• GLOBAL ECONOMIC GOVERNANCE PROGRAMME •

MAKING CORPORATE SELF-REGULATION EFFECTIVE IN DEVELOPING COUNTRIES

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Summary

Self-regulation by multinational corporations of social/ environmental impacts has been advocated as a solution to the regulatory capacity problems faced by developing states. Market pressures can provide incentives for firms to implement codes and standards, but rely on widely available information about corporate behaviour. Voluntary schemes attempt to provide reliable, standardized reporting of information. But government action – in the North and South – remains vital to effective regulation, by setting social goals and upholding the freedom of civil society actors to organize and mobilize. International organizations and legal instruments may be able to assist developing country governments in fulfilling these roles.

I. Introduction[1]

The operations of multinational corporations (MNCs) across state borders have become an increasingly important part of global economic activity. Of some 68,000 MNCs, the overwhelming majority are based in the advanced economies of developed countries (United Nations Conference on Trade and Development, 1999). Many developing countries play host to the operational activities of these firms and their some 500,000 subsidiaries. Multinational oil corporations conduct exploration and production operations in African states (Evans & Hencke, 2003). Clothing and footwear companies outsource their production to factories in developing Asian countries (O'Rourke, 2003). As John Ruggie has put it, increasingly business operates in a 'single global economic space' (Ruggie, 2004).

For people in developing countries, the globalization of business brings a wealth of potential opportunities. At the same time, it poses a significant regulatory challenge. In industrialized countries, as the activities of MNCs have grown governments have attempted to adapt more appropriately to regulate them. The goals of regulation have been both to facilitate competitive markets, and to uphold widely valued social and public goals. Hence, environmental protection laws, workers rights and safety, consumer rights, pensions, competition laws, financial rules and auditing requirements have all become part of a dense system of regulation in the industrialized world. No country boasts perfect regulation – indeed the recent corporate collapses of ENRON and WorldCom exposed significant gaps. However, yet more serious gaps exist in most developing countries where governments have far less capacity to regulate.

The challenge of regulation in developing countries is not a new issue. For over two decades the rising power of MNCs and the inability of developing countries to regulate them has been debated (Vernon, 1971; Strange, 1996). Weak rule of law, the absence of government administrative capacity, and weak bargaining power vis-à-vis Northern-based MNCs wielding vast resources of financial capital, technology, and employment, have all mitigated against the emergence of appropriate and effective regulatory institutions (Wawryk, 2002; see also Stopford, Strange, & Henley, 1998). Simply put, some developing states have limited control over the effects of economic activity within their borders on such social objectives as human rights, labour rights and environmental sustainability. Equally, some governments are unwilling to regulate, perceiving instead benefits to be gained from a lack of regulation as they compete for foreign direct investment. The result can be a regulatory 'race to the bottom' in the hope of attracting MNCs favouring countries with weak regulatory systems – and a concurrent pressure on other governments to reduce their regulatory standards (Haufler, 2001, p.2).

Global governance arrangements have to date offered little support to developing countries wishing more effectively or appropriately to regulate MNCs. To the contrary, the powerful industrialized members of institutions such as the International Monetary Fund, the Bank for International Settlements, the World Bank Group, and World Trade Organization have tended to focus on deregulation within

[1] The authors are deeply grateful to the two reviewers of this article for their helpful suggestions and comments.

the developing world. They have pressured developing country governments to recognize and protect the rights of foreign investors. Little attention has been paid on necessary correlate regulation to ensure the above-mentioned social and public goals of developing country societies. The result has been a framework of laws surrounding foreign direct investment, which are highly asymmetric (Lowe, 2002).

Against this background, it has become popular to ask whether voluntary codes and standards undertaken by MNCs offer a useful complement to government regulation. This article reviews the literature on this issue, reflecting on what it implies for regulation in developing countries. It examines how and why self-regulation might be effective, identifying some of the preconditions and government actions required to effect compliance within a voluntary regime.

II. The Rise and Limits of Self-Regulation

Global corporations have begun to address the gap in global economic governance by using their powerful position to impose binding minimum standards of their own. The term 'self-regulation' can be used to describe a variety of attempts by corporations to establish rule-based constraints on behaviour without the direct coercive intervention of states or other external actors. Especially prominent are codes of conduct issued by individual corporations or industry associations, some involving other groups of stakeholders, committing participants to minimum standards of environmental and social conduct (a good overview is provided by Haufler, 2001; see also Florini, 2003, p.6). An inventory prepared by the OECD analyses the contents of 246 such codes across most major industry sectors and finds that environmental and labour standards were most prominent among the goals addressed, which also included human rights commitments (OECD, 2001).

Governments of developed states have supported corporate self-regulatory efforts through the promulgation of 'OECD Guidelines for Multinational Enterprises' which invite corporations to uphold principles of human rights, labour rights and environmental conduct, across the whole extent of their global operations (OECD, 2000). Companies are encouraged to regulate their own conduct in line with broad, internationally agreed standards where effective governmental regulation is not present. Multinational corporations thus take on an important role in the implementation of global public policy. The expertise of firms deriving from their privileged access to information and knowledge combines, it is argued, with their own adaptable governance structures to 'produce a more efficient and effective policy process' (Reinecke, 1998, pp.3 & 219). Corporations, by adopting and developing international standards, may be able to control their conduct with even greater efficiency than traditional state regulation.

