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PROFITS WITH PURPOSE: AN ECONOMIC JUSTIFICATION OF CONSCIOUS CAPITALISM

By

Luke Hickox

A Thesis Submitted to the Department of Economics
of Trinity College in Partial Fulfillment of the
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Abstract

For years, mainstream economic theory has assumed that the only legitimate purpose of business is to maximize profits. In *Conscious Capitalism: Liberating the Heroic Spirit of Business*, authors John Mackey and Raj Sisodia reject this assumption, arguing that many firms have a genuinely motivated higher purpose. In addition to having a purpose beyond profit maximization, the *conscious* business model proposed by the authors calls for maximizing value for all stakeholders (employees, customers, suppliers, society, the environment, and investors), instead of for investors exclusively. However, the authors cite a number of examples of practices of *conscious* businesses that are justified in the economics literature for the exclusive goal of profit maximization, and indexes of firms with qualities similar to those of *conscious* firms have been shown to outperform the broader market, sometimes significantly. Despite the business model's rejection of profit maximization as the sole function of businesses, do the goals of a *conscious* business suggest a strategy that paradoxically leads to profit maximization? This paper explores the potential for the *conscious capitalism* business model to be justified from a profit maximization standpoint through a broad exploration of the economics literature on various common practices of *conscious* businesses. Additionally, a case study examines two discount retailers: Walmart has a reputation for having troubled relationships with its stakeholders, while Costco is frequently applauded for its generosity to its workers and the loyalty it engenders in its customers. Based on theoretical and empirical evidence from a broad range of fields including labor economics, management economics, sociology, and economic psychology, and on Costco's advantages in areas including employee turnover, customer loyalty, reputation, and community relations, it is reasonable to conclude that adherence to a *conscious* business model is a mechanism for profit maximization.

Dedication

This thesis is dedicated to Rae Rossetti, Lydia Haynes, Lucey Gagner, David Klestadt, and Ebban Maeda.

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I would like to thank John Mackey and Raj Sisodia for their eloquent ideas about capitalism and the purpose of business, as well as the community at the Motley Fool for making me aware of Conscious Capitalism and for their help through the process of writing this thesis.

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List of Abbreviations Used

ACSI	American Customer Satisfaction Index
CEO	Chief Executive Officer
CSR	Corporate Social Responsibility
COGS	Cost of Goods Sold
EPA	Environmental Protection Agency
FoE	Firms of Endearment
IPO	Initial Public Offering
kWh	kilowatt hours
NWM	UK National Minimum Wage
UK	United Kingdom
US	United States

Introduction

> How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it.
>
> -Adam Smith, *The Theory of Moral Sentiments,* 1759

Scottish philosopher Adam Smith is considered by many to be the intellectual founder of modern capitalism. His 1776 work *An Inquiry into the Nature and Causes of the Wealth of Nations* is the foundation upon which most modern economic theory is laid. It posits that self-interested free exchange leads to prosperity because it creates unintended social benefits. Many economists take for granted the idea that "people create businesses to pursue only their personal self-interest" (Mackey & Sisodia, 2014, p. 16), while ignoring another of Smith's works, which preceded *The Wealth of Nations* by seventeen years. *The Theory of Moral Sentiments* "outlined an ethics based on our ability to empathize with others and care about their opinions" (Mackey & Sisodia, 2014, p. 16), aspects of human nature that were often ignored by early economists attempting to describe economic systems. Instead, they assumed that maximizing profits "is the only important goal of business" (Mackey & Sisodia, 2014, p. 19). Over time, this assumption became a prescription, and it became "codified into corporate law as the de facto definition of fiduciary responsibility" (Mackey & Sisodia, 2014, p. 20). In 1970, economist Milton Friedman vigorously defended this view in a New York Times Magazine article entitled: "The Social Responsibility of Business is to Increase Profits." The article makes the case that people should be free to do as they please with assets they own, and that any attempt at "social responsibility" on the part of a corporation is simply "imposing taxes, on the one hand, and deciding how the tax proceeds shall be spent, on the other" (Friedman, 1970). These taxes are imposed on the firm's investors, whose assets are being used in a way that they might not agree with.

But as John Mackey and Raj Sisodia, the authors of *Conscious Capitalism: Liberating the Heroic Spirit of Business* point out: “with few exceptions, entrepreneurs who start successful businesses don’t do so to maximize profits. Of course, they want to make money, but that is not what drives them” (Mackey & Sisodia, 2014, p. 20). Profits are necessary to the long-term health of a business, but there is no need for the myopic focus placed on them by main-stream economics. In the view of the authors, “the purpose of business is to improve our lives and to create value for stakeholders” (Mackey & Sisodia, 2014, p. 20). Stakeholders are customers, employees, suppliers, society, the environment, and investors; anyone who is regularly affected by the actions of the firm. Just as people can have legitimate goals beyond maximizing their financial well-being, it is just as legitimate for firms to have a purpose beyond maximizing profits.

Freidman and Mackey debated both sides of the issue in an article published in *Reason Magazine* in 2005. According to Mackey: “From the investor’s perspective, the purpose of the business is to maximize profits. But that’s not the purpose of other stakeholders—for customers, employees, suppliers and the community. Each of these groups will define the purpose of the business in terms of its own needs and desires, and each perspective is valid and legitimate” (Friedman, Mackey & Rodgers, 2005, para. 7). Furthermore, while he personally believes that social responsibility can benefit investors, he adds that “such programs would be completely justifiable even if they produced no profits and no P.R.” (Friedman et al., 2005, para. 15). He sees the entrepreneurs or founders of a business, as opposed to the investors, as those with “the right and responsibility to define the purpose of the company” (Friedman et al., 2005, para. 15). After all, “it is the entrepreneurs who create a company, who bring all the factors of production together and coordinate it into a viable business…who set the company strategy and who

negotiate the terms of trade with all of the voluntary cooperating stakeholders—including the investors" (Friedman et al., 2005, para. 15). In his view, this provides businesses with legitimacy in adopting policies that go beyond profit maximization and help the community: "To extend our love and care beyond our narrow-self interest is antithetical to neither our human nature nor our financial success. Rather it leads to the fulfilment of both" (Friedman et al., 2005, p. 2, para. 5).

Friedman claims that his differences with Mackey are "for the most part rhetorical" (Friedman et al., 2005, p. 2 para. 6). He believes his statement that "'the social responsibility [is] to increase profits' and Mackey's statement that 'the enlightened corporation should try to create value for all its constituencies' are equivalent" (Friedman et al., 2005, p. 2, par 7). While maximizing profits is "an end from a private point of view, it is a means from a social point of view" and a system of free-markets based on self interest "enables separated knowledge to assure that each resource is used for its most valued use, and is combined with other resources in the most efficient way" (Friedman et al., 2005, p. 3 para. 4). In the case of the company Mackey co-founded, Whole Foods Market, the contribution to society "is to enhance the pleasure of shopping for food" (Friedman et al., 2005, p. 3 para. 2) and any of the firm's resources devoted to other causes would benefit society less than if they were devoted to furthering this contribution for the purpose of increasing profits. Whole Foods creates benefits for society when it maximizes profits, and that should be its only goal. Freidman believes that in many cases, "the doctrine of social responsibility is… a cloak for actions that are justified on other grounds," (Friedman, 1970) such as improving corporate reputation or improving employee productivity, both of which can be justified from a profit maximization standpoint.

Mackey disagrees that the two are essentially in agreement. He thinks "maximizing profits for investors is not the only acceptable justification for all corporate actions" (Friedman et

al., 2005, p. 4 para. 2) and that there "are thousands of other businesses similar to Whole Foods (Medtronic, REI and Starbucks, for example) that were created by entrepreneurs with goals beyond maximizing profits, and that these goals are neither 'hypocritical' nor 'cloaking devices' but are intrinsic to the purpose of the business" (Friedman et al., 2005, p. 4 para. 3). He sees profits as a means for creating value for all stakeholders, including investors, and for the realization of a firm's higher purpose.

Mackey lays out his vision for how to do business with co-author Raj Sisodia in *Conscious Capitalism: Liberating the Heroic Spirit of Business*. The business model of conscious capitalism that he advocates "is not about being virtuous or doing well by doing good. It is a way of thinking about business that is more conscious of its higher purpose, its impacts on the world, and the relationships it has with its various constituencies and stakeholders. It reflects a deeper consciousness about *why* businesses should exist and how they can create more value" (Mackey & Sisodia, 2014, p. 32-33). Conscious capitalism rests on four tenets: higher purpose, stakeholder integration, conscious leadership, and conscious culture and management. It is in the first two of these tenets—higher purpose and stakeholder integration—where the motives of *Conscious Capitalism* clearly diverge from the mainstream, profit-maximizing model of capitalism that Freidman espouses. Rather than seeking to maximize profits, the goal for conscious firms is to create value for everyone who interacts with the business and to work toward a worthwhile purpose.

The idea of a business model based on stakeholder value rather than shareholder value was first articulated in 1984, in R. Edward Freeman's *Strategic Management: A Stakeholder Approach* (Sheth, Sisodia & Wolfe, 2014, p. 1). Freeman claims that businesses and investors are better served if profit is not the myopic focus of management. Instead, he advocates creating a

sustainable business by attempting to maximize value for all stakeholders, defined as “all of those groups and individuals that can affect, or are affected by, the accomplishment of organizational purpose” (Freeman, 1984, p. 25). Specifically, a stakeholder relationship business model focuses on limiting trade-offs between stakeholder groups and instead searching for innovative and creative ways to align their interests. This is what allows a firm to sustain itself and continue to create value over the long term.

The debate over the true purpose of business comes down, in the end, to motive. Freidman believes that Whole Foods is a profit-maximizing firm, and its claims of higher purpose and creating value for stakeholders are simply mechanisms for generating the goodwill and reputation that benefit the firm financially. Mackey claims that his firm’s stated motives are genuine, as are the motives of many entrepreneurs who start a business not for profit, but because they see the opportunity to solve a problem in society. It is impossible to know for sure what the motives are of the growing number of firms who operate in a conscious, stakeholder-friendly manner. However, there is strong evidence that Friedman’s assertion that creating value for stakeholders and increasing profits are equivalent is true, and that a firm is justified in adopting a conscious business model even if long-term profit-maximization is genuinely the goal.

In *Firms of Endearment*, authors Raj Sisodia, David Wolfe, and Jagdish Sheth chose 28 companies, 18 of which were public, which in their view represented the clearest examples of practitioners of a conscious, stakeholder approach, which they called firms of endearment (FoE). They chose firms that “pay their employees exceptionally well, do not squeeze their suppliers, deliver great products and experiences at fair prices to customers, are conscious of their environmental impact, and spend significant resources in the community” (Sheth et al., 14). They then analyzed how the firms had performed as investments over various time periods, comparing

the performance to the S&P 500 as well as the 11 companies identified in Jim Collins' best-selling book *Good to Great.* These eleven firms were specifically chosen as being great "by virtue of their having delivered superior returns to investors over an extended time period" (Sheth et al., 2014, p. 15). The price activity of the Firms of Endearment, Good to Great firms, and S&P 500 were analyzed over the three-, five-, ten-, and 15-year time periods ending September 30, 2013, time frames that included "a range of market conditions, including the dawning of the Internet boom, the busting of the tech bubble, a slow recovery, and the Global Financial Crisis of 2008-2009" (Sheth et al., 2014, p. 113). The Firms of Endearment clearly outperformed both other sets of firms (see Figures 1 and 2), especially over longer time horizons, and they did so with "no more risk than the overall stock market" (Sheth et al., 2014, p. 113).

Figure 1: Cumulative Returns, Firms of Endearment, Good to Great, S&P 500

Cumulative Performance	**15 Years**	**10 Years**	**5 Years**	**3 Years**
U.S. FoEs	1681.11%	409.66%	151.34%	83.37%
International FoEs	1180.17%	512.04%	153.83%	47.00%
Good to Great Companies	262.91%	175.80%	158.45%	221.81%
S&P 500	117.64%	107.03%	60.87%	57.00%

Figure 2: Annualized Returns, Firms of Endearment, Good to Great, S&P 500

Annualized Performance	**15 Years**	**10 Years**	**5 Years**	**3 Years**
U.S. FoEs	21.17%	17.69%	20.24%	22.40%
International FoEs	18.53%	19.86%	20.48%	13.70%
Good to Great Companies	8.97%	10.68%	20.91%	47.64%
S&P 500	5.32%	7.55%	9.98%	16.22%

Other indexes which contain proxies for conscious capitalism models tell a similar story. Since 1997, *Fortune* magazine has published list of the "100 Best Companies to Work For," which are selected in partnership with The Great Places to Work Institute on the basis of such criteria as "trust, pride and camaraderie to determine whether a company provides a work environment that creates a genuine sense of satisfaction and fulfilment among team members" (Mackey & Sisodia, 2014, p. 279). In the period between 1997 and 2011, an index of the firms on this list outperformed the S&P 500 on an annualized basis 10.32% to 3.71% (as cited in Mackey & Sisodia, 2014, p. 279). Another organization, Ethisphere, has produced an annual list of the world's most ethical companies since 2007. They "are assessed in seven areas: corporate citizenship and responsibility; corporate governance; innovation that contributes to public well-being; industry leadership; executive leadership and tone from the top; legal, regulatory, and reputation track record; and internal systems and ethics or compliance programs" (Mackey & Sisodia, 2014, p. 280). As of 2014, the selected companies had outperformed the S&P 500 every year, by an average of 7.3 percent annualized (as cited in Mackey & Sisodia, 2014, p. 280). Finally, in *Corporate Culture and Performance?*, Harvard Business School professors John Kotter and James Heskett found that companies with stakeholder cultures, where "managers care strongly about the people who have a stake in the business (customers, team members, stockholders, suppliers)" (as cited in Mackey & Sisodia, 2014, p. 281), outperformed companies that did not by wide margins. In all three areas of business performance they analyzed, stakeholder firms outperformed during the eleven-year period studied: revenue growth (682 versus 166 percent), stock price increase (901 versus 74 percent), and net income increase (756 versus 1 percent) (as cited in Mackey & Sisodia, 2014, p. 281).

Part of the reason for outperformance may have to do with the pressure that profit-maximization puts on managers to perform in the short term. According to a study by the National Bureau of Economic Research, "most managers would *not* make an investment that offered an attractive return if it meant that they would miss their quarterly earnings target" and "80 percent of executives would cut R&D expenditures for the same reason, even if they truly believed doing so would hurt the business in the long run" (as cited in Sheth et al., 2014, p. 111). According to consulting firm McKinsey, this short term thinking comes from the focus on maximizing shareholder value: "Practiced as an unthinking mantra, 'the business of business is business' can lead managers to focus excessively on improving the short-term performance of their businesses, thus neglecting important longer-term opportunities and issues, including societal pressures, the trust of customers, and investments in innovation and other growth prospects" (as cited in Sheth et al., 2014, p. 111). But if profit maximization is not the focus, management is free to devote themselves to the business's long-term health.

