strategic and structural frontiers are correspondingly large. (This is a function of limited economic capacity, not necessarily a lack of desire to do good. In a country whose annual per capita GDP is $500, compared with $35,000 per capita in the United States, providing medical benefits to same-sex partners is not a pressing corporate issue. Making sure that companies don't sicken or exhaust their workers is.)

The varying depths of the world's civil foundations can affect the global supply of corporate responsibility both positively and negatively. On the positive side, globalizing corporations from advanced countries can enter developing economies and bring with them the employment, ethical, and environmental practices of their home countries' civil foundation. Those same practices are likely to be in the strategic or structural frontiers of the host country's

virtue matrix. In adopting those practices, local businesses engage in responsible behavior that eventually migrates to their country's civil foundation. In this way, globalization can "average up" the world's civil foundations.

What can be averaged up, however, can also be "averaged down." When a corporation from an advanced economy does business in a developing country, it may instead establish a level of corporate virtue consistent with the host country's civil foundation. Notoriously, Nike, by running its Southeast Asian athletic footwear plants and paying its workers in accordance with local customs and practices, opened itself to charges of operating sweatshops. In essence, it was accused of averaging down its level of corporate responsibility. Although the company protested that its conduct was virtuous by local standards, angry U.S. consumers made it clear that they expected Nike to conform to the U.S. civil foundation, even if doing so meant the company had to operate in the strategic or structural frontier of its Southeast Asian hosts.

Practices in developing countries can also average down the civil foundation of an advanced country. For example, American garment manufacturers have argued that competitive pressure from manufacturers in developing countries, where wages are low and benefits nonexistent, make it impossible to maintain benefits for their U.S. workforce. In effect, they are making the case that U.S.-level benefits packages have migrated from the civil foundation to the structural frontier as a result of foreign competition.

The net impact of globalization on the supply of responsible corporate behavior has yet to be calculated, of course. But it's apparent that companies from countries with robust civil foundations will determine the outcome. If their practices average up civil foundations worldwide, globalization advocates will be vindicated in their belief that increased international economic activity can address some of the world's most difficult development problems. On the other hand, a corporate race to the bottom would succeed only in averaging down civil foundations and confirming the most lurid fears of globalization opponents.

The Vision Shortage

Finally, let's put the virtue matrix to work on two crucial, related questions: What are the barriers to increasing the supply of corporate virtue? And what can companies do to remove those barriers?

The most significant impediment to the growth of corporate virtue is a dearth of vision among business leaders. Opportunities abound to devise programs and processes that benefit society as they enrich shareholders. What seems lacking is imagination and intrinsic motivation on the part of corporations and executives. This is by no means an insurmountable obstacle. Fundamental economics are on the side of innovation in the strategic frontier. What's needed is support for the companies and business leaders who undertake bold initiatives. This support is essential, since the benefits of innovation on the strategic frontier are speculative until action is taken.

Consumer agitation can help executives weigh the risks of action. For example, Scandinavian consumers have long pressed for more environmentally friendly paper products such as toilet tissue and disposable diapers. This pressure helped convince Scandinavian paper producers to take a chance on innovations such as using unbleached pulp in their products.

Even more effective than consumer agitation, perhaps, is peer encouragement. By publicizing their successes on the strategic frontier, business leaders can encourage further innovation by other companies. Prudential made a point of trumpeting the enthusiastic market acceptance of viatical settlements. Favorable newspaper articles and TV spots about the settlements convinced rival insurers that the risk of introducing similar products was negligible compared with the potential benefits.

Far more troublesome and difficult to dislodge are barriers to action on the structural frontier. As a result, the solutions I propose are provisional, and I encourage readers to challenge and extend my thinking on this question.

The greatest barrier to corporate action on the structural frontier, obviously, is the lack of economic incentives. Agitation from consumers won't sway companies, since, by definition, if consumers were enthusiastic and likely to reward corporations for a particular innovation, that innovation would be located on the strategic frontier. Nonetheless, there are ways to overcome this bias toward the status quo. The most effective weapon against inertia is collective action, either on the part of governments, nongovernmental organizations (NGOs), or corporate leaders themselves.

Although the business community frequently derides government regulators, pressure from these sources can help responsible corporate behavior migrate from the structural frontier to the civil foundation. Consider, for instance, the case of mandatory air bags in automobiles. If only one manufacturer had decided to equip its vehicles with air bags, it would likely have had to raise sticker prices by an average of $500 to $800. Absent similar price increases by rivals, the manufacturer would have probably lost sales without creating an offsetting societal benefit. But by mandating air bags on all passenger cars, U.S. regulators reduced traffic fatalities while they eliminated the transfer of purchases from one manufacturer to another. Likewise, by imposing Corporate Average Fuel Economy regulations, federal regulators goaded automakers into action that no single corporation was willing to undertake on its own.