A body of international relations scholarship has seized on the concept of self-regulation in the world economy with considerable enthusiasm. Scholars have focussed on ways corporations and non-governmental organisations (NGOs) could play 'increasingly important roles in generating, deepening and implementing transnational norms in such areas as human rights, the environment and anti-corruption' (Ruggie, forthcoming). The hope is that norms of human rights, labour rights and environmental standards for MNCs will become part of the cultural and institutional context within which global business operates. 'Norm entrepreneurs'

will play a role in persuading others to prioritize particular causes and values (Ruggie, forthcoming). For example, an activist NGO such as Global Witness aims to adjust the values of business and society, 'challenging established thinking on seemingly intractable global issues' and establishing a central place for the promotion of peaceful and sustainable development in the business of resource extraction (http://www.globalwitness.org/vision.php). When a sufficient number of corporate leaders have been persuaded to adopt a set of emerging norms, they will reach a 'threshold' or 'tipping point' at which they come to be seen as legitimate and to specify appropriate behaviour (Finnemore & Sikkink, 1998). Policies and procedures will then be developed to internalise these in corporations' operational structures.

The norms-based view of why self-regulation might work relies on arguments about legitimacy and socialization. MNCs will abide by rules and norms regulating social and environmental conduct because they are perceived to be 'legitimate' and appropriate. This mirrors the behaviour of governments who comply with international law even where it consists of 'powerless rules' because the law is perceived as possessing legitimacy, 'a property…which itself exerts a pull towards compliance on those addressed normatively' (Franck, 1990, p.16). By a similar argument, MNCs might obey global norms of human rights, labour and environmental conduct, even in the absence of a sanctioning body, because they are seen as legitimate.

An opposing collection of scholarship, rooted in theories of public choice, is highly sceptical about the impact of self-regulation. It is not the perceived legitimacy of certain standards that determine corporate behaviour, nor corporate leaders' desire for conformity. Indeed, as is noted by one scholar who has carefully analyzed corporate behaviour within self-regulatory codes, managers with altruistic concern for legitimacy may be removed or else their firms will not last long in a competitive market (Lenox, 2003). Corporations are economic, not normative actors who will, in the absence of coercive regulation, only undertake actions that are in their self-interest. The recent profusion of corporate and industry association codes of conduct is misleading. The existence of new codes does not necessarily mean that corporate behaviour or impact has changed. Indeed, in practice the codes are often not implemented. Many apparent instances of self-regulation are ineffective.

Why might corporations change their behaviour to adhere to corporate codes in line with internationally agreed social and environmental principles? A simple answer is when they face clear incentives not just to declare regulatory intent but also to comply with the rules they set for themselves. As an Australian government task force on self-regulation argued: 'For industry self-regulation to be effective, there need to be some vested interests or incentives to make it so. In other words, generally self-regulation needs to be in the self-interest of industry to not only occur, but also to be effective' (Commonwealth of Australia Department of the Treasury, 2000, p.48). Most empirical studies of self-regulatory regimes agree that, far from being driven by universal social phenomena, self-regulation requires specific conditions of transparency, monitoring and enforcement to be effective.

III. Market-Based Incentives to Self-Regulate

The incentives that shape corporate behaviour can be altered in the market-place as well as by threats of government or inter-governmental regulation. In essence, when a company attracts bad publicity several groups might react adversely. Investors may come under pressure from their portfolio holders to withdraw or reconfigure their investment in the firm. Consumers might react and threaten product boycotts and the like. These effects are further elaborated below.

(a) Pressures from risk management

Corporations causing environmental damage or human rights abuses generate significant financial risks for themselves (World Business Council for Sustainable Development, 2004; Dowell, Hart, & Yeung, 2000). The 'social, environmental and ethical risk' faced by corporations has been well enunciated by the Association of British Insurers. Their 2004 Report points to the financial implications of the 'social and environmental risks and opportunities for companies', which are to be found 'in every sector' (Cowe, 2004, p.4). Environmental or social misconduct in breach of the law leaves firms vulnerable to civil claims and criminal fines. But crucially such behaviour, even if legal, threatens corporate reputation. Risks to reputation are increasingly recognized as important. They may lead to adverse reaction from consumers and investors and consequent financial loss. These risks will be especially marked when firms derive much of their value from their brand. Recognising that risks to the business can 'arise not only from corporate rivals or competing technologies but also from damage to reputation', managers may seek to protect their companies and their shareholders from the adverse financial consequences of reputational damage (Financial Times Editorial, 2004).

The 'Biennial Risk Management and Financing Survey' undertaken in 2001 by the insurance group Aon found that loss of reputation was in fact seen as the leading risk by major British corporations (Cowe, 2004, p.25). The fear of loss of reputation and of consequent costs has led some corporations to view codes and monitoring standards as `a strategy to reduce reputational risks in the marketplace' (O'Rourke, 2003). The result is an avenue through which market forces can impel firms towards responsible corporate behaviour and towards the development of strong internal guidelines to manage risk to their business (Gordon, 2000, p.6).

However, in practice many MNCs do not formally evaluate these risks or undertake schemes to control them (Cowe, 2004, p.27). It is clear that additional external conditions are likely to be needed if risks are to appear sufficiently important to motivate firms to effective self-regulatory action.

(b) Pressure from investors

Corporations can face pressure from investors to regulate the social and environmental outcomes of their business activities. Investors will recognise that if other actors have social and environmental concerns, firms managing the associated risks through effective self-regulation will generate higher returns on investment capital. Alternatively, some groups of investors are explicitly motivated by normative concerns in respect of the environment or human rights.