Aside from helping managers focus on the long-term rather than the short-term, the outperformance of conscious firms seems counterintuitive. If value is being created for other stakeholder groups, it seems natural to assume that investors must sacrifice value. But there is a large body of evidence in the economics literature that suggests business policies advocated by *Conscious Capitalism* and implied by a stakeholder approach can help ensure the long-term health of a company and optimize long-term profits and long-term shareholder value. This thesis will examine a wide range of economics literature that relates to the tenets of *Conscious Capitalism* that are seemingly at odds with profit maximization—higher purpose and stakeholder value creation (for employees, customers, suppliers, and society/environment)—in an attempt to determine which aspects of the business model may lead to outperformance. These findings will

then help guide an analysis of the performance of two firms: Walmart and Costco. Both are very successful discount retailers which have provided excellent returns to investors since their founding. Walmart has a largely negative reputation among the public due to its history of conflicts with stakeholders in its pursuit of low prices for customers and high returns for investors. In contrast, Costco is listed in both *Conscious Capitalism* and *Firms of Endearment* as an exemplar of the conscious business model, and has a reputation for being highly ethical and generous to employees and other stakeholders. The thesis will examine how stakeholder relationships and company purpose have affected the financial performance of these firms. The evidence from the literature and case study largely explains the outperformance of the Firms of Endearment and other proxies for a conscious business model, justifying the model even from the perspective of Friedman and those who believe a firm exists to maximize profits.

Economic Theory

Higher Purpose

The first tenet of *Conscious Capitalism* is that a business should have a higher purpose beyond maximizing shareholder value or profits. David Packard, co-founder of technology firm Hewlett-Packard, said that “a group of people get together and exist as… a company so that they are able to accomplish something collectively that they could not accomplish separately—they make a contribution to society” (Sheth et al., 2014, p. 171). While purposes vary widely from company to company, in all cases they boil down to adding “quality to people’s lives and the world at large” (Sheth et al., 2014, p. 171). Examples include Johnson & Johnson’s mission to “alleviate pain and suffering” and Google’s original purpose to “organize the world’s information and make it easily accessible and useful” (Mackey & Sisodia, 2014, p., 46-8). These are noble goals that advance society and improve people’s lives, and they are a hallmark of a conscious capitalist approach.

To an investor, a higher calling could seem like a distraction which will eat away at returns. But proponents argue that corporate cultures which emphasize purpose have “higher levels of employee productivity, stronger customer loyalty, and higher margins” (Sheth et al., 2014, p. 171), all traits of a firm coveted by investors. Additionally, purpose gives leadership teams a specific focus, isolating them to a large degree from “the winds of public opinion or changes in the competitive environment” (Mackey & Sisodia, 2014, p. 49), which unchecked could cause short-term-focused decision-making and incredible pressure to conform with competitors.

In “Value Maximization, Stakeholder Theory, and the Corporate Objective Function,” author Michael Jensen argues that without the specific objective of long-term shareholder value

maximization, an organization will have no criteria for evaluating managers and their decisions. Every decision, he argues, can be justified as providing value to some stakeholder group or other. At the same time, he acknowledges that "as a statement of corporate purpose or vision, [shareholder] value maximization is not likely to tap into the energy and enthusiasm of employees and managers to create value" (Jensen, 2001, Abstract). To solve this problem, he advocates what he calls enlightened value maximization, whereby the firm's goal is shareholder value maximization, but the strategy by which this goal is attained comes from stakeholder theory and by having good relationships with suppliers, customers, employees and other stakeholder groups. He also advocates having a purpose within the organization to motivate employees, such as "to build the world's best automobile or to create a film or play that will move people for centuries" (Jensen, 2001, p. 16). This allows for focus and specificity in decision-making, he argues, while retaining the long-term benefits that come with good stakeholder relations. The key is to allow firm value to be the scorecard, but use stakeholder strategies to achieve it.

Jensen identifies a very real problem with stakeholder theory, but his solution is insufficient. If profit maximization is the goal, and employees and managers are rewarded based on its achievement, then that is the goal that will be focused on. Claiming a higher purpose, such as the example he uses of building the worlds best automobile, will not matter if that is not what is being used in evaluating performance. Inevitably, there must be trade-offs between stakeholders, even with the creative, win-win solutions advocated by *Conscious Capitalism*. As Jensen notes:

> Customers want low prices, high quality, and full service. Employees want high wages, high-quality working conditions, and fringe benefits, including vacations, medical

> benefits, and pensions. Suppliers of capital want low risk and high returns. Communities want high charitable contributions, social expenditures by companies to benefit the community at large, increased local investment, and stable employment. And so it goes with every conceivable constituency (Jensen, 2001, p. 13).

These trade-offs, rather than decided arbitrarily by managers with their own agendas, as Jensen fears is the consequence of a stakeholder approach, or decided through the lens of shareholder value maximization, could be decided based on adherence to the higher purpose of the firm. All this requires is a sufficiently specific and well-expressed statement of that purpose. This would have the effect of both eliminating the ambiguity that comes with multiple objectives and stakeholder constituents, and at the same time bring the energy and productivity that comes with the entire firm being on the same page, working toward the same worthwhile goal.

There is plenty of evidence that a focus on higher purpose, as opposed to profit, will counter-intuitively be the best strategy for increasing profits. A higher purpose is therefore not only good for society, but for investors, since "profits are best achieved by not making them the primary goal of the business" (Mackey & Sisodia, 2014, p. 52). According to Mackey, a focus on profits over all else will "eventually create negative feedback loops that will end up harming the long-term interests of the investors and shareholders, resulting in sub-optimization of the entire system" (Mackey & Sisodia, 2014, p. 52). Evidence for this comes from "The Economics of Higher Purpose," by Anjan Thakor and Robert E. Quinn. In this paper, the authors develop a principal agent model of higher purpose, where they define higher purpose as the pursuit of a goal that transcends measurable financial benefits, and whose outcome is not realized during the planning horizons of the principal and agent. They conclude that a firm operating in this way has reduced moral hazard due to worker aversion to effort, lower labor costs and increased capital

inputs. Firms operating with a higher purpose are likely to attract workers who share said purpose, and they can afford to pay them a smaller wage due to the added utility the worker derives from "warm-glow" in working toward that purpose. This observation is backed up by experimental data in "Man's Search for Meaning: The Case of Legos," by Dan Ariely, Emir Kamenica and Drazen Prelec. The authors conducted two experiments in which they "compare situations with no meaning… with situations having some additional meaning" (2008, p. 671). They found that reservation wages for subjects who saw their work as meaningful were lower.

Of course, *Conscious Capitalism* advocates paying above market wages to frontline workers, not below market wages, but that serves only to decrease moral hazard further. Conscious firms are also characterized by low management-to-worker pay ratios, so the "warm glow" effect may be even more important in recruiting talented managers who will be paid less relative to the average employee than their peers. The loyalty that purpose-aligned workers feel to both the firm and the purpose it serves make them expend considerably more energy than workers at profit-maximizing firms, increasing productivity. The authors of "The Economics of Higher Purpose" also note that their model implies that companies with a higher purpose "have a leg up on their competitors when it comes to innovation" (2013, p. 28). The presence of higher purpose incentivizes companies to invest in exploratory projects that spur innovation. This innovation may not have been deemed worthy of investment by a profit-maximizing firm, but in the long term, an innovative company is more likely to continue to survive and profit than a more stagnant one.

Finally, higher purpose could have the effect of differentiating a company's products in the view of consumers, provided they are aware of and believe in the sincerity of that purpose. While some customers "only care about getting a quality product for a good price, many

increasingly want to do business with businesses whose purpose and values align with their own" (Mackey & Sisodia, 2014, p. 76). The economics literature often models philanthropic giving in terms of "warm-glow:" the idea that people have a taste for giving and derive utility from the act, rather than the result, of their charity (Andreoni, 1989, p. 1448-9) (Owen & Videras, 2006, p. 2-3). Empirical evidence for this phenomenon can be found in "Public Goods Provision and Well-Being," in which the authors use a sample of 35,000 individuals in 40 countries. They find that individuals who contribute to environmental causes have higher life satisfaction and happiness than those who do not and that the well-being does not increase proportionally with contributions. They conclude that their evidence is consistent with a warm-glow motive, in which utility increases partially due to higher self-regard after giving and for some due to conformity to social norms (Owen & Videras, 2006, p. 24). In James Andreoni's model of warm-glow, the consumer derives utility both from the act of giving, the warm-glow, and from the increase in a public good as a result of their gift (1989, p. 1449). If a consumer sees the higher purpose of a company as being worthwhile to society, then they will gain utility from the consumption of the private good they are purchasing as well as from the warm-glow that comes with feeling like they've contributed to that goal. In the absence of other differentiating factors, consumers will therefore prefer a good from a company with a genuine higher purpose than one without.

Higher purpose is the main way a conscious capitalist approach differs from a pure stakeholder approach. It solves the problem of unfocused or ambiguous management, encourages innovation, differentiates products, and matches workers to the firm who are aligned with the purpose and therefore more likely to have higher motivation and effort than those with a purely financial motive. So even for an investor motivated purely by profit, there are benefits to a firm

having a purpose the goes beyond profit maximization. Clearly however, that these benefits only accrue if the higher purpose is not only genuine, but all the stakeholders see it that way. Therefore, “purpose is never something… [to] take for granted… [or] it starts to be forgotten and soon disappears. It has to be at the forefront of consciousness…” (Mackey & Sisodia, 2014, p. 49). Having a higher purpose can yield large economic benefits, provided it is not faked.

Employees

In *The Human Equation: Building Profits by Putting People First,* Stanford professor Jeffrey Pfeffer asks the book’s intended audience, business managers, the following: “When you look at your workforce, do you see the source of your organization’s sustained success and your people as the only thing that differentiates you from your competition? Or do you, like so many, see people as labor costs to be reduced or eliminated; implicit contracts for careers and job security as constraints to be negotiated; and mutual trust and respect as luxuries not affordable under current competitive conditions…?” (1998, p. xix). Employees are a vital stakeholder group to almost every business. They interact with customers, management, and suppliers, and “either benefit or burden every dimension of a company’s existence” (Sheth et al., 2014, p. 61). Despite this, from 2000 to 2012, “average employee engagement in the United States ranged between 26 and 30 percent” while the proportion of employees “actively disengaged (in other words, deeply unhappy and even hostile) has ranged between 16 to 20 percent” (Sheth et al., 2014, p. 62). The philosophy of *Conscious Capitalism* is to view employees as a source of strong competitive advantage, an asset that requires a substantial investment, and not as adversaries in a transaction that wrings out as much value for the firm as possible at the cheapest price. As noted in *Firms of Endearment*, “higher wages and benefits can actually *lower* employee-related costs” due to “lower employee recruiting and training costs and higher productivity” (Sheth et al., 2014, p.

59). In addition to lowering costs, having committed, loyal employees can translate into improved loyalty and satisfaction among customers.

A key attribute shared by many conscious firms in their relations with employees is a commitment to paying above-market wages, called efficiency wages in economics. There is a broad range of literature devoted to efficiency wages that describes the benefits to a firm that employs them. These benefits can include higher levels of motivation, a larger pool of productive and capable workers, lower turnover, a reduction in disciplinary problems, lower monitoring costs, enhanced quality and customer service, and enhanced reputation. Janet Yellen, in "Efficiency Wage Models of Unemployment," provides a number of reasons why labor productivity depends on the level of real wages paid by a firm. First, through the lens of the shirking model, she notes that "workers have some discretion concerning their performance" and "workers can decide whether to work or to shirk" where the cost of being caught shirking is the loss of the job (Yellen, 1984, p. 201). If a firms pays workers higher wages than other firms, the cost of being caught shirking becomes higher, creating an incentive for effort and work. For the same reason, the efficiency wage reduces turnover, as a worker is less likely to quit a job if the cost of doing so is high. A third benefit noted by Yellen concerns adverse selection: "if ability and workers' reservation wages are positively correlated, firms with higher wages attract more job candidates" (1984, p. 203). Theoretically, efficiency wages have the benefits of increasing productivity, reducing disciplinary problems—and therefore the need for monitoring—and increasing the size and quality of applicants.

Empirical studies back up the theoretical framework. In "Can Wage Increases Pay for Themselves," David Levine, using data from two thousand business units of large North American manufacturing companies, found that the "increase in productivity from an increase in

wages was approximately enough to pay for itself" (1992, p. 1114). Using a survey of auto production plants in "An Interplant Test of the Efficiency Wage Hypothesis," Peter Cappelli and Keith Chauvin found that "wage premiums are in fact associated with lower levels of disciplinary problems" (1991, p. 769) and "reductions in shirking" (1991, p. 784). They conclude that the improved discipline was due to an incentive to avoid dismissal. They do point out that "it is difficult to identify the value of the reduction in shirking associated with a given wage premium" but that the returns to a wage premium were almost certainly "nontrivial" (1991, p. 785). Using a natural experiment brought about by the introduction of the UK National Minimum Wage, Andreas Georgiadis, in "Efficiency Wages and the Economic Effects of the Minimum Wage," found that "wage increases induced by NMW were on average more than offset by a fall in monitoring costs" (2008, p. 4). Finally, in "Strengthening State Capabilities: The Role of Financial Incentives in the Call to Public Service," authors Ernesto Dal Bo, Frederico Finan, and Martin Rossi found that "higher wages attract a better candidate pool in terms of both quality and motivation," (2013, p. 1172) and that candidates to higher paying jobs were "smarter, had better personality traits, had higher earnings, and had a better occupational profile" (2013, p. 1172). These empirical studies support the theory that efficiency wages can lead to higher productivity, reduce shirking, and improve the size and quality of the pool of job applicants.

Yellen also refers to a sociological model developed by George Akerlof in "Labor Contracts as Partial Gift Exchange." In this paper, he attempts to reconcile the behavior of workers who provide more than the minimum effort despite having no clear incentive for doing so, with the firm not raising minimum standards to reflect their knowledge of the ability of workers to go beyond the minimum. He notes a sociological concept that "the determinant of the workers'

effort is the norm of the work group" (Akerlof, 1982, p. 549). When workers become a part of an institution, they "tend to develop sentiment for their co-workers and for that institution" (Akerlof, 1982, p. 550). In conscious firms this is especially evident. In addition to the alignment of a conscious firm's higher purpose and the values of its workers—explored in the section on higher purpose— "many conscious businesses organize their people into teams" (Mackey & Sisodia, 2014, p. 91). This team structure is "fundamentally fulfilling to basic human nature" (Mackey & Sisodia, 2014, p. 91) and gives members a sense of belonging. Akerlof notes that people gain utility by providing gifts to other people to whom they feel sentiment, and this can be extended to the institution. Being a part of a team means that "they gain utility if the firm relaxes pressure on the workers who are hard pressed; in return for reducing such pressure, better workers are often willing to work harder" (Akerlof, 1982, p. 550). This model of workers and firms engaging in partial gift exchange means both receive benefits from a good relationship and a team atmosphere, underscoring the validity of two themes of *Conscious Capitalism*.

A number of studies have also provided evidence that workers perform better when they do not have the psychological stress of worrying about income security. In "Poverty Impedes Cognitive Function," the authors hypothesized that "poverty directly impedes cognitive function" (Mani, Mullainathan, Shafir & Zhao, 2013, Abstract) and tested the hypothesis using two datasets: a laboratory group with experimentally induced thoughts about finances, and farmers before and after a harvest, when they are impoverished and wealthy respectively. Because the poor "must manage sporadic income, juggle expenses, and make difficult tradeoffs" (Mani et al.) and due to the fact that "the human cognitive system has limited capacity" (Mani et al.), there is a "causal, not merely correlational, relationship between poverty and the mental function" (Mani et al.). Both datasets confirmed the hypothesis. Further evidence comes from the

World Bank, which in its 2015 Development Report surveyed a broad range of economics, psychology and development literature and found that "the constant, day-to-day hard choices associated with poverty in effect 'tax' an individual's…mental resources" (2015, p. 81). Thus, very low pay affects an individual's ability to be productive and make good decisions, both personal and firm-based. Higher wages can help make up for this by decreasing the cognitive load brought about by poverty.