Too bad so few regulations produce such happy outcomes. Some U.S. pollution-control guidelines, for instance, have been estimated to cost society $1 billion per

life saved. Were such inefficiencies to occur on the strategic frontier, they would be quickly disciplined by the marketplace. But erroneous judgments in the structural frontier often face less scrutiny and can therefore remain in force indefinitely, creating a societal cost that ultimately diminishes the civil foundation. For that reason, before they impose a requirement on business, regulators should be sure to establish metrics that enable them to assess whether a regulation's value exceeds its cost. Failure to do so can have the wholly unintended effect of shrinking the civil foundation by causing a dramatic slowdown in economic progress. That's precisely what has happened in British Columbia over the past two decades. Regulators, in their attempt to compel corporations to increase their production of socially responsible behavior, imposed so many costs and administrative burdens on businesses that many simply decamped for friendlier climes. As a result, the Canadian province has suffered a marked slowing in the improvement of living standards, working conditions, and real income – hardly the outcome regulators sought.

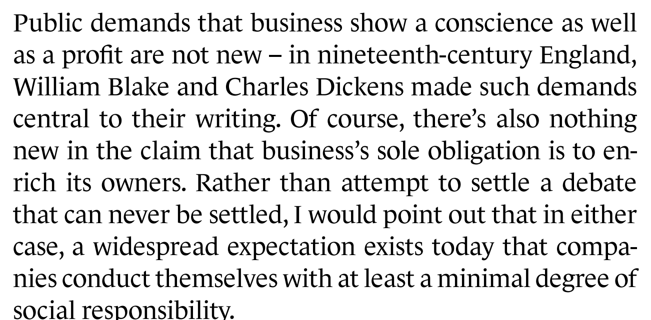
Nike, by running its Southeast Asian plants and paying its workers in accordance with local customs and practices, was accused of "averaging down" its level of corporate responsibility.

NGOs that wish to exert effective pressure on corporations can learn an important lesson from British Columbia's experience. They must be careful not to tip over into extremism or to advance agendas that lack popular support. Those cautions aside, the successes of NGOs can't be denied. It was primarily pressure from NGOs that convinced oil companies to withdraw their support of the corrupt and despotic Abacha regime in Nigeria and that helped improve working conditions in Southeast Asia.

But perhaps the most effective pressure on corporate leaders will be the pressure they impose on themselves. To date, the U.S. government has given no sign that it will force energy producers, utilities, and heavy industries to reduce their output of greenhouse gases. And no single corporation can be expected to do so alone, since the attendant costs would dwarf any marginal improvement in public health and safety. If any action is to be taken, it will have to come from a corporate coalition assembled by an intrinsically motivated leader with the energy, vision, and communication skills necessary to convince other corporate leaders to take a sizable risk.

Such leadership is also required to address globalization's most troublesome dilemma – that is, the inconsistency among the world's civil foundations. The lack of global standards can hobble attempts at collective action on the structural frontier. Consider the Foreign Corrupt Practices Act, for example. The act attempts to universalize a feature of the U.S. civil foundation by prohibiting bribery overseas by this country's corporations. For the most part, the act has maintained a level playing field for U.S. corporations as they go after foreign business. But many of these companies complain that the act puts them at a disadvantage compared with corporations from countries where bribes are considered just another cost of doing business.

If differing attitudes toward bribery can cause such headaches, imagine the difficulty corporations and countries will encounter as they grapple with the question of global warming. Already, countries with relatively undeveloped civil foundations protest that they're being held to the environmental standards of advanced economies, which in turn complain that companies in countries with shallow civil foundations enjoy an unfair cost advantage over their more socially responsible rivals. And while this squabbling goes on, the threat posed by global warming only increases. Ultimately, I believe the logjam will be broken only when courageous and intrinsically motivated corporate leaders promote the notion of a global civil foundation that businesses, together with governments and NGOs, work constantly to upgrade.



Public demands that business show a conscience as well as a profit are not new – in nineteenth-century England, William Blake and Charles Dickens made such demands central to their writing. Of course, there's also nothing new in the claim that business's sole obligation is to enrich its owners. Rather than attempt to settle a debate that can never be settled, I would point out that in either case, a widespread expectation exists today that companies conduct themselves with at least a minimal degree of social responsibility.

Most business leaders, I'm convinced, sincerely wish to meet that expectation, if not exceed it. The virtue matrix is designed to aid them in their efforts. It cannot resolve or eliminate the competing claims of shareholders, society, and government, but the matrix offers a framework for evaluating those claims and encourages business leaders to be as bold and innovative in enriching society as they are in enriching their shareholders.

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