Do voluntary standards beyond those required by law improve overall investor confidence? Some argue that such standards are a liability to a firm, imposing higher costs than are necessary and reducing the market value of the corporation. However, several recent studies have demonstrated that adoption of high performance standards in areas where the corporate reputation might otherwise be at risk can improve financial returns (Cowe, 2004, p.25). Analysis of a sample of 89 manufacturing and extracting companies drawn from the Standard & Poors 500 Index found that those firms choosing to follow their own strict global environmental standard had an individual value approximately $10.4 billion higher than those firms that met only the less stringent United States legal requirements (Dowell, Hart, & Yeung, 2000). The risks of investing in firms that fail to uphold stringent standards were made clear after the Bhopal chemical accident of December 1984. In the following five trading days shares in Union Carbide, the operator of the factory, lost approximately $1 billion, 27.9% of their value (Blacconiere & Patten, 1994). Thus shareholders wishing to maximise the return on their investment in a firm do have an incentive to ensure that risks arising from environmental and social conduct are adequately addressed.

Some investors are normatively committed and seek only to invest in firms, which effectively govern their impact on human rights, labour rights and the environment. There is evidence that these pressures from the investment market are being increasingly applied. Investments in professionally managed funds employing major socially responsible investment strategies grew substantially during the 1990s and remained at a high level through the market downturn at the start of this decade. In 2003 the total value of these investments was $2.16 trillion (Social Investment Forum, 2003, p.2). Almost one quarter of pension funds' holdings in United Kingdom equities, some £90 billion, are managed according to a socially responsible investment policy.

Firms can be pressured by investors through two principal strategies: screening and shareholder advocacy. Screened funds will invest only in corporations that meet the funds' standards of performance in key ethical areas. In the United States investments of $2.14 trillion are managed in screened accounts (Social Investment Forum, 2003, p.7). A recent report by the Eiris corporate governance consultancy found that in the United Kingdom such funds grew to account for £2.4 billion, despite a reduction in overall funds under management (Davis, 2004, p.2). However, 'ethically' screened funds can incorporate a very wide range of normative concerns, many of which may not be relevant to controlling the potentially damaging effects of corporate activity in developing countries. Labour standards and the environment are among the most significant screens deployed by United States mutual funds, being the third and fourth most prevalent respectively. But screens against investment in tobacco and alcohol each account for more then three times as much investment capital as either the labour rights or environment screens and human rights concerns are still less prevalent among screened funds (Social Investment Forum, 2003, pp.9-10).

Shareholder advocacy has had a greater role in prompting self-regulation by MNCs. Instead of restricting their investments to corporations meeting certain defined criteria, investors may use their voting rights in firms in which they are shareholders to improve corporate regulatory policies. Significantly, this is a strategy relevant not only to normatively committed investors, but also to others who seek to

maximise their returns by urging corporate attention to risks that might potentially undermine value. According to the Social Investment Forum 2003 Report, some 87% of United Kingdom pension funds responding to a 2002 poll claimed to exercise their voting rights on grounds of social, ethical and environmental risk (Cowe, 2004, p.16). In the United States, $448 billion of professionally managed funds were used to support shareholder advocacy campaigns. Environmental advocacy has been especially prominent. In the first eight months of 2003, 28 shareholder resolutions were moved in United States corporations on issues relating to climate change, with a particular focus on reducing greenhouse gas emissions and reporting on progress. Twelve resolutions were voted on and seven received support from over 20 percent of shareholders, including resolutions filed with multinational oil corporations Exxon Mobil and Chevron Texaco.

Shareholder campaigns have been effective in bringing about corporate self-regulation. Shareholder pressure organized by union pension funds pushed the California-based oil and gas corporation Unocal to adopt the commitments of the International Labour Organization's (ILO) 'Declaration on Fundamental Principles and Rights at Work', including the rights to freedom of association and collective bargaining (see http://www.unocal.com/ucl_code_of_conduct/ethics/labor.htm). The ILO principles comprise the labour rights principles, which the UN Global Compact aims to advance and are now applied to Unocal's global exploration and production operations. The Investor Responsibility Research Center assesses the new code to be among the best in the industry sector (see http://www.irrc.org, cited in Social Investment Forum, 2003, p.21). The example of Unocal highlights ways shareholders in advanced economies can work with international instruments to bring about the self-regulation of corporate operations in developing countries.

(c) Pressure from consumers and activists

MNCs may be prompted to self-regulate as a direct response to consumer pressure, intensified and assisted by NGO campaigns to encourage boycotts of firms with poor social and environmental standards. The development of voluntary regulatory standards for footwear and apparel manufacture in Asia indicates the latent power of a large segment of consumers who, though not active ethical shoppers, have a normative concern with social and environmental issues. When activists highlight an issue and encourage consumer action, the resulting loss of share of demand can encourage MNCs to undertake effective self-regulation of their operations in developing countries.

A combination of activist and consumer pressure against Nike following a 1996 CBS news report revealing sweatshop conditions at a Vietnamese supplier contributed to decreases in the company's market share and profits (Haufler, 2001, p.59). The impact of consumer boycotts and activism led the company to attend to the effective implementation of the code of conduct for suppliers' labour and environmental practices, which it had adopted four years earlier. It developed new internal and external monitoring tools and improved management practices and training. Nike's principal competitors within the sports footwear industry, Reebok and Adidas, sought to avoid the reputational damage suffered by Nike by establishing effective self-regulatory programmes of their own (O'Rourke, 2003).