Because of the unique qualities of conscious firms, turnover costs are higher for them than for most firms. The culture of the firm, the team atmosphere, and the alignment of employee values and firm goals make hiring new workers costlier. They need to be trained extensively: for example, The Container Store has 263 hours of training for employees in their first year, followed by at least 160 hours a year after that. This is in sharp contrast to the industry average of seven hours per year (Karol, 2012). The culture of the firm may take time to learn and emulate, and the labor pool is restricted due to an insistence on workers aligned with the higher purpose of the firm. Thus, efficiency wages are even more important if all other tenets of *Conscious Capitalism* are being adhered to, because turnover is so costly. In "Do Firms Pay Efficiency Wages," Carl Campbell III found that "firms with the highest turnover costs pay the highest wages" and also evidence that "wages affect productivity as well as turnover" (1993, p. 463). Thus the practice of paying efficiency wages is even more valuable to a firm that practices other aspects of *Conscious Capitalism* as well.

Conscious firms are "exemplary in their focus on helping employees maximize their potential through training, development, and mentoring" (Sheth et al., 2014, p. 75). Not only is training necessary at such firms to integrate workers into the culture of the firm, but "even the most experienced and highly qualified employees need and benefit from continuous education" (Sheth

et al., 2014, p. 75). But there is evidence that the cost to the firm of providing training, like the cost of the efficiency wage, is an investment that raises the value of the firm. In “Effects of Employee Training on the Performance of North American Firms,” J.A. Molina and R. Ortega used a survey of executives in human capital management to determine the impact of training on total returns to shareholders. They found that “higher levels of training are indeed associated with significant benefits which can increase firm performance” (Molina & Ortega, 2003, p. 551). Some of these benefits include: “lower levels of both voluntary and involuntary turnover… a better reputation among new applicants as a desirable place to work… [and the ability] to translate higher employee satisfaction and and lower turnover into higher customer loyalty” (Molina & Ortega, 2003, p. 551). The connection between turnover and training becomes a virtuous cycle. Firms are willing to invest more in employees who are likely to stay longer, and the training creates firm specific human capital that makes employees less likely to be let go or leave voluntarily.

Management at conscious firms tends to be much more engaged with frontline workers, due to flat management hierarchies. The flat hierarchy allows frontline workers to interact directly with senior leaders, which is “highly energizing for the CEO and motivating to employees” (Sheth et al., 2014, p. 79). Consulting firm Towers Perrin, in a 2003 report, said senior management’s interest in employee’s well being is the most important driver of employee engagement. Respondents to their survey gave low favorability scores on this metric and in particular on management’s ability to communicate (2003, p. 10-11). Flat hierarchies like those found at conscious firms can help reduce such communication issues. The level of management compensation relative to that of frontline employees is also often lower at conscious firms. For example, Whole Foods Market “caps the total cash compensation, including bonuses, for any

team member at nineteen times the average pay of all team members. In publicly traded companies of a similar size, this ratio…can be as high as four hundred to five hundred times" (Mackey & Sisodia, 2014, p. 93). Mackey feels that if compensation for management were any higher, the perceived unfairness would reduce employee motivation and effort. In "The Effect of Wage Dispersion on Satisfaction, Productivity, and Working Collaboratively: Evidence from College and University Faculty," authors Jeffrey Pfeffer and Nancy Langton found a significantly negative effect of pay dispersion on "productivity, satisfaction, and working collaboratively" (1993, p. 403). The problem with capping compensation is the firm may lose out on the best qualified candidates who want to be paid the highest wages. But as Mackey argues regarding Whole Foods' policy in *Conscious Capitalism*: "We want leaders who care more about the purpose and people of the company than they do about power and personal enrichment" (Mackey & Sisodia, 2014, p. 94). The concept of having a higher purpose complements the lower wage ratios inherent in a conscious approach.

More than traditional firms, conscious firms are dedicated to promoting internally rather than recruiting. For example, Costco promotes from within for 98 percent of open positions (Karol, 2012). In "External Recruitment versus Internal Promotion," William Chan notes that "the accumulation of firm-specific human capital usually involves a joint investment between the employer and the employee, so that both parties have the incentive to maintain a long-term relationship. And the longer the tenure of the worker, the more firm-specific human capital accumulated, and the costlier it would be for the firm to find an external candidate who could outperform and existing worker" (1996, p. 556). In Costco's case, "employees hired externally made 18% more than those who were promoted internally to the same position, and were 61 percent more likely to be fired" (Karol, 2012).

The link between employee satisfaction and profitability is demonstrated in "Putting the Service-Profit Chain to Work," from the *Harvard Business Review.* The authors of this paper propose that "profit and growth are stimulated primarily by customer loyalty. Loyalty is a direct result of customer satisfaction. Satisfaction is largely influenced by the value of services provided to customers. Value is created by satisfied, loyal, and productive employees. Employee satisfaction, in turn, results primarily from high-quality support services and policies that enable employees to deliver results to customers" (Heskett, Jones, Loveman, Sasser & Schlesinger, 1994, p. 164-5). The paper notes that in addition to turnover's explicit costs of recruiting, hiring and training replacements, it also reduces productivity and customer satisfaction. In a study targeting automobile dealers that is cited by the authors, "the average monthly cost of replacing a sales representative who had five to eight years of experience with an employee who had less than one year of experience was as much as $36,000 in sales" (as cited in Heskett et al., 1994, p., p. 167). A key to reducing turnover is increasing employee satisfaction. The authors attribute employee satisfaction to the internal quality of a working environment, which ideally is characterized by "investment in people, technology that supports frontline workers, revamped recruiting and training practices, and compensation linked to performance for employees at every level" (Heskett et al., 1994, p. 164). It is this high level of internal quality that conscious firms try to maintain for their employees, and the Service-Profit Chain provides a direct link between investments in this working environment and profitability. The links in the chain related to customers will be more fully explored in the next section.

Customers

"The customer is always right" is a slogan heard so much in business it is almost cliché. The customer is the stakeholder group most closely linked to profit, so on the surface it makes

sense for a profit maximizing business to focus on customers more than other stakeholder groups. Just as many businesses have mission statements that bear very little relation to the way their businesses are run, many profit-maximizing businesses pay lip service to pleasing customers, “but surprisingly they are often forgotten. It is easy to get caught up in the internal processes of a company and lose sight of the primary reason for the company to exist” (Mackey & Sisodia, 2014, p. 76). The way conscious companies differentiate themselves, in the same way they do with mission statements and higher purpose, is to commit to taking care of customers as a part of the culture that infuses the firm. In addition, “the well-being of customers is treated as an end and not just a means for profits for the business” which creates a high “level of empathy, commitment to service, and understanding of customer needs” (Mackey & Sisodia, 2014, p. 76). There is evidence that this extra commitment to the customer—through lenient return policies, customer advocacy, and service quality—produces referrals, repeat purchasing behavior, and higher levels of loyalty and satisfaction which have been linked empirically to higher levels of profitability.

One way conscious firms can try to improve value for customers is to offer a generous return policy. For example, L.L. Bean offers unlimited lifetime guarantees. *Firms of Endearment* tells a story of a recent customer who “returned a threadbare coat bought in the 1950s and received a new coat in exchange in fulfillment of L.L. Bean’s guarantees without commitments” (Sheth et al., 2014, p. 99). This creates trust in the quality of the product on behalf of the consumer. The company, in turn, must trust customers not to abuse the system, a reason many firms might have stricter return policies. In “The Effect of Return Policy Leniency on Consumer Purchase and Return Decisions: A Meta-Analytic Review,” authors Narayan Janakiraman, Holly Syrdal, and Ryan Freling analyzed twenty-one papers on returns and observed “a more

pronounced increase in purchase stemming from lenient return policies than for return rates" (2015, p. 8). Therefore, "overall, return policies do in fact benefit retailers" (2015, p. 9). In "Can Product Returns Make You Money?," J. Andrew Peterson and V. Kumar found "a moderate amount of product returns by a customer could not only lead to greater future purchases but also maximize profits" (2010, p. 86). At the same time, money-back guarantees and other lenient return policies "increase perceptions of product quality, reduce consumers' perceived risk, and enhance price expectations, emotional responses, value perceptions, and the retailers' image" (Krafft & Suwelack, 2012, p. 556). Lenient return policies create a two-way trust between customers and firms, serving to increase purchase intentions, signal product quality, and create value for all stakeholders.

Conscious companies "provide customers with honest and complete information and help them find products that best fit their needs—even if those products are made by competitors" (Mackey & Sisodia, 2014, p. 83). They truly represent the customers' best interests, rather than their own. This is called customer advocacy, and "the value of strengthening the relationship and building trust with customers far outweighs the cost of losing an occasional transaction" (Mackey & Sisodia, 2014, p. 83). There is a large body of evidence to support this claim. In *Don't Just Relate, Advocate*, Glen Urban found that genuine advocacy leads reciprocation as customers gain loyalty and increase future purchases and referrals (as cited in Mackey & Sisodia, 2014, p. 83). These referrals are key, as they create "unpaid but very effective salespeople" (Mackey & Sisodia, 2014, p. 83), allowing companies to have lower marketing budgets. Trader Joe's, for example, "spends less than 1 percent of its revenue on advertising, much below the industry average" (Mackey & Sisodia, 2014, p. 81). Demonstrating genuine commitment to the well-being of customers is hard, as it "requires a long-term outlook and patient expectations for

return on investment" (Urban, 2004, p. 82). But the cost of investing in advocacy is partially offset by reduced marketing budgets, and the returns—in terms of trust in the company on the part of the consumer—are very valuable. "Trust creates a barrier to entry by increasing customer loyalty and by forcing would-be competitors to spend considerable time and resources to make inroads" (Urban, 2004, p. 82), according to "The Emerging Era of Consumer Advocacy" by Glen Urban.

A firm with a conscious business model would have an advantage in appealing to customers even without a specific focus on them as a stakeholder group. Firms driven by a higher purpose, as discussed previously, may supply utility to customers beyond what would be expected from the good or service itself. Additionally, the *service-profit chain*, discussed in the employee section, demonstrates direct links between employee satisfaction and retention, customer satisfaction and loyalty, and profitability. Increased employee productivity leads to more value, leading to satisfied and by extension more loyal customers. The goal of management should be to create *apostles* or "customers so satisfied that they convert the uninitiated to a product or service" (Heskett et al., 1994, p. 166) and to avoid *terrorists*, customers who "speak out against a poorly delivered service at every opportunity" (Heskett et al., 1994, p. 166). The paper on the *service-profit chain* points out that the "value of a loyal customer can be astronomical, especially when referrals are added to the economics of customer retention and repeat purchases of related products" (Heskett et al., 1994, p. 164). To back up this claim, the authors cite "Zero Defections: Quality Comes to Services," by Frederick Reichheld and W. Earl Sasser, Jr., who estimate that "companies can boost profits by almost 100% by retaining just 5% more of their customers" (Reichheld & Sasser, 1990). There are several reasons for this statistic. The first is that over time, as customers get used to a new service or good, the amount they

purchase tends to increase. This was true across "more than 100 companies in two dozen industries" (Reichheld & Sasser, 1990) analyzed by the authors. At the same time, operating costs come down as the relationship lengthens, as fixed costs per customer are spread over more and more time and experience allows the company to serve the customers more efficiently. The long-term relationship indicates loyalty and comfort with the company on the part of the customer, so a firm is able to charge a premium over the price charged by other businesses. Finally, long-time customers provide free advertising: one leading home builder cited in the paper "has found that more than 60% of its sales are the result of referrals" (Reichheld & Sasser, 1990). Over time, the authors say that "companies with loyal, long-time customers can financially outperform competitors with lower unit costs and high market share but high customer churn" (Reichheld & Sasser, 1990).

The relationships between customer satisfaction, customer loyalty, and profitability are further explored in "Managing Customer Relationships for Profit: The Dynamics of Relationship Quality," by Kaj Storbacka, Tore Strandvik, and Christian Gronroos. They explore the assumption that service quality is linked to satisfaction by noting two potential paradoxes: when a customer perceives service quality as high but is not satisfied, and when a customer perceives service quality as low and is satisfied anyway. In the first case, they point out that "the service might be too expensive or does not fit the customer's preferences" (Gronroos, Storbacka & Strandvik, 1994, p. 26). For example, "a customer could… respond on a questionnaire that a particular bank is of high quality… [but] it might have too high interest rates on loans or it might not fit the customer's preferences for some other reason" (Gronroos et al., 1994, p. 25). In the case of poor perceived quality but a satisfied customer, it could be that the service is priced according to its low quality. In both of these cases, the paradox is explained by the "budget of

different consumers and their preferences for different attributes" (Gronroos et al., 1994, p. 26), implying satisfaction is related to perceived value. If that relationship is true, then a firm actively trying to create value for its customers, as conscious firms do, should have a distinct advantage.

The literature is full of evidence that enhanced customer satisfaction leads to increased profitability. In "The Relationships of Customer Satisfaction, Customer Loyalty, and Profitability: An Empirical Study," Roger Hallowell found that there was a clear correlation between customer satisfaction, customer loyalty, and profitability. In "Customer Satisfaction and Stock Prices: High Returns, Low Risk," authors Claes Fornell, Sunil Mithas, Forrest V. Morgeson III, & M.S. Krishnan surveyed empirical literature on satisfaction and found that "customer satisfaction tends to improved repeat business, usage levels, future revenues, positive word of mouth, reservation prices, market share, productivity, cross-buying, cost competitiveness and long term growth, and… it tends to reduce customer complaints, transaction costs, price elasticity, warranty costs, field service costs, defective goods, customer defection, and employee turnover" (2006, p. 4). The authors used data from the American Customer Satisfaction Index (ACSI) and found a significant relationship between the index and the market value of a firm's equity. At the same time, they found that news about changes to the ACSI had no impact on stock prices. This implies that investors may be undervaluing the impact of customer satisfaction on the value of the firm. Using portfolio studies, they found that "investments based on satisfaction produce sizeable excess returns, but they also upset the basic financial principle that assets producing high returns carry high risk" (2006, p. 11). Further, they claim that the "economic value of satisfied customers seems to be systematically undervalued, even though these customers generate substantial net cash flows with low volatility" (2006, p. 11). If investors are undervaluing the asset of customer satisfaction, it is likely that managers

who are trying to please investors would too. Conscious firms, with their focus on value for the customer, are unlikely to undervalue customer satisfaction in this way.

Customer satisfaction can also be linked to enhanced brand loyalty. In “The Complex Relationship Between Consumer Satisfaction and Brand Loyalty,” authors Jose Bloemer and Hans Kasper distinguish between brand loyalty based on inertia (latent brand loyalty) and brand loyalty based on decision making and evaluative processes that lead to commitment (true brand loyalty). They found a positive impact of satisfaction on true brand loyalty (1995). This result is confirmed by Christian Homburg and Annette Giering, who found that “the empirical results clearly indicate that increasing customer satisfaction leads to increasing customer loyalty” (2001, p. 58). They also found that “satisfaction with the sales process and with the after-sales service have a much stronger effect on a customer’s intention to stay loyal to a distributor than is the case for satisfaction with the product itself” (2001, p. 58). So a firm with a conscious business model, with loyal and motivated employees who will likely provide high levels of service during and after the sale will be better able to convert satisfaction into loyalty.

Despite the vital role customers play in every business and the lip service paid to pleasing them, conscious firms go further than traditional firms in advocating for their customers and implementing policies, such as lenient returns, that benefit them. Other aspects of a conscious business model, like the care paid to employees and higher purpose, lead to further improvements in the relationship between the firm and customers. This results in customer satisfaction, which leads to loyalty, which leads to all manner of benefits for the company, including increased referrals and higher levels of profitability.

Suppliers

Suppliers are a vital but often-overlooked stakeholder group. *Conscious Capitalism* encourages adherents to deal with suppliers by "treating them fairly, understanding their needs, ensuring they that they are able to make a profit… and looking for ways to enhance the relationship over time" (Mackey & Sisodia, 2014, p. 114). In contrast, many traditional or profit-maximizing firms think of suppliers "as adversaries from whom the business tries to extract as much value as possible for the lowest price" (Mackey & Sisodia, 2014, p. 115). At first glance, from the perspective of maximizing profit, squeezing suppliers through things like annual mandates for suppliers to reduce prices seems reasonable. It lowers costs to the business, which can be passed on to customers to increase sales or used to increase margins and therefore profits. But there are problems with this approach, which often only come up in the longer term. Without trust in their customer, suppliers will "recoup their profit margin by lowering quality, reducing service, or cutting corners on safety" (Mackey & Sisodia, 2014, p. 115). This hurts business as quality suffers and innovation lags. On the other hand, maintaining good supplier relationships brings a number of benefits, including "lower costs over time, higher quality, a better fit with the company's requirements, greater resiliency in bad times, reduced risk for both parties, and more opportunities to innovate" (Mackey & Sisodia, 2014, p. 114).

In "Cooperation, Opportunism and the Invisible Hand," Charles Hill presents a game theory model of opportunism and cooperation in transactions. Using a prisoner's dilemma game, where players can choose to cooperate and trust or act opportunistically, he first notes that if the game is played only once or a finite number of times, it pays to act opportunistically, no matter what the actions of the other player are. The problem with this argument is that "across a majority of exchanges both parties enter with the expectation that they *may* interact again in the

future" (Ch. Hill, 1990, p. 505). Even in those few exchanges where the players are likely to interact only once or a finite number of times, Hill notes that due to the effects of reputation, if a player acts opportunistically in one transaction, other players are less likely to enter into transactions with the opportunistic one, and "will demand that the potentially opportunistic party absorb bonding costs" (Ch. Hill, 1990, p. 505) if they do enter into transactions. Each transaction has repercussions that go beyond "the context and bounds of that exchange," and must be viewed as "simply one in an infinite series of possible future exchanges" (Ch. Hill, 1990, p. 505). Thus the model should not reflect a finite number of transactions, but an infinite number. In an infinitely repeated game, realistic decision rules often indicate that "the interest of both parties is best served by adopting a position of cooperation and trust" (Ch. Hill, 1990, p. 506). In studies of groups of players participating in round-robin tournaments in which they were given the choice between opportunism and cooperation, "players that deliberately tried to exploit other players (opportunistic rules) always faired poorly in the long run" (Ch. Hill, 1990, p. 507). Indeed, when an evolutionary selection mechanism was introduced, "over time actors whose decision rules… stressed cooperation and trust, rather than opportunism, came to dominate the population of players" (Ch. Hill, 1990, p. 507). This is the case even in uncompetitive markets, where an opportunistic player may have an advantage over the other player, as is often the case in the relationships between large firms and their suppliers. This is because in the long run, the ability "to compete in its end market [is] limited by higher costs that were the direct result of a lack of cooperation" (Ch. Hill, 1990, p. 507). So even in situations where in a single market, opportunism could be beneficial to one party due to power they have over another, the presence of other competitive markets where the former transacts makes cooperation the best course.

Hill goes on to list some reasons why opportunism might be favorable in certain situations. These include when "the future is not important to the aggressor" (Ch. Hill, 1990, p. 509) and when opportunism cannot be detected due to uncertain outcomes. But with a view of maximizing long-term value, the future is certainly important, and over a long-term relationship, as is the case with most supplier relationships, opportunism is unlikely to remain undetected indefinitely. Another instance where opportunism might pay is limits to the efficiency of reputation. In other words, lack of communication could lead to a situation where other players are unaware of an opportunistic party. In a world of increasing openness and transparency, this becomes less and less likely. It is especially unlikely for a firm which takes a conscious approach with its other stakeholders, where any opportunistic act is likely to be seen as highly unusual and therefore would be more likely to be examined.

Innovation is another area where trusting and cooperative relationships with suppliers can lead to benefits for a firm. In "The Impact of Trust on Innovativeness and Supply Chain Performance," the authors conduct a literature review on trust, innovativeness and supply chain performance, spanning economics as well as marketing and operations management literature. Through this review, they hypothesize that "the manufacturer's trust in the supplier is positively related to innovativeness in a manufacturer-supplier relationship" (Lun & Panayides, 2009, p. 38). An empirical cross-sectional study of United Kingdom based electronics manufacturing firms provided the authors support for their hypothesis, and they suggest that "trust will facilitate better understanding that will reflect needs for service and process innovations in the supply chain more accurately" (Lun & Panayides, 2009, p. 40). Trust allows firms to better gather information about the needs of customers and improve their capacity to innovate in order to meet these needs. This "requires a level of commitment and understand on behalf of both parties"

(Lun & Panayides, 2009, p. 43) and management must invest resources to build this trust. This explains why so many profit-maximizing firms, unwilling to part with these resources, may exhibit opportunistic behavior in their supplier relationships. As noted in *Firms of Endearment*, a study by the National Bureau of Economic research found that "most managers would *not* make an investment that offered an attractive return if it meant that they would miss their quarterly earnings target" (Sheth et al., 2014, p. 111). But this leads to conscious firms having an advantage in both innovation and transaction costs.

For an illustration of how businesses can reduce costs and increase their ability to innovate from having trusting relationships with suppliers, consider the automobile industry. Hill notes that "part suppliers are vulnerable to opportunistic action by the large auto makers" (Ch. Hill, 1990, p. 507) and that historically, US automakers have taken advantage of that power. For example, in 1986, "Chrysler instructed its parts suppliers to cut their prices by 2.5 percent, irrespective of prior price agreements" (Ch. Hill, 1990, p. 508). Contrast that with Japanese companies such as Honda and Toyota, who consistently are ranked by auto-parts suppliers as some of the best companies to work with (Woodall, 2015) (Sheth et al., 2014, p. 133). Japanese companies have a reputation for following a strategy in which they have "long recognized and nurtured cooperative long-term relationship with their part suppliers" (Ch. Hill, 1990, p. 508). This has resulted, for Chrysler and other US manufacturers who follow a similar opportunistic strategy, in "higher costs, lower quality, and a declining market share, relative to Japanese competition" (Ch. Hill, 1990, p. 508). In 1985, the cost of parts, materials and services for small cars was on average $3,350 for US manufacturers and on average $2,750 for Japanese manufacturers. A major reason for this $600 cost savings was the Japanese firms' cooperative relationships with their suppliers. In a cross sectional empirical study of supplier-automaker

exchange relationships in the United States, Korea, and Japan, Jeffrey Dyer and Wujin Chu found that high levels of trust were significantly correlated with substantially lower transaction costs, and therefore may be "an important source of competitive advantage" (Chu & Dyer, 2003, p. 57) in the auto manufacturing industry. They also note both empirical and anecdotal evidence that high levels of trust are positively correlated with increased information sharing. In interviews with over 70 suppliers, the authors frequently found that they were "much more likely to bring new product designs and new technologies to 'trustworthy' automakers" (Chu & Dyer, 2003, p. 66). They presented the following quote as representative of comments they heard:

> We are much more likely to bring a new product design to [Automaker A3] than [Automaker Al]. The reason is simple. [Automaker Al] has been known to take our proprietary blueprints and send them to our competitors to see if they can make the part at lower cost. They claim they are simply trying to maintain competitive bidding. But because we can't trust them to treat us fairly, we don't take our new designs to them. We take them to [Automaker A3] where we have a more secure long-term future (Author interview, October 1995) (as cited in Chu & Dyer, 2003, p. 66).

In *Firms of Endearment*, the authors note that Honda was able to reduce the cost of manufacturing the Accord by 21.3 percent by gathering ideas from hundreds of its suppliers and employing the best ones (Sheth et al., 2014, p. 133). By combining the expertise of its partners, Honda was able to innovate in a way it would not have otherwise.

Yet another benefit to having good supplier relationships occurs during tough times, and "the test of a true partnership is what happens when the business declines due to an economic downturn, unexpected competition, or some other unfortunate event" (Mackey & Sisodia, 2014, p. 120). In these cases, good relationships with suppliers can act to some degree as a form of

insurance. In 1981, just when Whole Foods Market was starting out in Austin, Texas, the city was hit by the worst flood it had seen in seventy years. Not only did customers and employees come to help clean up Whole Foods' only location and get the grocery store back on its feet, but as Mackey recalls in *Conscious Capitalism:* "dozens of our suppliers offered to resupply us on credit because they cared about our business and trusted us to reopen and repay them" (Mackey & Sisodia, 2014, p. 6). In "On the Corporate Demand for Insurance," authors David Mayers and Clifford W. Smith examine the incentives which motivate the purchase of insurance policies by corporations. One incentive they note is to allocate risk to those agents who have a comparative advantage in risk bearing. They note that while investors and bondholders can reduce risk through portfolio diversification, "the ability to diversify claims on human capital is limited" (Mayers & Smith, 1992, p. 192). Thus, employees and managers have a comparative disadvantage in risk bearing, which will be reflected in their reservation prices, or the prices at which they will be willing to work. These reservation prices will be higher due to uncertainty about the ability of the firm to maintain its contract. Thus it is in the firm's best interest to shift "the risk bearing within the corporation to those claimholders who will bear the risk at lowest cost" (Mayers & Smith, 1992, p. 192). If the relationships that the firm has developed with suppliers are trusting and cooperative, to the extent that the suppliers are willing to extend payment periods, sell on credit, and help the firm survive in a crisis, the risk to employees and managers, and by extension their reservation wages, will fall.

While there are some clear economics benefits to having the collaborative, trusting and cooperative relationships with suppliers prescribed by a conscious business model, the specifics of the firm and the industry will determine the extent of those benefits. For goods, such as automobiles, with a high level of complexity and a large number of parts, the benefits to

innovation and pricing that come from collaborative relationships are large. On the other hand, in industries with simpler goods and services the benefits are reduced.

Society/Environment

Corporate Social Responsibility has a nebulous definition. A study by A. Dahlsrud analyzed 37 different definitions, and according to "The Business Case for Social Responsibility: A Review of Concepts, Research and Practice," this underestimates the true number by excluding academically defined constructs (Carroll & Shabana, 2010). The general idea is that corporate social responsibility programs are actions that further a social good beyond the interests of the firm and what is required by law. This definition includes other stakeholder groups, who are of course a part of society and who benefit from a clean environment. But since these groups have been discussed previously, the focus of this section will be on corporate philanthropy and environmental sustainability. *Conscious Capitalism* takes the view that "when engaged in wisely, corporate philanthropy is simply good business and works for the long-term benefit of investors and other stakeholders as well," provided of course, that it has "the legitimacy of investor approval" (Mackey & Sisodia, 2014, p. 125). In "The Business Case for Corporate Social Responsibility," Elizabeth Kurucz, Barry Colbert, and David Wheeler lay out the four main business arguments for CSR: cost and risk reduction, gaining a competitive advantage, developing reputation and legitimacy, and seeking win-win outcomes through synergistic value creation. Based on evidence from numerous studies, actions that would be defined as CSR, such as those that create high levels of engagement with the community and the environment, often come with long-term business benefits (2008).

One way firms can use Corporate Social Responsibility for cost and risk reduction is to engage in environmental programs. In "Environmental Leadership: From Compliance to

Competitive Advantage," the authors "make the case that sound environmental practices can be profitable" (Altman, Dechant, Downing, Keeny, Mahoney, Miller, Post, Swaine, 1994, p. 18). One reason for this is defensive: it helps the firm avoid large fines from environmental negligence. But going beyond minimum compliance to avoid paying fines also has benefits: "A reduction in toxic emissions reduces the risk of costly accidents and lowers the bill on insurance premiums" (Altman, et al., 1994, p. 18). Additionally, firms who are pro-active and forward-thinking about environmental policy can "anticipate the direction of regulations" which gives them "time to introduce new products and processes, explore new markets, and re-engineer plants. Such time advantages often cost less than if things are rushed to meet an externally imposed deadline" (Altman, et al., 1994, p. 18). In "The Role of Corporations in Achieving Ecological Sustainability," author Paul Shrivastava notes that "there is the opportunity to drive down operating costs by exploiting ecological efficiencies. By reducing waste, conserving energy, reusing materials, and addressing life-cycle costs, companies can save costs" (1995, p. 955). Additionally, "ecological sustainability offers the potential for reducing long-term risks associated with resource depletion, fluctuations in energy costs, product liabilities, and pollution and waste management" (1995, p. 955). In "Corporate Social Responsibility and Access to Finance," the authors used a broad panel study and found that "firms with better CSR performance face lower capital constraints" (Cheng, Ioannou & Serafeim, 2011, p. 27). They believe there are two mechanisms through which this relationship materializes: first, "stakeholder engagement based on mutual trust and cooperation reduces potential agency costs by pushing managers to adopt long-term rather than short-term orientation" and second "firms with better CSR performance are… more transparent and accountable. Higher levels of transparency reduce informational asymmetries between the firm and investors, thus mitigating

perceived risk" (Cheng et al., 2011, p. 27). Reducing costs is essential to profitability, and while investments in CSR can be costly in the short-term, over the longer term the benefits in cost savings can add up.

Another argument for CSR is that it can create a competitive advantage in the form of differentiation. In "The Impact of Corporate Social Responsibility on Consumer Trust: The Case of Organic Food," the authors gather survey data from customers purchasing organic food and find that "consumer perception of CSR performance is positively and significantly correlated to trust… trust in private-label organic products… positively and significantly correlates with brand loyalty to those products" (Misani, Pivato & Tencati, 2008, p. 8). In "Creating and Capturing Value: Strategic Corporate Social Responsibility, Resource Based Theory, and Sustainable Competitive Advantage," by Abigail McWilliams and Donald Siegel, CSR is viewed through the lens of resource based theory to show how it can create a long-term competitive advantage. The authors say that "CSR may be a cospecialized asset that makes other assets more valuable than they otherwise would be" (McWilliams & Siegel, 2011, p. 1491). For example, CSR can enhance a firm's reputation, which "can lead to premium pricing or consumer loyalty, which increase revenue" (McWilliams & Siegel, 2011, p. 1492). In another example of cost and risk reduction, the authors also find CSR can lower personnel costs "if employees are motivated by the CSR actions of the firm" or capital costs "if CSR actions lower the subjective risk profile of the firm" (McWilliams & Siegel, 2011, p. 1492).