Enforcement by consumers is likely to be more effective when firms directly face the mass market and are highly visible, selling products with which they are strongly identified by branding (Haufler, 2001, p.70). The campaign against Nike relied on the ease with which the brand could be targeted as well as the significance of the brand's reputation to the company's value (O'Rourke, 2003). Nestlé's mass-market foodstuff sales could be targeted with relative ease following concerns over the company's aggressive marketing of breast-milk substitutes in the developing world (Sikkink, 1986). In the visibly branded and mass market-facing oil industry, Shell and its principal European rival BP each developed their own self-regulatory systems. For these MNCs, reputation is clearly a significant private asset. In the face of consumer and activist pressure they are likely to mount individual attempts to control reputational risk by regulating the outcomes of their activities. In industries which do not face the mass market, however, consumers, even if accurately aware of a firm's poor conduct, may lack of information about which brands and products they should boycott in order to sanction the company (see the research done by Oxfam into the second tier of companies).

There are limits to the extent of consumer pressure. Even when consumers have information and the capacity to target firms, they may lack the inclination to bring sanctions to bear against badly performing companies. Research conducted in the United Kingdom by the Co-operative Bank found that only 12% of consumers would be persuaded to buy one product over another of similar price and quality by a clear corporate policy on social and environmental issues (Co-operative Bank, 2001, p.28). Just 6% of consumers claimed to have actively sought information on a company's behaviour and policies four or more times in the previous 12 months (Co-operative Bank, 2001, p.30). It seems likely that even when information is publicly available, consumers may not be willing to seek it out and use it to sanction poorly performing companies.

Ethical concerns that are manifest in consumers' purchasing decisions in advanced economies are often not those most relevant to the conduct of multinational corporations in the developing world. Organic produce and free-range eggs are among the most prominent 'ethical' purchases (Co-operative Bank, 2001, p.18). Fairly traded coffee, tea and fruit and sustainable timber can have a positive social and environmental conditions in developing countries. But environmentally concerned products such as energy-efficient appliances, unleaded petrol and renewable electricity which reflect a concern with the global environment may show little concern about local environmental impacts of companies' operations in developing countries. High profile boycotts and campaigns such as those against Shell for human rights abuses in Nigeria and against Nike for poor labour conditions in Asia may be an exception rather than the rule. Even with perfect information, enforcement by consumers in the market of high standards of human rights, labour rights and environmental conduct for MNCs in the developing world is likely to be only partially effective, limited at most to sectors with global brands or that sell directly to consumers and are therefore most susceptible to such pressures.

(d) Pressure to retain and attract employees

Within large global companies an oft-cited influence on self-regulation is the desire to recruit and retain the most able employees. Even where NGO campaigns

and consumer boycotts lead to only a small loss of share of demand in the market for a corporation's products, they may have significant knock-on effects in the labour market in the MNC's home country (Financial Times Editorial, 2004). Firms with poor reputations are likely to find it more difficult to recruit and retain employees in tight labour markets. Corporations, which fail to control risks to their reputation will effectively face higher labour costs than those, which are perceived as socially and environmentally responsible (Lenox, 2003). A 2003 study of employees for Business In The Community found that almost half regarded it as very important that their employer take social and environmental issues seriously (Social Investment Forum, 2003, p.21). Shell, for instance, argues that 'our commitment to sustainable development is an important factor in people's decision to join and stay' and that 'alignment between personal values and values of staff and corporate values is a powerful motivator' (Royal Dutch/Shell Group of Companies, 2003, p.7). Since the best graduates are particularly averse to working for corporations with poor reputations (World Economic Forum, 2003, p.17), a further cost may be incurred in the long run if key executive positions are filled with less able candidates.

All the pressures mentioned this far – those stemming from risk management, investors, consumers, and the labour market – can play a role in mitigating behaviour damaging to the environment, human rights and labour rights in the developing world. Yet only in an environment in which markets are extensively informed about corporate activities.

IV. The Role of Information and Reporting

From the company's point of view, disclosure can be a cost-effective means of satisfying investors' demands to know the exposure of the company to risks arising from its social and environmental conduct (Blacconiere & Patten, 1994). As a 2003 study by Standard & Poors noted, 'large institutional investors are intensifying the pressure on management to disclose all material information' (Standard & Poor's, 2003, quoted in Repetto, 2003). The Association of British Insurers states in its 'Disclosure Guidelines on Socially Responsible Investment' that companies' annual reports should 'include information on SEE [social, ethical and environmental] related risks and opportunities that may significantly affect the company's short and long-term value' (Cowe, 2004, p.40). These pressures may be sufficient to alter the incentive that many firms would otherwise face – to control their reputation without actually changing their behaviour. If stakeholders' demand for credible information is strong enough, corporations will be unable to buy reputational benefits cheaply by adopting voluntary standards or codes without attempting to implement them. Incentives for reliable and comprehensive disclosure and monitoring will be therefore be necessary if voluntary codes are to have a real effect on MNCs' impact in developing countries.

Balanced or full disclosure of relevant performance information is difficult and costly to ensure. Any one firm attempting balanced disclosure alone faces the risk that bad news will be seized upon whilst more secretive competitors are let off the hook. Following the Bhopal accident, chemical companies with more extensive environmental disclosure in their previous annual reports suffered a lesser loss of stock market value. However, references to environmental risk in these annual reports were made in the absence of any institutional requirements or guidelines for

disclosure. Investors may have misinterpreted highly selective disclosure of good performance as indicating that a firm was less exposed to environmental risk (Blacconiere & Patten, 1994). The importance of accurate comparison of disclosures between firms has led to recent attempts to develop standardized voluntary reporting indicators, which permit investors to form reliable comparative judgements of different firms' exposure to risks.

The Global Reporting Initiative (GRI) is a particularly important development in voluntary standardized reporting by companies. It was initiated in 1997 in partnership between the United Nations Environment Programme and the Coalition for Environmentally Responsible Economies (CERES) and in 2002 became an independent organization. Previously, CERES, a group of NGOs including environmentalists, labour unions and religious groups established after the Exxon Valdez oil spill of 1989 had attempted to draw up standards of environmental behaviour and to encourage corporations to report their performance against them. Efforts to agree standards were plagued by disputes and very limited adoption by corporations (Nash & Ehrenfield, 1997).