Corporate philanthropy is an area where companies can gain a competitive advantage. In "The Keys to Rethinking Corporate Philanthropy," Heike Bruch and Frank Walter argue that philanthropy, when designed according to external demands, achieves competitive advantages which may include "improved marketing and selling capabilities, higher attractiveness as an

employer or better relationships with governmental and nongovernmental organizations" (2005, p. 50). Firms can also leverage their unique internal strengths by focusing on philanthropies aligned with their abilities and core competencies. When the internal focus and external focus are combined, the firm can "gain opportunities to learn how to apply their core competencies in new business areas, boost their employees' intrinsic motivation, stimulate customer demand and enhance their attractiveness in the labor market," while at the same time "providing substantial benefits to society" (2005, p. 53).

Competitive advantages from CSR can also appear through innovation. For example, IBM's Reinventing Education program "enabled technological learning, skill transfer and the development of new technologies with commercial potential" (Bruch & Walter, 2005, p. 54). These new technologies eventually enabled IBM to "make its K-12 education business profitable even though the business had been losing money before the program started" (Bruch & Walter, 2005, p. 54). A survey by KPMG found that "the most commonly cited opportunity of social and environmental change is innovation of new products and services, mentioned by 72 percent of reporting G250 companies" (2013, p. 13-14). For the most part, competitive advantages from CSR stem from a firm "strategically orienting and directing resources toward the perceived demands of shareholders" and viewing stakeholder demands not as constraints, "but as opportunities to be leveraged for the benefit of the firm" (Colbert, Kurucz & Wheeler, 2008, p. 89). So stakeholders of all types, provided they have a preference for CSR, will choose the firm over competitors specifically due to it's CSR practices.

This preference for CSR is also related to the firm's reputation. In the KPMG survey, the second most cited reason for social and environmental change, after innovation, was "the opportunity to strengthen brands and corporate reputation" (2013, p. 14). In "Corporate Social

Responsibility: Not Whether, but How?," N. Craig Smith says that "firms may be penalized by consumers—and others—for actions that are not socially responsible" (2003, p. 15). He cites a 1999 survey that found 40% of respondents "had at least thought about punishing a specific company over the past year they viewed as not behaving responsibly" (2003, p. 17). He also notes that "employees express a preference for working at socially responsible companies" and "employees who are aware of a firm's CSR activities have been found to be more likely to speak highly of it" (2003, p. 20). The firm's reputation within the community and with the government can also be affected by CSR, and "siting new facilities will be easier when the local community perceives the firm to be one with a 'clean' reputation." (Altman et al., 1994, p. 18). In "A Theory of Corporate Civic Giving," David Kamens argues that civic engagement and CSR are "a legitimation strategy in which the purpose is to reduce uncertainty in the firm's immediate local environment" (1985, p. 45). In this model, the firm uses giving to manage local dependency and maintain trust. Finally, the reputation effects of CSR allow firms to engage in cause marketing, which combines emphasizing product advantages with appeals for charitable giving. Benefits include "creating purchasing incentives and enhancing company and product images" (Carroll & Shabana, 2010, p. 99). A firm's reputation is an extremely important asset, and CSR practices can improve the value of that reputation.

Finally, a commitment to CSR can allow a firm to seek out and connect "shareholder interests, and creat[e] pluralistic definitions of value for multiple stakeholders simultaneously" (Carroll & Shabana, 2010, p. 91). In "Focusing on Value: Reconciling Corporate Social Responsibility, Sustainability and a Stakeholder Approach in a Network World," the authors point out that "evidence is mounting that what is said to one stakeholder group, i.e. the investors, need no longer be in conflict with what is said to employees, customers, supply chain partners

and local communities" (Colbert, Freeman & Wheeler, 2003, p. 18), citing as evidence two empirical studies: "The Corporate Social Performance – Financial Performance Link" by Sandra Waddock and Samuel Graves and "The Relationship Between Social and Financial Performance" by R.S. Roman, S. Hayibor and B. Angle. To increase the value of its reputation and brand, a firm must be proactive about "balancing (or ideally integrating) stakeholder interests and combine them with a clear vision of what is achievable for customers, employees, investors, and other stakeholders" (Colbert et al., 2003, p. 18). To illustrate this, the authors point to Monsanto, which "failed to address European consumer and other stakeholders' concerns about the genetic modification of foods" (Colbert et al., 2003, p. 7). CEO Hendrik A. Verfaillie later said that Monsanto "was so blinded by its enthusiasm for (this) great new technology that it missed the concerns the technology raised for many people" (as cited by Colbert et al., 2003, p. 8) which had led to a drop in "confidence in the company, its products, and its leadership" (Colbert et al., 2003, p. 7). In contrast, Novo Group, another company "deeply involved in genetic modification" has maintained a "strong reputation" due to its "highly interactive and constructive relationships with stakeholders" (Colbert et al., 2003, p. 8). Novo Group publishes a highly rated social and environmental report each year, providing transparency and keeping stakeholders aware of their actions. Michael Porter and Mark Kramer argue in "The Competitive Advantage of Corporate Philanthropy" that firms are best served by "focusing on the contextual conditions most important to their industries and strategies… and by enhancing the value produced by philanthropic efforts in their fields… [to] gain a greater improvement in competitive context" (2002, p. 14-15), pointing out the "ability of companies to compete depends heavily on the circumstances of the locations where they operate" (2002, p. 7). Over the long-term, they claim, "social and economic goals are not inherently conflicting but integrally connected" (2002,

p. 7). Firms can create win-win situations between investors, society and other stakeholders by channeling their philanthropy into projects that improve the community and business context.

Clearly, benefits can accrue to a firm that engages in Corporate Social Responsibility practices. Philanthropic and environmental sustainability programs can lead to cost and risk reduction, competitive advantages, improved firm reputation and situations that benefit both society and the firm. By improving their local communities and practicing sustainability, the firm creates an environment that will help them thrive and continue to create value over the long term.

Case Study

For many people, Walmart epitomizes what is wrong with corporate America. With its reputation for low quality, poor wages and benefits, and mercilessness in dealing with suppliers and competitors, especially small businesses, it is the last company that many would feel represented the tenets of *Conscious Capitalism*. And yet, there is no question that Walmart has been highly successful: the family of founder Sam Walton is the richest in America, with a net worth of $149 billion according to *Forbes* ("America's Richest Families," 2015). An investor who purchased 100 shares of Walmart at its IPO in 1970 for $1,650 would have an investment worth over $12 million today, an annualized return of over 21% (Nickolas, 2015a). Walmart was among the top 50 most admired companies for 2016, according to *Forbes*, at number 42 ("World's Most Admired," 2015).

On that same *Forbes* list, at number 12, is another retailer with a reputation for low prices, Costco. Costco's better ranking comes in large part from a reputation for good relationships with its stakeholders. It is mentioned by both *Conscious Capitalism* and *Firms of Endearment* as an example of a firm with a conscious business model that has allowed it to "pay its employees well, make good money for investors, have highly satisfied customers and suppliers, and generally be welcomed with open arms into every community it wants to enter" (Sheth et al., 2014, p. 36). There is no question that Costco has been good to its investors: purchasing 100 shares of Costco at its IPO in 1985 for $1,000 would be worth over $90,000 today, an annualized return of over 16% (Nickolas, 2015b).

The two firms do not offer a perfect comparison, despite being competitors in the low priced specialty retail industry, as they have different business models. Costco charges an annual membership fee and sells large quantities of goods in bulk. Additionally, it has a *working capital*

business model, with fast inventory turnover and collection of receivables allowing the firm to "finance its operations with vendors' cash while also paying vendors quickly enough to capture early payment discounts" (Dawar & Stornelli, 2013, p. 88). Costco achieves this turnover by only offering merchandise that sells quickly, typically carrying fewer than 4,000 unique products. On the other hand, Walmart charges no membership fees and sells goods in small quantities. It typically carries around 120,000 unique products in a store, although it has begun cutting this number recently (Nassauer, 2015). It operates under a *margin* business model, where "since the cost of goods sold (COGS) is the retailer's biggest cost, those focused on margins are typically relentless in their efforts to drive this cost down, even if it means brutal negotiations with their suppliers" (Dawar & Stornelli, 2013, p. 88). Walmart has its own warehouse club, Sam's Club, which operates using a model much more similar to Costco, with annual membership fees and larger quantity items. Unfortunately, in many cases, Walmart does not break out information about Sam's Club separately from its overall data. This case study will compare Sam's Club and Costco when possible and appropriate, but in most cases Costco will be compared to Walmart in general.

Recently, Walmart has clearly begun to adopt a more conscious approach, trying to fix its reputation as a corporate villain. In "Don't Spin a Better Story. Be a Better Company," Leslie Dach, former vice president of corporate affairs at Walmart, talks about how when he first joined, the company had the sole aims of "running an efficient business and making customers happy" (2013, p. 2). But after Walmart mobilized in the face of Hurricane Katrina to "provide meals, emergency supplies, and cash," Walmart leaderships' eyes were opened "to the broader opportunity to make a difference" (Dach, 2013, p. 2). Advocating many of the ideas found in a conscious business model, Dach writes that Walmart was "showing others that taking on large

social issues can be compatible with building a stronger business," (2013, p. 2) pointing out the improved fuel efficiency of Walmart's truck fleet, the leadership provided by hired veterans, savings from energy initiatives, and the stronger communities and more-relevant products that come from a more diverse group of suppliers, including those owned by women and minorities. Walmart has been relentlessly trying to improve their relationships with stakeholders, and in doing so it has reduced much of the criticism it used to receive. Much of the commitment seems to be genuine, but reputations are hard to change, and it will take a lot of work from Walmart to convince much of the public that it has truly changed its culture.

Higher Purpose

When Sam Walton accepted the Presidential Medal of Freedom in 1992, he remarked: "If we work together, we'll lower the cost of living for everyone…we'll give the world an opportunity to see what it's like to save and have a better life." This would come to be Walmart's official company purpose: "saving people money so they can live better." ("Our History," 2016). To achieve this mission, Walmart focuses on four core beliefs: service to customers, respect for the individual, strive for excellence, and act with integrity ("Working at Walmart," 2016). This mission statement places the focus of the firm on one specific stakeholder group: the customer. In contrast, Costco's mission is "to continually provide our members with quality goods and services at the lowest prices. In order to achieve our mission, we will conduct our business with the following code of ethics: Obey the law; Take care of our customers; Take care of our employees; Respect our suppliers; Reward our shareholders" (Sheth et al., 2014, p. 177). The idea that all stakeholders should be taken into account and taken care of is evident. But again, the primary ultimate stakeholder group being served by the mission statement is the customer (member).

The higher purpose of keeping prices low in order to deliver great value to customers would fall under the category of *the good* in *Conscious Capitalism* (as opposed to *the true, the beautiful,* and *the heroic,* which are the book's categories of higher purpose). When people save money at Walmart or Costco, it increases their consumer surplus, the difference in the amount customers are willing to pay for a good and the amount they actually pay. Those savings can be spent on other goods, saved for retirement, invested, used to pay off debt, or a host of other things. Society benefits when companies innovate to improve efficiency and ensure that more of a customers' wants and needs can be fulfilled at a lower price. But from the perspective of financial returns, in order to achieve the benefits of having a higher purpose, a firm needs more than just a noble sounding mission statement. The purpose needs to be an ingrained part of the culture of the company, which will keep management focused and on track and to draw employees and customers whose values are in alignment with that purpose. Whether this applies to Walmart and Costco is difficult to say, but by explicitly acknowledging the necessity of serving all stakeholders in order to serve customers, Costco benefits from many of the advantages inherent in a stakeholder model.

One important benefit of having a higher purpose is—when aligned with employee values—that it can create an excited, motivated and loyal workforce. In *Nickel and Dimed*, author Barbara Enhrenreich spent months living as a low wage worker in various positions trying to make ends meet. One of her employers was a Walmart in Minnesota. During her orientation, she writes that "over and over we hear in voiceover or see in graphic display the 'three principles,' which are maddeningly, even defiantly, nonparallel: 'respect for the individual, exceeding customers' expectations, strive for excellence'" (Ehrenreich, 2001, p. 144). It seems that the fourth core belief, act with integrity, has been added since the book was written in 2000.

When first meeting with Barbara, a manager of the store—the same one who later led orientation—mentioned that "the three pillars of Wal-Mart philosophy precisely fit her own, and these are service, excellence (or something like that), and she can't remember the third" (Ehrenreich, 2001, p. 125). If the manager running orientation has trouble remembering the tenets on which the culture of Walmart is supposedly built, it is hard to imagine that those tenets are a huge part of the day-to-day operations of the business. Other anecdotes include people who started out with Walmart believing fully in their mission, but were disappointed by what was actually happening. One global services manager, Jim Bill Lynn, worked at Walmart for 9 years. In *Walmart: The High Cost of a Low Price*, a documentary directed by Robert Greenwald, he says: "I believed in the mission, and the culture which I thought existed at Walmart. I led more Walmart cheers than just about anybody that I know… if you had cut me I would have bled Walmart blue blood…Walmart let me down" (Greenwald, 2005, 1:08:39-1:10:00). After reporting on inhumane working conditions at a supplier's factory, Lynn was fired by the company. According to Edith Arana, who worked for Walmart for 6 years as an inventory specialist: "They explained to me…the type of company Walmart was. I said that's a company I want to work for. I always found it rewarding, to me, to help the customer find what they were looking for" (Greenwald, 2005, 0:34:00-0:34:30). But Edith was treated poorly as an employee and lost her faith in Walmart.

At the same time, there is little evidence that the higher purpose of Costco, providing quality goods and services at the lowest possible prices, does much to motivate employees either. On Glassdoor, an anonymous review website for employees of firms and management, Costco rates highly among employees, but "positives include a fast-paced environment, great co-workers, growth potential, and excellent benefits" (Moskowitz, 2014), with no mentions of

company purpose. Although Costco has a very specifically worded, strong mission statement that takes stakeholders into account, it is very utilitarian and does not seem to be employed as a motivational message. Providing customers with high quality, low priced goods does not seem as exciting and noble-sounding as Disney's "use our imaginations to bring happiness to millions" or Johnson & Johnson's "to alleviate pain and suffering" (Mackey & Sisodia, 2014, p. 46).

Another potential benefit to a firm having a higher purpose is that its customers might see their purchases from both a practical standpoint and a philanthropic standpoint, which adds to their utility through a "warm-glow" from giving. In the cases of Walmart and Costco, customers are unlikely to feel this way. Even to the extent that customers are aware of the two firms' mission statements, the purposes are tailored specifically for the customer, so there is no sense of giving involved with purchases.

The main way the Costco's higher purpose differs from Walmart's is its explicit acknowledgement of the stakeholders that need to be served in order to reach the ultimate goal of serving customers at low prices. The benefits that come from having a higher purpose are best realized when all stakeholder groups feel it is genuine, from employees and customers to management and suppliers. Costco benefits from many of the advantages that come from a stakeholder focused model, while Walmart has had struggles with almost all of its stakeholders over the years.

Employees

When it comes to employees, it would be hard to find two companies more different in the eyes of the public than Costco and Walmart. While Walmart has a reputation for "union busting, sex discrimination, low wages, and minimal benefits" (Featherstone, 2008), Costco is

known for having "some of the best wages and working conditions in the industry" (Sheth et al., 2014, p. 227).