The GRI has not attempted to establish codes of conduct or standards of behaviour. Rather, it has developed standardised reporting indicators to enable comparison of performance between reporting firms and against firms' own codes of practice or industry association standards (GRI, 2002, p.i). The goal is to permit consumers and investors to make accurate and reliable comparisons of corporations' conduct and thereby to enhance the incentives to comply with high standards of social and environmental performance. The indicators specify information to be provided in six categories: direct economic impacts, environmental impacts, labour practices and decent work, human rights, society and product responsibility (GRI, 2002, p.36). Environmental reporting includes information on biodiversity, and on levels of emissions, effluent and waste. Although the labour practices indicators focus on industrial relations between labour and management, they also include health and safety reporting. More fundamental aspects of labour rights, including the use of child labour and forced labour, are covered by the human rights indicators which also include indicators for impacts on indigenous rights. The society indicators include information relating to bribery and corruption and political contributions (GRI, 2002, pp.50-55). Firms are required to report 'all information that is material to users for assessing the reporting organisation's economic, environmental, and social performance' and can then refer to their reporting as being 'in accordance' with GRI Guidelines (GRI, 2002, p.26).

Of the 418 organisations in 43 countries using the GRI Guidelines, 19 are 'in accordance' reporters. Although some organisations using the Guidelines are small or nationally based, a significant number of GRI organisations are multinational corporations, including BP and Shell. Both Ford and General Motors are 'in accordance' reporters (see http://www.globalreporting.org/guidelines/companies.asp). There is some evidence that the 'incremental approach' envisioned in the GRI approach - whereby companies are encouraged to apply at least some of the guidelines and to work incrementally towards fuller compliance - is effective. In its 2002 'Environment and Social Report', BP recognised the value of the GRI indicators but gave reasons for not following the guidelines to structure BP's reporting (see http://www.bp.com/extendedgenericarticle.do?categoryId=48&contentId=2007989).

By 2003, the BP 'Sustainability Report' provided extensive reporting of the GRI indicators and indexed all the core indicators, pointing to the forms in which each was reported and declaring when an indicator was not reported or covered only in part (BP, 2004, pp.46-47).

The GRI indicators, incorporated in reports respecting the GRI principles, offer a strong prospect of escaping the problems of anecdote and incomparability that have dogged reporting of environmental and social impacts. Though much relevant information remains qualitative and cannot easily be expressed quantitatively (as the GRI indicators recognize), standardized reporting facilitates systematic inter-firm and inter-temporal comparisons.

V. The Importance of Verification and Audit

What ensures that the information companies provide is accurate and reliable? In spite of incentives to provide convincingly audited disclosures to stakeholders to show that risk has been adequately managed, the adoption of independent monitoring of environmental, human rights and labour rights information remains limited. In 2002 just 36 of the FTSE 250 companies had their environmental and social reports independently audited (Maitland, 2002).

Environmental and social auditing, when it does take place, faces particular difficulties. When companies report on their finances, their accounts are audited in a highly formalised process aimed at ascertaining whether the reporting conforms 'in all material aspects' to 'an identified reporting framework' (OECD, 2001, p.11). Statutory controls and formal standards remove discretion from the auditor and require professional standards of expertise and independence of judgement (OECD, 2001, p.11). In respect of non-financial reporting there have been few such statutory controls, presenting the risk that non-financial auditors or monitors face unbalanced incentives to err towards favourable treatment of their clients.

Independence and appropriate expertise are vital qualities of auditing bodies, but have been especially difficult to achieve for social and environmental monitoring. Even when monitoring is carried out by bodies external to the reporting corporation, its independence can be undermined if the monitors are paid by the corporation being audited. An examination of labour standards monitoring in China and Korea by Pricewaterhouse Coopers (PwC) found 'significant and seemingly systematic biases' in the auditors' methodologies, which 'call into question the company's very ability to conduct monitoring that is truly independent' (O'Rourke, 2000). The problems encountered by PwC are likely also to be symptomatic of the difficulties faced by monitors with experience of financial audits adapting to the necessarily very different methods and objectives of environmental and social auditing. Unguided by auditing standards, monitoring will struggle to achieve the credibility that it seeks to provide to the reporting of corporations' environmental, human rights and labour rights performance.

Can the quality of non-financial auditing be improved? One proposal is to benchmark the performance of auditors (O'Rourke, 2003). An OECD report on making corporate codes of conduct work effectively identifies the need for formal auditing standards for social and environmental monitoring which echo the processes

used in financial auditing. Formal standards remove discretion from the auditor and 'reinforce its claim to be acting independently of the firm being audited'. Further, auditing standards make it easier for all stakeholders 'to determine whether the audit has been done competently' (OECD, 2001, p.11).

The introduction in March 2003 of the AccountAbility AA1000 Assurance Standard, 'the first non-proprietary, open-source assurance standard' (Institute of Social and Ethical Accountability, 2003, p.4) for non-financial audits is a significant recent development in standardized social and environmental auditing. The Institute of Social and Ethical AccountAbility is a membership association of a range of stakeholders including corporations, NGO advocacy groups, business service firms and researchers. Established in 1996, by March 2004 it comprised over 300 members in 20 countries (see http://www.accountability.org.uk). Its guidelines and standards have emerged from consultation among this diverse group of stakeholders. The AA1000 Assurance Standard is designed to address auditors' 'need for a single approach that effectively deals with the qualitative as well as quantitative data that makes up sustainability performance plus the systems that underpin the data and performance' (see http://www.accountability.org.uk). Three assurance principles form the core of the assurance standard. Reporting should be assessed against requirements of materiality, completeness and responsiveness. The assurance provider must state whether the reporting firm has included in its report all material information 'required by its Stakeholders for them to be able to make informed judgements, decisions and actions.' It must assess the degree of completeness to which the reporting company can identify and understand what are the material aspects of its environmental and social performance. Finally, the auditor must ascertain whether the reporting firm has 'responded to Stakeholder concerns, policies and relevant standards, and adequately communicated these responses' (Institute of Social and Ethical Accountability, 2003, pp.15-18)

The principle of materiality points to a particularly helpful advance in the standards of non-financial auditing. It notes that firms' reporting should be assessed for the extent to which it includes information about performance against statutory requirements as well as policies promulgated by the firm or industry association. Attention should also be given, the principle states, to conceptions of materiality held by a firm's peers as well as to the expressed views and perceptions of stakeholders (Institute of Social and Ethical Accountability, 2003, pp. 16-17). Attention to supplying material information can serve to sway social and environmental reporting away from 'good news' stories and force audited reports to address frankly the risks to which companies remain exposed. Ernst and Young's assurance report on BP's sustainability reporting for 2003 was carried out in accordance with the AA1000 assurance standard. In its assessment of materiality the auditor drew attention to the omission of information about legal liabilities faced by the company in connection with its participation in the Baku-Tbilisi-Ceyhan pipeline project. The audit also emphasised the importance of further reporting of BP's attempts to manage its own reputational risk by encouraging its suppliers to behave consistently with its policies (BP, 2004, p.42).

The AA1000 standard is a potentially significant development in enhancing the quality of non-financial auditing corporate reporting on activities in the developing world. Currently most of the firms whose social and environmental

reporting is audited in accordance with the standard are based in the United Kingdom and many of these have operations focused in that country. But, alongside BP a number of other significant MNCs have adopted AA1000 auditing for their reporting, including British American Tobacco and United Utilities, whose operations include several major water supply projects in developing countries (British American Tobacco, 2003; United Utilities, 2003). Where reporting of MNCs' environmental, human rights and labour rights behaviour is carried out in accordance with standardized guidelines, and independently audited according to standardized monitoring guidelines, consumers and investors are more likely to have access to sufficient information about companies' performance to make reliable judgements of their conduct.

The development of the GRI and the AA1000 standard both indicate the role of a diverse group of stakeholders, including activist NGOs, in developing standardized reporting to ensure transparency of information about corporate conduct. But although more large corporations are undertaking reporting of environmental and social performance, many remain resistant. The 'business case' for voluntary reporting has not yet proved strong enough to persuade many large multinational corporations to take part. Research in the United Kingdom in 2002 showed that although fifty of the FTSE 250 index of the country's largest companies had reported for the first time in 2001/2, still only 103 companies produced substantial environmental or social reports. 87 firms supplied short notes in their annual reports whilst the remainder provided very limited data without detail (Maitland, 2002). As a result many NGOs have focused not on developing voluntary standards but on advocating mandatory disclosure requirements imposed by states.

VI. The Role of Governments in Enforcing Disclosure

A clear pre-requisite for corporate self-regulatory codes to be effective is disclosure. Yet companies are unlikely to disclose in any meaningful way unless government mandates their reporting. Within a voluntary system if one company were to publish extensive information on their compliance (or inability to comply) but rival companies did not, the most transparent company would likely suffer as rivals, regulators and NGOs used the disclosures to their own advantage.

Such problems are highlighted in the recent efforts of the UK Department for International Development to champion an Extractive Industries Transparency Initiative with the goal of getting companies and governments to disclose the terms of contracts, which permit the extraction of minerals, fossil fuels and other natural resources in a country (see http://www2.dfid.gov.uk/news/files/extractiveindustries.asp). Up until the present the secrecy of contracts between senior government officials and company executives has made extractive industries a fertile ground for large-scale corruption. Transparency is being sought to reduce the corruption and open up the possibility of harnessing the rents accruing from extractive industries for development.

Mandatory disclosure requirements set by government regulatory authorities in MNCs' home countries can oblige firms to disclose standardized information on environmental, labour rights and human rights performance, in a similar way to the requirements for disclosure of financial information in annual reports. This opens up

the possibility of legal redress for misstatements – a more robust incentive than exists in self-regulatory reporting (see http://www.foe.org/corporatesunshine/faq.html). Indeed, for this reason recent campaigns by NGOs have sought to expand the scope of mandatory disclosure requirements in both the United Kingdom and the United States.

A number of NGOs have pushed for mandatory disclosure. In the United Kingdom, the 'CORE' coalition of 40 NGOs including Amnesty UK, Christian Aid, Friends of the Earth, trade unions and church groups has pressed for more demanding disclosure requirements (see http://www.foe.co.uk/campaigns/corporates/core/news/index.html). CORE worked with sympathetic MPs to develop the 'Performance of Companies and Government Departments (Reporting) Bill', which would require the directors of a company to include information in their annual reports on the impact of the company's operations, policies, products and procurement practices in relation to employment, the environment, and social and community issues when they consider such information to be material to providing a fair review of the company's financial performance (Performance of Companies and Government Departments (Reporting) Bill). Although more than 300 MPs signed an Early Day Motion supporting the Bill's aims, the government blocked further consideration of the Bill on 30 January 2004 (see http://www.foe.co.uk/campaigns/corporates/core/index.html). Requirements to disclose social and environmental performance are also being discussed under the rubric of the Department of Trade and Industry's 2002 White Paper 'Modernising Company Law' which sets out the government's intention to expand the scope of mandatory disclosure requirements by necessitating preparation of an Operating and Financial Review in the Annual Reports of listed companies. Company Directors will, from 2005, be obliged to consider including information affecting the company's reputation and details of corporate policies and performance on the environment, employment, and social issues. However, the proposed regulations would restrict directors' obligations to considering inclusion, and only when they judge these issues to be material to a company's financial performance (Cowe, 2004, p.15).