According to Costco founder Jim Sinegal: "Paying your employees well is not only the right thing to do but it makes for good business. In the final analysis, you get what you pay for" (Sheth et al., 2014, p. 36). According to *Competing in Tough Times*, in 2010 approximately 70 percent of Costco's expenses went to labor costs, with an average wage of $19 per hour. Full time employees reach the top of the pay scale after completing five years at the company. Costco's workers pay only 10 percent of their healthcare premium costs, and 82 percent of workers are covered. In addition, ninety-one percent of Costco's employees are covered by retirement plans. It is the philosophy of Costco that "if you hire good people, pay them good wages, and provide good jobs and careers, good things will happen in your business" (Berman, 2011, p. 91). According to their annual report: "With respect to expenses related to the compensation of our employees, our philosophy is not to seek to minimize the wages and benefits that they earn. Rather, we believe that achieving our longer-term objectives of reducing employee turnover and enhancing employee satisfaction requires maintaining compensation levels that are better than the industry average for much of our workforce" (Costco Wholesale, 2015a, p. 25). Costco also works to keep pay dispersion low, especially with regard to top management. In 2009, founder and then-CEO Jim Sinegal had a salary of $350,000, compared to the median CEO who made $1.01 million. Said Sinegal: "I figured if I was making something like 12 times more than the typical person working on the floor, that was a fair salary…Having an individual who is making 100 or 200 or 300 times more than the typical person working on the floor is wrong" (as cited in Berman, 2011, p. 94). In 2012, current CEO Craig Jelinek made $2.63 million in total, compared to $45,800 for the median employee, for a ratio of 57:1. While

this may seem considerably higher than Sinegal, the ratio was 19th lowest among the Fortune 100, as CEO pay in general has increased dramatically ("Putting CEO Pay in Perspective," n.d.). Costco also "regularly organizes employee appreciation days where the management waits on regular employees" (Sheth et al., 2014, p. 79), and monitors employee satisfaction through surveys (Sheth et al., 2014, p. 81), keeping a connection between upper management and frontline workers to ensure that the latter are being properly valued, respected, and taken care of.

In stark contrast, in 2012, then-CEO of Walmart Michael Duke made $23.15 million in total, compared to just $22,400 for the median employee: a ratio of 1034:1. This ratio was the highest among Fortune 100 companies ("Putting CEO Pay in Perspective," n.d.). The average wage at Walmart in 2010 was $12 per hour, and increases are much slower than at Costco, with 4% raises per year (Greenwald, 2005, 0:25:45). A coworker of Enhrenreich from *Nickel and Dimed* saw her wages rise from $7 to $10 between 2000 and 2011, an annualized increase of just 3.295% (Ehrenreich, 2001, p. 229). Less than half of workers had health insurance coverage, which is described by one employee as "crummy", and they were responsible for 33 percent of their total healthcare costs. A study by Arindrajit Dube and Ken Jacobs called "The Hidden Cost of Walmart Jobs" from 2004 found that California subsidized Walmart at a cost of $86 million a year because of their "workers' reliance on public assistance due to substandard wages and benefits" (Dube & Jacobs, 2014, p. 8). In *Nickel and Dimed,* Enhrenreich opted out of the Walmart health insurance plan because "the employee contribution seemed too high," and many employees feel it "isn't worth paying for" (Ehrenreich, 2001, p. 182-3). There does not appear to be data on how the Affordable Care Act has impacted Walmart workers' reliance on public assistance. At Sam's Club, 64% of employees are covered by a retirement plan (Berman, 2011, p. 92-3).

There is a history of problems between Walmart and their employees. In July of 2008, there were over 80 lawsuits against Walmart. The common thread of many of these lawsuits was a corporate culture of holding down labor costs, often by illegal means such as "forcing employees to work off the clock, requiring employees to skip lunch and rest breaks and manipulating time and wage records" (Walmart Watch, 2008, para. 2). There have been allegations of routine understaffing at Walmart stores, such that the work needs to be made up off the clock by employees. According to Edith Arana: "They would come in the office or on the floor… They would say, well you know we have no overtime, there is to be no overtime whatsoever. We have five baskets of clothes, merchandise, that need to be put back. You may have 30 minutes left on your eight-hour shift, but we need those baskets put away… You would go along with it because you needed that job" (Greenwald, 2005, 0:34:38-0:35:08). The implication was that with Walmart constantly hiring, anyone not willing to comply would be fired. John Lehman, a store manager for 19 years, describes how he was taught by a district manager how to cheat workers: "He said this is how you can come in on your payroll budget for this week. He said if you had, say, 3 workers that have overtime… he explained to us how to go in the system under a false user ID…and move that time to the next week" (Greenwald, 2005, 0:36:32-0:36:55). According to Stan Fortune, former Walmart loss prevention manager for 17 years, "They don't care about what you sacrifice. It doesn't matter how many people lose their families. It doesn't matter if the associates have good health care. It doesn't matter—anything—except what the bottom line profit is for that store for that month" (Greenwald, 2005, 0:17:06-0:17:19).

In *Nickel and Dimed*, Walmart's culture is described as one of "dominant corporate miserliness" (Ehrenreich, 2001, p. 163). Enhrenreich talks about learning in orientation "that the

store's success depends entirely on us, the associates…our bright blue vests bear the statement 'At Wal-Mart, our people make the difference.' [But] underneath those vests… there are real life charity cases, maybe even shelter dwellers" (Ehrenreich, 2001, p. 175). Walmart requires associates to wear shirts with collars, but one associate couldn't afford one, despite it being on sale due to a stain. "There's something wrong when you're not paid enough to buy a Wal-Mart shirt, a *clearenced* Wal-Mart shirt with a stain on it" (Ehrenreich, 2001, p. 181). Another issue is scheduling, which is very inflexible at Walmart. Enhrenreich claims "there is a lot of frustration over schedules, especially in the case of the evangelical lady who can never get a Sunday morning off, no matter how much she pleads" (Ehrenreich, 2001, p. 183). The low wages would be one thing if employees could supplement their income with other jobs. Despite wanting to work at a supermarket where she had been offered a job on the weekends, Enhrenreich realized "I had no guarantee I could arrange my schedule at Wal-Mart to reliably exclude weekends" (Ehrenreich, 2001, p. 198).

Despite these numerous issues, there is some evidence that Walmart is starting to improve its relations with workers. When under the control of the charismatic Sam Walton, who drove an old pickup truck and remained extremely frugal despite his wealth, employees felt more connected to the firm. "Walton made a point of keeping in touch with employees on the ground" and he "had a sense of when to let penny-pinching take a backseat to other priorities" (Frank, 2006). But after Walton's death in 1992, "Wal-Mart's new leaders took to heart one element of the founder's business philosophy—the importance of reducing costs—but they didn't show his intuition about the importance of making employees feel as though they had a stake in the company" (Frank, 2006). But according to *Firms of Endearment*, there are "many encouraging signs that Walmart is reconnecting with its DNA, which was developed when Sam Walton built

the company up from its small town roots with bedrock American values" (Sheth et al., 2014, p. 186). In February, the company boosted its minimum wage to $10 per hour, increasing their average full-time hourly wage $13.38. They also updated their paid time off policy to make scheduling much easier for associates, increased training, and improved other benefits ("More Than One Million," 2016). Back in 2015, as part of a push to improve worker comfort and happiness, Walmart allowed associates to start wearing denim at work, in addition to introducing "warmer temperatures inside stores and a more varied music diet" (Kauffman, 2015). All these changes move Walmart in a more conscious direction. In his letter to shareholders, CEO Doug McMillon said these were "strategic investments in our people to reignite the sense of ownership they have in our stores and foster an improved customer experience to drive sales growth" (Wal-Mart Stores, Inc., 2015b, p. 2). After an earlier wage increase last April, the McMillon told a media briefing: "Our job applications are going up and we are seeing some relief in turnover" (as cited in Layne, 2015).

Employees at Costco seem to be very satisfied with their company and working conditions. Costco was #40 on Glassdoor's Employees' Choice Awards: Best Places to Work 2016, ahead of other conscious firms like REI (#45) and Southwest Airlines (#42) ("Best Places to Work," 2016). Overall, Costco has a Glassdoor rating of 4.0 out of 5.0, 83% of employees would recommend it to a friend, 92% approve of the job being done by Jelinek ("Costco Wholesale," n.d.). According to *Firms of Endearment*, this employee satisfaction allows Costco to generate "significantly more sales and profit per employee…Costco's higher wages—in conjunction with a culture of respect and empowerment—buy it lower recruiting and training costs and better relationships with customers that lead to higher sales per customer and deeper customer loyalty" (Sheth et al., 2014, p. 35-36). According to Jim Sinegal, "When employees are happy, they are

your very best ambassadors," otherwise, employees will be looking for other jobs and "managers spend all their time hiring replacements rather than running our business" (Sheth et al., 2014, p. 36). On the other hand, Walmart has significantly lower ratings from Glassdoor, with an overall rating of 3.1 out of 5.0. Only 53% of employees would recommend it to a friend, and 64% approve of the job being done by McMillon ("Walmart," n.d.). Since 2014 all of these statistics have been trending upward, indicating that Walmart's efforts to change are resonating with employees. There are indications that Costco's higher employee satisfaction leads to more productivity. Sales per square foot, one measure of productivity, are approximately $677 at Sam's Club, while they are $1,156 at Costco. (Levin-Weinberg, 2014). Costco also benefits from lower turnover than Walmart. Although Walmart does not break out turnover data, according to "The High Cost of Low Wages," Costco's turnover is very low for retail, at 17% overall and only 6% for employees working there over a year, while at Walmart, turnover is 44% a year. The authors estimate that Costco's employee churn costs it $244 million per year, while it costs Sam's Club $612 million. (Cascio, 2006). Issues of productivity at Walmart are discussed in *Nickel and Dimed*, where one employee says: "They talk about having spirit…but they don't give us any reason to have any spirit," (Ehrenreich, 2001, p. 184) referring to management. Early in her employment at Walmart, a coworker told Enhrenreich that "although I had a lot to learn, it was also important not to 'know too much,' or at least never to reveal one's full abilities to management, because 'the more they think you can do, the more they'll use you and abuse you'… there are few or no rewards for heroic performance" (Ehrenreich, 2001, p. 195). Clearly, Walmart's practices do not encourage its associates to do their best work, innovate, or go above and beyond for customers.

Clearly, employees are happier, more satisfied, and more loyal at Costco than they are at Walmart, exhibiting less turnover and higher ratings on Glassdoor. There is also some evidence that they are more productive. In "Should Walmart Imitate Costco? The Variation in Retail Wages," authors Pamela Villareal, Jacob Kohlhepp and Anna Shapovalova examine both businesses and conclude that those who advocate for Walmart to pay workers as well as those at Costco are misguided, due to the companies' different business models and customer base. That may be true, but Walmart increasing wages and training and trying to be a better place for workers is evidence that wages should at least be moving in an upward direction. Already, these more conscious policies are paying dividends in the form of reduced turnover and increased applications, just as is predicted by economic theory.

Customers

The average shopper at Walmart and the average shopper at Costco are very different. According to "Should Walmart Imitate Costco? The Variation in Retail Wages," a study by Kantar Retail found that "the average Walmart shopper is a white, 50-year-old female, with an annual household income of $52,125" (as cited in Kohlhepp, Shapovalova & Villarreal, 2016, p. 4). On the other hand, the average Costco shopper has an average income of of $85,000 a year. The most frequent shopper is similar to Walmart's average shopper, a "white woman from a large household, with $50,000+ in annual income," but the average is pulled up by "Costco's target consumers—small business owners with $100,000+ incomes" (Kohlhepp et al., 2016, p. 5). Both companies have mission statements centered around their customers, but there are large differences in the policies they have toward customers.

Costco shows its commitment to its customers by "limiting the markup of any branded product to 14 percent and to 15 percent for Kirkland private label products" (Sheth et al., 2014,

p. 100). In general, supermarkets have a markup of 25 percent and department stores 50 percent or more (Berman, 2011, p. 32). Sinegal referred to the temptation to allow margins to creep us as "the heroin that killed many a retailer. Holding prices down is part of the faith that our customers have in us" (Berman, 2011, p. 32). So important is this to Costco, that when a supplier lowered wholesale prices of 35mm film to Costco due to the item selling so well, margins increased above Costco's limit. Worried about eroding brand equity if they lowered the price, Costco kept the package price the same but increased the number of rolls per package (Sheth et al., 2014, p. 100), showing a genuine commitment to the welfare of their customers. Costco also provides value to customers through an extremely generous return policy: "no receipts; no questions; no time limits" (Sheth et al., 2014, p. 100), with the exception of televisions, major appliances, computers, touchscreen tablets, cameras, camcorders, MP3 players and cellular phones, which must be returned within 90 days ("Costco Return Policy," n.d.). This displays the trust Costco has in its customers and signals to customers that Costco has faith in the value of its products. Despite their low prices, "Costco carries only high quality products" and because of this occupies the "best value" position in its industry (Sheth et al., 2014, p. 197).

Costco is able to provide this value because, with the notable exception of labor costs, Costco focuses on "eliminating all the frills and costs historically associated with conventional wholesalers and retailers" (Berman, 2011, p. 30). According to Sinegal: "We run a tight operation with extremely low overhead, which enables us to pass dramatic savings to our members" (as cited in Berman, 2011, p. 30). Costco uses facilities that are "bare-bones with concrete floors, exposed ceilings, and a lack of signage" (Berman, 2011, p. 30). Everyday low pricing reduces Costco's expenses by resulting in "more efficient warehouse and trucking utilization…, fewer stockouts, and lower labor costs due to fewer pricing changes" (Berman,

2011, p. 42). Additionally, Costco's "corporate marketing budget is miniscule compared to other retailers of its size" and it has no public relations department (Berman, 2011, p. 42).

Walmart also has a commitment to everyday low prices, which it has achieved through global sourcing initiatives which "have cut intermediaries and dramatically reduced costs for categories like perishables" (Dawar & Stornelli, 2013, p. 89). Walmart also has huge economies of scale and a focus on efficiency. It also has what is considered a fairly generous return policy, although it does not go as far as Costco's: most items can be returned within 90 days, with various minor exceptions based on department. ("Return Policy," n.d.). Customers are allowed up to 3 no receipt returns in a 45 day period ("No Receipt," n.d.). However, even those complimentary of Walmart's business, as Jim Collins is in his book *Good to Great*, admit that Walmart has no interest in quality (as cited in Sheth et al., 2014, p. 35). In Consumer Reports' 2015 rankings of the best and worst grocery stores, Walmart Supercenter, the largest, ranked 67 out of 68. According to Tom Marks of Consumer Reports, Walmart "didn't do so well for its courteous staff and store cleanliness… It did score better than many chains for its prices, but it wasn't the best for price." Walmart also scored very low in ratings for freshness of its produce. Costco ranked number 6 of 68 on the same list (Han, 2015).