In the United States, the Securities and Exchange Commission (SEC) requires reporting of certain known risks and non-financial trends that might affect future financial results. It mandates disclosure 'where a trend, demand, commitment, event or uncertainty is both presently known to management and reasonably likely to have material effects on the registrant's financial condition or results of operations' (SEC regulations quoted in Repetto, 2003). At present risks and trends for which disclosure is mandated are restricted to environmental liabilities, labour relations and legal proceedings and exclude entirely human rights and workers' health and safety (see http://www.foe.org/corporatesunshine/faq.html). Pressure for further change is being brought to bear by a coalition of NGOs called the 'Corporate Sunshine Working Group' (CSWG) which aims to address the perceived inadequacy of information about corporate risks available to institutional investors (Corporate Sunshine Working Group). The coalition includes Friends of the Earth and the World Resources Institute, institutional investors and trade unions. They support the voluntary GRI standards but argue that without statutory regulation investors will not receive adequate information. Hence, their proposal for an expansion of the SEC's mandatory disclosure requirements for social and environmental information focusing on items of particular material significance to financial value (Corporate Sunshine Working Group).

Mandatory disclosure requirements are just half the picture. Effective enforcement has to accompany disclosure if it is to lead to compliance. Yet even industrialized governments face serious problems. In the last 25 years of the 20th century the SEC brought only three administrative proceedings and one civil action for inadequate environmental risk disclosures (Repetto, 2003). A study by the US Environmental Protection Agency showed that 74% of companies do not meet SEC rules in their disclosure of environmental information (see http://www.foe.org/corporatesunshine/index.html). In many other countries the record of disclosure against statutory requirements was even worse (Repetto, 2003). A history of low levels of compliance with statutory obligations and of limited efforts by statutory bodies to enforce their requirements argues for caution in identifying the potential achievements of mandatory disclosure in regulating social and environmental outcomes in the global economy.

In developing countries the enforcement of mandatory disclosure requirements is likely to be yet more difficult. For a start, many MNCs are registered on stock markets in their home countries. This means that disclosure requirements of securities regulators in developing states will have little effect on them (although they may be able to address the behaviour of joint ventures and subsidiary companies). Equally, investors `back home' are unlikely to access or respond to reporting about the operations of individual plants, although clear and standardized reporting will permit investors, consumers and the like to bring pressure to bear towards compliance. This means that even where there is mandatory disclosure, it will not necessarily provide an incentive for MNCs to comply with self-regulatory codes in their operations in developing countries. For this reason we need to examine other possible government actions which shift incentives.

VII. Other Ways Governments Might Alter Incentives

Alongside self-regulation and mandatory disclosure there are several actions governments can take to create incentives for the private sector to meet social and public goals. The first and most obvious is regulation. Although this article is premised on the fact that many developing country governments have little capacity to regulate, it is nevertheless worthwhile reprising the forms that regulation might take and with what effect on the incentives faced by the private sector. We can then assess alternatives.

Governments can regulate how companies work by mandating specific technologies or behaviours – requiring firms to do things in a specified way (Breyer, 1982). Alternatively governments can specify particular outcomes that need to be achieved or avoided by firms, leaving it to firms to decide how they achieve such goals. This is sometimes called `performance-based regulation'. It might entail setting a disclosure goal, which firms will then decide upon how to meet. More recently, scholars have focussed on regulation which intervenes at the planning and management stage so as to effect a `management-based' or responsive regulation which ensures firms pay attention to social and public goods (or to avoiding public bads) (Coglianese & Lazer, 2003; Braithwaite, 1982; Gunningham & Rees, 1997). The emphasis in this third form of regulation is on making firms responsible for putting in place internal planning and management processes which take into account the public goods defined by the regulators.

The mere threat of government regulation has often been the catalyst for industry associations and the like to form and to forge voluntary systems and codes of behaviour. Corporations mostly believe that self-imposed constraints will be less costly than those that governments would impose. Government standards are likely to be based on less perfect information than is available to the firm about its own activities and as a result may impose wasteful costs beyond those necessary to correct the objectionable behaviour. If firms can 'get ahead' of statutory regulation they will achieve prudential cost savings (Nash & Ehrenfield, 1997). Effective adoption of a voluntary standard may also subdue political pressure that would otherwise have led to statutory enforcement of a considerably more demanding standard, which regardless of its efficiency would impose a higher cost on the firm. The American Chemical Council (ACC) cited the forestalling of anticipated government regulation as one of its motives for the establishment in 1989 of its 'Responsible Care' programme for the self-regulation of the United States chemical industry (Lenox, 2003). Following the major accident at Union Carbide's plant at Bhopal, India in December 1984, political pressure mounted in the United States for tighter statutory regulation; within two months a seven-bill legislative package had been introduced to Congress (Blacconiere & Patten, 1994). By initiating its own self-regulatory programme the ACC hoped to alleviate such political pressure and so avoid an extension of coercive constraints.