There is other evidence that Costco performs better than Walmart in terms of creating value for customers. Costco had a membership renewal rate of 91% in the US and Canada and 88% worldwide for 2015 (Costco Wholesale, 2015a). This high level of loyalty among customers is despite the fact that Costco makes it very easy to cancel a membership, and will "refund your membership fee in full at any time if you are dissatisfied." The renewal rate has increased every year for the last five years. (Kalogeropoulos, 2015). A report from the American Customer Satisfaction Index ranked Costco number one among specialty retailers, with a score

of 81 out of 100. Sam's Club was number eleven on the list with a score of 76 out of 100, and Walmart was number sixteen, last, on the list of Department & Discount Stores with a score of 66 (American Customer Satisfaction Index, 2016, p. 2-4). In "Bad Profits, Good Profits, and the Ultimate Question," authors Fred Reichheld and Rob Markey surveyed customers in a wide range of industries and separated them into promoters, passives, and detractors. Promoters are "loyal enthusiasts who keep buying from a company and encourage their friends to do the same," while detractors are "unhappy customers trapped in a bad relationship" (Markey & Reichheld, 2008, p. 21). The authors determined a Net Promoter score for each company by subtracting the percentage of detractors from that of promoters. Costco came in first place among department, wholesale and specialty stores with a Net Promoter score of 77%. (Markey & Reichheld, 2008, p. 23)

The loyalty customers feel to Costco is what allows it to get away with spending so little on marketing: "customers are so loyal that the company can rely on positive word of mouth for its growth" (Markey & Reichheld, 2008, p. 13). Joel Benoliel, senior vice-president of membership and marketing, says "If we do a superb job delivering value to our members, they will be our best ambassadors and we don't need to buy time in television, in radio, or magazines and newsprint because the best kind of advertising is word of mouth" (as cited in Berman, 2011, p. 42). Costco spends essentially nothing on advertising, with the exception of occasionally sending mail out to prospective members. Walmart spent $2.4 billion on advertising in 2013. It spends less than other retailers on advertising as a percentage of revenue, but that is because the amount of revenue it brings in is so huge (Green, 2015).

With similarly low prices and generous return policies, evidence points to the connection between employee and customer satisfaction, discussed in "The Service Profit Chain," as the

main reason for the gap between Walmart and Costco in their appeal to customers. According to "Secret Recipes – The Power of Culture in and Experience Economy," everyone at Costco, "immersed in that culture, is dedicated to creating the kind of store that they would want to shop at; and they usually get it right" (Vossoughi, 2013, p. 25). On the other hand, Walmart's problems with employee relations cause problems for their customers as well. Employees at Walmart are supposed to offer customers "aggressive hospitality," described in *Nickel and Dimed:* "as soon as anyone comes within ten feet of a sales associate, that associate is supposed to smile warmly and offer assistance" (Ehrenreich, 2001, p. 154). While Ehrenreich tries to practice this at first, she soon stops. "I never see a more experienced associate do this" (Ehrenreich, 2001, p. 154), she writes. Later, she says the "'aggressive hospitality' gives way to aggressive hostility" (Ehrenreich, 2001, p. 165). According to Will McKitterick, a retail analyst for IBISWorld, one reason Walmart shoppers dislike the experience is because "some shelves aren't stocked [correctly], items are missing, shelves are messy, merchandise may be in a different spot," (as cited in Ca. Hill, 2015) all issues with either understaffing or unmotivated employees. Additionally, "Walmart isn't known for its friendly or helpful employees" (Ca. Hill, 2015) and "while you may not hear people complaining about their customer service, you won't hear a lot of praise for it either" (Hyken, 2016).

There is further evidence of the link between employee and customer satisfaction at Walmart: since Walmart began trying to repair relations with employees through higher wages and better training, customer satisfaction scores are going up, according to a study by Cowen & Co. (Wahba, 2015). Walmart is opening 200 training academies in an attempt to use "enhanced training to address concerns about customer service quality" (Stern, 2016).

While both Costco and Walmart center their mission statements around their customers, by maintaining excellent relationships with their employees, Costco is better able to carry out that mission. Both companies try to provide value to customers with low prices and generous returns, but the large gap between customer satisfaction scores between the two companies indicates that the experience shoppers receive at Costco is significantly better than the experience at Walmart. This allows Costco to spend nothing on advertising, relying on loyal customer advocates, and receive a steady, predictable stream of recurring revenue from fees for memberships, which are almost never cancelled and have renewals of over 90%.

Suppliers

There is mixed evidence on how consciously suppliers are treated at both Costco and Walmart. Both have extremely tough policies with regard to suppliers, with high expectations on price as well as stringent supply chain requirements. While some Walmart vendors find the company very fair and transparent, others feel that the company tries to squeeze too much out of them for the sake of lower prices. As recent wage increases have cut into Walmart's profitability, suppliers have been asked to pick up more of a burden. Costco communicates effectively with suppliers, but the firm is also tough in negotiations and uncompromising if it feels slighted by a vendor. Both companies have had initiatives involving suppliers that indicate a willingness to cooperate and innovate collaboratively.

According to *Firms of Endearment*, Costco is a "preferred compan[y] to do business with" among suppliers. Whereas "manufacturers of high-quality products such as Titleist and Cuisinart initially shunned warehouse-style retail stores because of their 'bare bones' image," now "such companies eagerly sell their products at Costco" (Sheth et al., 2014, p. 37). In 2004, Costco was honored as candy industry magazine *Confectioner's* Retailer of the Year (Khun,

2004) and in 2015, Frank Padilla, Costco's vice president general merchandise manager for meat a produce was awarded Produce Retailer of the Year by the Packer, a fresh fruit and vegetable industry news source (Riemenschneider, 2015). This award was in part due to Costco's "strong relationship with suppliers around the globe" (Riemenschneider, 2015). In a 2004 PowerRanking survey, in which "retailers are ranked by vendors on criteria that include achievements in areas such as purchasing and category management, among others" Costco ranked in the top ten (as cited in Khun, 2004).

Accolades from suppliers come despite Costco's reputation for toughness in their dealings. Retail consultant Thomas Aquilina speaks to the difficulty of breaking in as a new vendor at Costco. The first criteria for a new retailer is taste, and "if the taste isn't first-rate, the process will stop right there," (as cited in Khun, 2004) an indication of Costco's focus on quality. But their relationship with vendors is straightforward: "Not counting product quality, which must be a given, it's all about high-volume sales and rapid turn" and "they're very forthcoming with vendors about what their needs and requirements are" (as cited in Khun, 2004). According to another consultant, Neil Stern, "The good news about Costco… is that it's hard to get in, but you get in based on performance. You're not working with slotting fees or advertising rebates or all the games that certain channels play" (as cited in Khun, 2004). That performance must continue throughout the relationship: "If you sell to Costco, you'd better have 100 percent fill and 100 percent on-time delivery" (as cited in Khun, 2004). Frank Padilla has a reputation among fresh foods vendors for "always pushing vendors to improve and never [shying] away from asking the hard questions." (Riemenschneider, 2015).

One expectation Costco places on vendors that allows for very little compromise is their commitment to low prices. According to *Competing in Tough Times,* "Costco's Sinegal has

consistently warned Costco's suppliers not to offer other retailers lower prices than Costco receives" (Berman, 2011, p. 38). One vendor mistakenly sent Costco an invoice meant for Walmart indicating that Walmart was receiving a lower price. "We have not brought that supplier back," said Sinegal (as cited in Berman, 2011, p. 38). Costco must be made aware of all of a supplier's alternative pricing terms, such as if there are different prices for truckload versus trainload quantities, to allow it to analyze the options. If this information is not provided consistently and voluntarily, a supplier will be "immediately and permanently discontinued" (Berman, 2011, p. 38). Costco previously purchased a majority of its bananas from a supplier called Bonita, but when heavy rains and flooding threatened the crop in 2007, "Bonita tried to add an extra $6 'force majeure' fee per case, while its competitors were only adding $2" (Mcgregor, 2008). For ten weeks, rather than raise prices for customers or take losses on bananas, whose margins were already razor thin, Costco had very few bananas in its stores.

According to Charles Fishman in "The Walmart You Don't Know," "for many suppliers, the only thing worse than doing business with Walmart is not doing business with Walmart" (2003). Walmart is extremely tough in its relationships with suppliers, to the point where "supplying Walmart is like getting into the company version of basic training with an implacable army drill sergeant" (Fishman, 2003). Some suppliers, like Bill Nichols, who negotiated with Walmart about a line of infant socks, find their style tough but fair. Said Nichols:

> Walmart has continuously improved the quality of their supplier performance. It is often perceived to be about price. But it is much deeper than price. If you are willing to work in a collaborative relationship, then your profitability with Walmart can be very good…Walmart goes to many extremes to give their suppliers the opportunity to be profitable. They want them to be profitable; they want them to have a good return on

investment. (Knebel & Sebenius, 2010, p. 3-4)

Nichol appreciates the "open door policy" and the fact that "Walmart encourages… open discussion; it is welcome to constructive criticism" (Knebel & Sebenius, 2010, p. 5). Supplier Vlasic had a different experience with Walmart, at least in terms of profitability. When the gallon jar of pickles sold by Vlasic to Walmart began cannibalizing their profits in other channels, they tried to increase the price from $2.97 to $3.49, and Walmart told them: "If you do that, all the other products of yours we buy, we'll stop buying" (Fishman, 2006, p. 14). Vlasic couldn't afford to risk Walmart's business, so they endured the cripplingly low price for two and a half years. Finally, Walmart allowed Vlasic to begin selling a half-gallon for $2.49. An employee at Walmart said, "Well, we've done to pickles what we did to orange juice. We've killed it. We can back off" (Fishman, 2006, p. 14). Said another executive who worked with Walmart, Robin Prever, who was the CEO of a supplier to Walmart from 1992-2000, "Everyone from the forklift driver on up to me, the CEO, knew we had to deliver [to Wal-Mart] on time. Not ten minutes late. And not 45 minutes early either…The message came through clearly: Either you're there, or you're out. With a customer like that, it changes your organization. For the better. It wakes everybody up. And all our customers benefitted" (as cited in Fishman, 2003). Vendors are desperate to avoid the "penalty box," when they are punished or excluded from store shelves for failing to meet performance benchmarks or doing something that Walmart dislikes. But when Charles Fishman reached out to former suppliers or executives who used to do business with Walmart but do not any longer, "to a person, [they] credit Wal-Mart with a fundamental integrity in its dealings that's unusual in the world of consumer goods, retailing, and groceries. Wal-Mart does not cheat suppliers, it keeps its word, it pays its bills briskly…But Wal-Mart also clearly does not hesitate to use its power" (Fishman, 2003). Taken together, these

anecdotes present evidence of a company that is extremely difficult to work with due to their enormous power but generally fair in their dealings.

Academic research on Walmart's effect on suppliers is mixed. In an empirical study, "Retailer Power and Supplier Welfare: The Case of Wal-Mart" from 2001, Paul Bloom and Vanessa Perry concluded that "it is not possible to identify the impact of Wal-Mart upon supplier relationships unambiguously" (Bloom & Perry, 2001, p. 391). While they found that suppliers identifying Walmart as a primary customer perform more poorly financially than those who do not, they also noted that "large-share suppliers to Wal-Mart extract more profits from their market share than do counterparts without such a relationship" (Bloom & Perry, 2001, p. 391). Sandra Mottner and Steve Smith, in an empirical study from 2008 called "Wal-Mart: Supplier Performance and Market Power," found that "Wal-Mart suppliers do have lower gross margins than non-Wal-Mart suppliers" but that this is due to suppliers' strategic choice to be a low cost manufacturer, rather than due to Wal-Mart negotiating lower margins (Mottner & Smith, 2009, p. 539). The authors updated data from the Bloom and Perry study and the results "do not support the finding that suppliers have lower profits" (Mottner & Smith, 2009, p. 540). They also say that "Wal-Mart's reputation for developing and working with small manufacturers appears to be well deserved," and that while public perception of Walmart's relationships with suppliers is poor due to anecdotal evidence from a few disenchanted suppliers, Walmart has a partnership model with suppliers with "the idea that the buying and selling of products is a long-term relationship that implies performance expectations for both parties" (Mottner & Smith, 2009, p. 540). The author's conclude that "while this type of relationship may be Wal-Mart's intent, the perception of the public and suppliers may differ. Wal-Mart can and should help manage this perception" (Mottner & Smith, 2009, p. 540).

In the 2014 Walmart Supplier Survey, only 5.3% of suppliers characterized their relationship with Walmart as “adversarial,” which was the least used word in describing the relationship. The most used, with 41.7%, was “very solid w/ occasional conflict.” On the other hand, only 6.1% described the relationship as “profitable.” Suppliers had “generally favorable views of Walmart’s senior leadership and merchandising organization” (Wal-Mart Stores, Inc., 2013, p. 13), with 79.2% agreeing with the statement “Walmart U.S.’s senior leadership is receptive to my views as a supplier.” According to the survey, Walmart damaged its relationships with suppliers in 2010 by “pursuing strategies and an approach to managing its business that were inconsistent with long-standing partnership principles” but in 2014 things had improved considerably. When asked to identify where Walmart had the best opportunity to improve its capabilities and operations, “store level execution was the top choice, mentioned by 85.6 % of respondents.” In particular, 92.3% of suppliers thought that the statement, “labor in stores is set at an appropriate level to accomplish Walmart’s objectives” was false. (Wal-Mart Stores, Inc., 2013, p. 13)

As noted before, in an effort to improve the store execution that is seen as a problem by suppliers, Walmart is trying to improve relationships with employees through increased training and improved wages. There is evidence that by improving relationships with the employee stakeholder group, Walmart is damaging its recently improved relationship with its suppliers. According to a *Wall Street Journal* article from October 2015, “Vendors hope Wal-Mart’s big investment in stores and online sales can make the company stronger in the long term. But news of next year’s lower profits sent a shudder through the supplier community, where there are concerns there will be ‘increased pressure on suppliers to fund their problems,’ said one Arkansas-based executive at a large consumer-goods company” (Nassauer, 2015). In June of that

year, Walmart began asking suppliers to "pay a fee for passing products through Wal-Mart's warehouses and accept longer payment windows." In addition, Walmart has "aggressively pruned the stores' promotional-sales space" (Nassauer, 2015). Walmart has been pressuring suppliers to provide lower prices by not spending trade funds on promotion. This focus on "relying strictly on price with no control over displays and promotions could lead to further commoditization" (Anderson, 2015) and harm suppliers. According to Deisha Barnett, a spokeswoman for Walmart, "All of the changes we are asking suppliers to make are true to our business model and everyday low prices…Change isn't always easy" (Nassauer, 2015). But Walmart should be careful not to upset one of their better stakeholder relationships in their efforts to improve their relationships with others.

The transparency and fairness both Costco and Walmart exhibit in their supplier relationships has brought benefits to the both firms. Specifically, cooperative relationships have created innovations that allow both firms to have extremely efficient supply chains. Costco worked with vendors "to redesign product packages to fit more items on a pallet" and the efforts have resulted in Costco needing "200,000 fewer pallets a year overall" (Mcgregor, 2008). The simple tweak of putting cashews into square containers instead of round ones decreased the number of pallets shipped by 24,000 in 2008, "cutting the number of trucks by 600" (Mcgregor, 2008). By working with a supplier to redesign the the shape of a milk bottle, Costco "eliminated the need to ship more than 500 truckloads of freight annually" (Berman, 2011, p. 40). In 2009, Costco was able to reduce both packaging and shipping costs by reducing the amount of resin in its Kirkland Signature brand of water (Berman, 2011, p. 40). Walmart has partnered with suppliers to develop more sustainable products. In 2014, Walmart "joined forces with CEOs from more than a dozen global companies to sign new commitments that accelerate innovation in

sustainable agriculture and recycling" ("Walmart convenes," 2014). The suppliers involved represented more than $100 billion in sales at Walmart, and commitments included initiatives such as "a 25 percent reduction in water per dose for all liquid laundry detergent" with Proctor & Gamble, and "a small-scale pilot focused on improved beef supply chain visibility" with Cargill, with the eventual goal of Walmart sourcing "15 percent of its beef supply with environmental criteria by 2023" ("Walmart convenes," 2014). Walmart is leveraging its relationship with suppliers to improve its record with regard to society and the environment.

The innovation benefits that come from collaborative relationships are greater when products are more complex, evidenced by the example of auto-manufacturers in the United States and Japan. Costco and Walmart tend to sell much simpler goods than automobiles, and they are not involved in the production process of the goods they sell. Perhaps that is why, despite having fair and transparent relationships with suppliers, so many characterize the two companies as being very tough to work with. To the extent that innovations can be had however, through packaging changes or improved supply chain efficiencies, the firms' relationships with suppliers seem to work very well. Walmart has a reputation of squeezing suppliers unfairly, while Costco does not. And though that reputation seems to be unwarranted in Walmart's case, it is could be that negative anecdotes from suppliers are magnified due to the problems Walmart has had in relationships with other stakeholders. For that reason, Walmart's recent push to improve these relationships could improve the way the public views its interactions with suppliers, provided the firm does not push too much of the cost onto their vendors.

Society/Environment

According to *Firms of Endearment*, "communities generally welcome a Costco warehouse because it is recognized as a good corporate citizen that provides excellent job

opportunities and tax revenues" (Sheth et al., 2014, p. 148). On the other hand, a paper by Paul Ingram, Lori Yue and Hayagreeva Rao claims that "Wal-Mart's biggest enemy…is not a business rival, but antisprawl advocates who oppose its proposals for stores in their hometowns" (Ingram, Rao & Yue, 2010, p. 53). Costco is most often welcomed by local communities, while Walmart is often protested. A large part of that likely comes from the company's reputations regarding quality and treatment of employees and suppliers. But there is evidence that some relates to how the companies engage with the community itself.

In "Trouble In Store: Probes, Protests, and Store Openings by Wal-Mart," the authors note that between 1998 and 2005, "Wal-Mart floated 1,599 proposals to open new stores. Wal-Mart successfully opened 1,040 stores. Protests arose on 563 occasions, and in 65% of the cases in which protests arose, Wal-Mart did not open a new store" (Ingram et al., 2010, p. 53). So 35% of the time when Wal-Mart proposed a new store, communities reacted negatively. They were also largely successful in preventing Wal-Mart's entry, prevailing 65% of the time. This could indicate an especially passionate response from protestors, or as the authors of "Trouble In Store" hypothesize, it could be that Walmart uses new store proposals as low-cost probes for community backlash and likely shopper demand. In either case, a significant number of Wal-Mart store proposals are met with protests.

One reason for this response could be Wal-Mart's economic impact on the local community. In 2006, Elena Irwin and Jill Clark surveyed the extensive literature on this subject in "Wall Street vs. Main Street: What Are the Benefits and Costs of Wal-Mart to Local Communities?" First they note the impact on consumers within the community, which is almost always positive, even for non-Walmart shoppers. Because Walmart's "prices for various food items and other 'nontraditional' large discount food retailers are 5-48% less than prices for the

same product in conventional supermarkets," a Walmart opening can lead to "price declines of 7-13% in the long run" (Clark & Irwin, 2006, p. 117) at other local businesses. On the other hand, Walmart has been found to have a generally negative effect on local labor markets. While one study found that Walmart's entry into a county increased retail jobs in that county by 100 in the intermediate term, falling to 50 over the long term, another found that "Wal-Mart entry reduces retail employment at the county level by about 180 workers" (Clark & Irwin, 2006, p. 118). That same study also found retail earnings declined at the county level by about 2.8%. A 2006 paper found "that counties with more Wal-Mart stores in 1987 had higher rates of poverty in 1999 than counties with fewer or no Wal-Mart stores" (Clark & Irwin, 2006, p. 118). The impact of Walmart's entry on small retailers is unambiguously negative. One paper found that an average of four small retailers are displaced within five years as the result of Walmart opening a store, and another found that "Wal-Mart's expansion from the late 1980s to the late 1990s… account[s] for 50-70% of the decline in small retailers" (Clark & Irwin, 2006, p. 118). In *Wal-Mart: The High Cost of a Low Price,* Weldon Nicholson, a Walmart Store Manager Trainer for 17 years, talked about how it was Walmart's intention to shut down local stores: "The hell with it. Walmart will buy the whole town. We'll shut them down. And we used to drive through towns going: six months; three months; that's when we'll be closing them" (Greenwald, 2005, 0:12:42-0:12:55). In terms of overall economic impact, "in rural areas, a 'zero-sum game' frequently prevails" where Wal-Mart "captures its sales from existing businesses rather from growing market" (Clark & Irwin, 2006, p. 119). The survey concludes that "consumers have benefited from Wal-Mart's tremendous cost efficiencies… evidence also shows that Wal-Mart does not bear the full economic and social costs of its business practices. As a result, the benefits and costs are unevenly distributed across individuals" (Clark & Irwin, 2006, p. 119).

There are no studies that specifically study the economic impacts from the entry of a Costco, but they are likely to be very similar to Walmart in some ways. Because of its low prices, it is likely to have a similar impact to Walmart with regard to pulling down prices of all retailers and its positive impact on consumers. It is also likely to have a similar effect on small retailers as a large competitor that is very difficult to outcompete. However, the effect on the labor market in a community is likely to be very different from Walmart due to Costco's notably higher wages and benefits. The impact on employees and the labor market appears to tip public perception in favor of Costco despite the similarities it shares with Walmart in other areas. Clearly, this perception has harmed Walmart, as it has been unable to expand into every community it would like.

When Costco is met with resistance in a community, the firm works with them and tries to address concerns. According to *Firms of Endearment*, "Costco representatives sit with the local stakeholders and ask them to voice their concerns about the proposed new warehouse" (Sheth et al., 2014, p. 148) when they are looking to enter a new community. Costco planned to build a warehouse in Cuernavaca, Mexico in 2002, but was resisted by residents, community activists, and environmental groups who were concerned about a loss of trees in the area and about protecting murals by Mexican artists housed in the building that the warehouse was meant to replace. Costco responded by taking the concerns seriously: "It spent previously unbudgeted money to preserve and restore the murals, relocate older trees, and donate 30,000 trees to the city" (Sheth et al., 2014, p. 148). Actions such as this are part of the reason Walmart proposals are frequently protested but Costco's are not. An article in the Huffington Post from 2012 noted that while there were vocal protests concerning proposals to bring six Walmarts to Washington DC, but "there hasn't really been any vocal protest of Costco" (Greenwood, 2012), which was

entering the market as well. In interviewing three people who protested the entry of Walmart, the consensus was that Costco's reputation for better working conditions and wages made its entry more palatable.

Walmart has become one of corporate America's leaders with regard to reducing the negative effects of its business on the environment. But it was not always so conscious about sustainability. In *Walmart: The High Cost of a Low Price*, Donna Lisenby, a riverkeeper for the Catawba River, describes how "Walmart had a practice of storing herbicides, pesticides and fertilizers in the parking lots" (Greenwald, 2005, 0:55:38-0:55:42). The bags were torn and open to the elements, and a creek that ran by the Walmart emptied into the Catawba River. Rain washed the fertilizer into the river, so Lisenby called Walmart to tell them about her concerns. After being told by person after person at Walmart to talk to somebody else, she finally contacted the local news, who ran a story on the way the fertilizer was being stored. The local manager of the Walmart saw the story on the news, unaware until that point that the chemicals were an issue at all, and contacted his regional manager. The regional manager had all the stores in his region pull the chemicals out of the parking lots. But Walmart headquarters never responded, even to tell their managers that a complaint had been made.

This was not an isolated incident. In 2001, the EPA ordered Walmart to pay a million dollar fine for clean water violations in Texas, Oklahoma and Massachusetts. In 2004, they were fined again by the EPA, this time for a retailer record $3.1 million dollars, for clean water violations in nine different states. In 2005, they paid another $1.5 million to the Connecticut EPA for violating the Clean Water Act (Greenwald, 2005, 0:59:38-1:00:07). But in 2005, Walmart began to change course, launching a sustainability program. The program, which "was originally seen as a way to insulate the company from environmental criticism has evolved into something

much broader" (Mackey & Sisodia, 2014, p. 148). The initial goals of the program were to use "100 percent renewable energy, to create zero waste and to sell products that sustain people and the environment" (Wal-Mart Stores, Inc., 2015a, p. 4). According to their 2015 Global Responsibility Report, since 2005, Walmart has improved the fuel efficiency of its fleet by 87.4 percent and reduced waste by 82.4% in the US. Walmart improved its efficiency by "installing energy-efficient lighting and refrigeration, using better fuel, streamlining its trucks, and planning better routes" (Mackey & Sisodia, 2014, p. 149). Walmart "is finding new uses for things that used to be sent to landfills, such as converting plastic waste into dog beds and food waste into compost" (Mackey & Sisodia, 2014, p. 149). Walmart currently has dozens of initiatives in place, as well as ambitious goals, including aspirations to "drive the production or procurement of 7 billion kilowatt hours (kWh) of renewable energy globally by Dec. 31, 2020 – an increase of more than 600 percent versus our 2010 baseline" and "by Dec. 31, 2020, reduce the total kWh-per-square-foot energy intensity required to power our buildings around the world by 20 percent versus our 2010 baseline" (Wal-Mart Stores, Inc., 2015a, p. 56-7). Walmart has been the leader in solar capacity, with 105.1 megawatts installed in 2014. The runner up, Kohl's, had less than half that capacity with 50.2 (Solar Energy Industries Association, 2014). Walmart has also encouraged and cooperated with suppliers in improving the sustainability of their operations, helping "suppliers in the United States and China [to] reduce their carbon emissions and energy bills by 20 to 60 percent" (Mackey & Sisodia, 2014, p. 149) and working with suppliers to reduce packaging.

These environmental initiatives have had an unambiguously positive impact on Walmart's profitability. In Walmart's 2015 sustainability report, CEO Doug McMillan makes the business case for sustainability, saying: "The most important asset a business has is the trust

and respect of customers and other stakeholders. By tackling large issues and being transparent, a business can earn that trust, and be in a much better position than a company that only focuses on the short term" (Wal-Mart Stores, Inc., 2015a, p. 1). According to *Conscious Capitalism,* "Earlier than most large companies, Walmart realized that a strong business case can be made for taking measures to enhance environmental sustainability" (Mackey & Sisodia, 2014, p. 149) even beyond the positive effects on the firm's reputation. Reducing its waste has allowed Walmart to earn "$100 million a year from waste it previously paid to have hauled away" (Mackey & Sisodia, 2014, p. 149). In 2005 alone, "the combined efforts of changing loading, routing and driving techniques, as well as collaborating with tractor and trailer manufacturers on technologies… save the company nearly $1 billion" (Makower, 2015).

Costco has been slower to embrace environmental initiatives than Walmart, with its first Corporate Sustainability Report coming in 2008. But in its 2015 report, Costco notes that its business model is "inherently more carbon-efficient than other retailers" (Costco Wholesale, 2015b, p. 5). This is because the bulk emphasis reduces trips to the store by customers and a highly efficient distribution system. Costco also notes that striving to bring merchandise to customers at the lowest cost has caused them to always look for ways to reduce expenses, including through tracking energy usage and seeking to reduce use of electricity. Costco believes "continuing to focus on our expertise on reducing costs and improving efficiency is…the best way for us to reduce our impact on the environment" (Costco Wholesale, 2015b, p. 6). Costco is less public about their environmental initiatives, perhaps because they are smaller in scale than Walmart's and because the company has not had problems with its reputation to the extent Walmart has. But it was 3rd in total solar capacity in 2014, with 48.1 megawatts installed. Additionally, it was 6th in terms of percentage of facilities with solar, at 17% (Solar Energy

Industries Association, 2014). Costco has also been innovative in reducing packaging, for example using drop-down false pallet bases to “save up to 50% in freight costs” (Costco Wholesale, 2015b, p. 42). For Costco, the opportunity to help the environment is viewed as the result of improving the core strength of the business, cost efficiency and low prices. Walmart, on the other hand, seems to have a genuine commitment to improving the environment, next to which increased efficiency and business benefits are secondary. There is no question that Walmart has benefitted financially from its environmental initiatives.

Conclusion

The rise in the popularity and success of conscious business models has coincided with two enormous trends, in demographics and technology. The first trend is the aging of the population. In 1989, for the first time in history, the majority adults in the US were 40 or older (Sheth et al., xxviii). The authors argue that this has made the general population less materialistic and more interested in experiences and self-actualization. Tastes have therefore shifted to higher quality products, with less of a focus on price, purchased from firms that the consumer sees as sharing similar values. At the same time, the rise of the Internet has created an age of increased transparency and scrutiny, democratizing the flow of information and making individuals and groups much more accountable. These trends have worked to the advantage of stakeholder-based firms. Customers have developed a taste for more meaningful and fulfilling interactions with firms, and at the same time they can now avoid those firms whose practices, revealed by an era of increased transparency, do not align with their values.

Walmart's business practices did not align with the values of many in the public in the early 2000's, and a huge amount of criticism was leveled at the company as a result. It was compared unfavorably in a number of articles to the more employee-friendly Costco, a firm whose commitment to stakeholders had been at the core of its business model since inception, evidenced by its inclusive mission statement. The reputation Walmart developed drove away potential customers and kept Walmart out of potentially profitable communities, and its practices left employees unmotivated and unproductive. Though it resisted change for a long time—Leslie Dach described Walmart as being in a "defensive crouch" (Dach, 2013, p. 2) and unwilling to listen to its critics—since 2005 the firm has taken steps to improve its reputation and relationships with stakeholder groups. Executives talk about these changes as necessary to ensure

the continued long-term success of the retailer, indicating the company may truly be convinced of the business benefits of becoming more conscious.

Overall, the evidence presented suggests that the approach advocated by *Conscious Capitalism* is consistent with the maximization of long-term shareholder value, despite this not being the stated goal. The outperformance of firms which represent various aspects of a conscious approach seems to be explained in large part by the economics literature, which shows links between policies benefiting stakeholders and profitability. Examples include efficiency wages for employees, genuine advocacy for customers, cooperation instead of opportunism with suppliers, and environmental initiatives that help the broader community and environment. In many cases, the link to profitability is indirect, and improvement initially comes in things that are difficult to measure, such as customer loyalty and innovation. The difficulty in measurement makes these things no less important however, and *Conscious Capitalism* beseeches managers and business leaders to consider all the potential second and third degree consequences of their decisions and how those decisions affect stakeholder groups. While paying low wages may seem like the best way to lower labor costs, they serve to lower productivity and increase turnover, frequently resulting in higher net costs. Businesses are complex systems, and they are filled with these counterintuitive intricacies. Walmart's recent actions provide further legitimacy to the business model, as the firm has responded to declining prospects by pivoting in a more conscious direction.

The case for *Conscious Capitalism* could be strengthened by further case studies and a deeper exploration of the economics literature. The breadth of the topic made it necessary to explore a very wide range of topics within economics, and time did not permit a level of depth necessary to be exhaustive with each. Additionally, case studies comparing other firms,

industries, and time periods could be useful in exploring how different dynamics amplify or dampen the business benefits. Finally, an empirical evaluation of the performance of conscious firms specifically, as opposed to the proxies noted, could lend further insight into the connection between a conscious business model and profit.

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