The key problem for governments is that regulation is costly. It takes time, expertise, information and valuable human resources. The debate about regulation is how to minimize the resources required yet still achieve effective regulation. In all countries there are gaps in regulatory enforcement due to a lack of government capacity. This fact has spurred the new thinking about regulation reflected in our analysis for far. However, even management-based regulatory strategies designed to overcome capacity issues have been difficult to effect. This was highlighted by a US government audit of that country's implementation of a Hazards Analysis and Critical Control Points strategy applied to seafood. The government audit found that the Food and Drug Administration (FDA) simply could not keep up with the necessary level of reviews and monitoring (General Accounting Office, 2001). Similar results have been found in other industries (Coglianese & Lazer, 2003).

In developing countries the limits of governments' capacity to regulate are even more striking. Regulators have fewer resources. Furthermore, they often have less leverage from industry, social and political pressures than their industrialized governments counterparts. As Debora Spar has argued, governments seeking to regulate are sometimes strongly supported or even pressured by segments of industry. Established firms often need regulation in order to consolidate their own position in the market and to prevent incursions by rogue firms (Spar, 2001). In politically responsive systems, governments will often face wider pressures to regulate – particularly where public anger is directed at industries seen to be acting irresponsibly. In developing countries, the lack of these kinds of leverage exacerbates the problems discussed above. Here other kinds of government policy can play an important role.

In countries without capacity closely and effectively to regulate industry, transparency can bolster government action not just because it offers a relatively more straightforwardly enforceable standard than direct regulation of practices but by

catalysing other social forces. Statutory disclosure programmes have been effective in reducing environmental damage by companies in developing countries in South East Asia and Latin America (World Bank, 2000). Notably, such programmes have been highly dependent on well-organized community groups in the immediate vicinity of polluting (or otherwise non-compliant) plants, which encourage enforcement of disclosure requirements and use the resulting information to exert pressure on companies for improved performance (World Bank, 2000, p.59). In other words, as mentioned above government action has been backed up by social action.

Crucial in bolstering the capacity of governments and leveraging transparency is civil society or organized groups, which bring together concerned or affected citizens. Such groups have typically played a central role in pressing for information, in monitoring the information and in publicizing non-compliance. Yet these groups do not organize or act in a vacuum. Their activities are greatly affected by government policy and institutions. Two examples highlight this. In Vietnam laws and institutions for environmental protection created a framework within which communities organized and channelled complaints to regulatory agencies. The result has been labelled `community-driven regulation' and highlights the importance of government-created institutional frameworks for mobilizing and channelling social pressures (O'Rourke, 2004). A rather different example is afforded by the experience of water privatization in South Africa where government policy created expectations that citizens would have particular kinds of rights to water. That policy combined with local institutions to set up a framework within which local communities have held private companies taking over water systems strongly to account (Morgen, 2004).

Civil society – social organizations as well as non-governmental organizations – plays a key role in bolstering government and corporate regulatory initiatives. But they face barriers created by firms, governments, and resources such as when their organization or activities are banned, systematically disrupted, or otherwise strongly discouraged. The effectiveness of such groups depends upon national and local laws, which ensure the freedom to organize and mobilize by upholding rights to associate as workers or consumers and the right to freedom of speech and the capacity to publish (in independent media) criticisms of the actions of companies. More broadly, activism by civil society requires expectations on the part of citizens for better lives or treatment, which can themselves be generated by government policy. Finally, government agencies can provide a crucial focal point and important target for those wishing to uphold standards expressed in government or corporate policy.

VIII. The Role of International Organization and Instruments

This far we have highlighted important ways governments might shift incentives faced by MNCs, in this final section we examine whether international institutions, actors and standards might bolster or support such actions.

Typically, international law has played a rather weak role. Human rights, environmental standards and such like are covered by international treaties such as the Universal Declaration of Human Rights, the ILO's Fundamental Principles on Rights at Work and the Rio Principles on Environment and Development, all of which commit governments to respect standards to which they have jointly agreed. None apply directly to corporations and firms. None are directly enforced by legal actions

or sanctions. The proposed adoption by the United Nations Commission on Human Rights of 'Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with regard to Human Rights' (United Nations, Economic and Social Council, 2003) has highlighted firms' fear of an expansion of the coercive regulatory burden (Eaglesham, 2004). Though the exact legal status of the document is disputed, business associations have argued that it may impose specific, enforceable legal obligations on multinational corporations. In their campaign against adoption of the document, the United States Council for International Business has drawn attention to the development of many voluntary codes for the good conduct of business towards human rights (United States Council For International Business, 2003b). The UNCIB aims to use evidence of ongoing voluntary regulation to alleviate political pressure for coercive standards and convince governments on the UN Commission on Human Rights not to adopt the 'Norms' document (United States Council For International Business, 2003a). Though attempts to impose statutory regulation through agreement in the United Nations remain some way from fruition, they indicate a possible strengthening of international incentives for MNCs to continue and strengthen self-regulatory undertakings.

The weaknesses in international law in upholding public goods and social standards look particularly striking when we compare them with the specific and enforceable sets of rights enjoyed by investors against the rights of government to regulate economic activity within their borders. The legitimate regulatory aspirations of governments have long been pitted against the desire of investors to enjoy some guarantee against illegitimate interference or expropriation. This issue was hotly debated in the United Nations in 1974 when developing countries passed a resolution in the General Assembly entitled a Charter of Rights and Duties of States which strongly reinforced the rights of governments to regulate within their borders. Since that time companies and industries have lobbied successfully for their rights to be protected in an enforceable way.

The protection of investors is entrenched in bilateral investment treaties (or Investment Promotion and Protection Agreements), through the 1965 Washington Convention, which created the International Center for the Settlement of Investment Disputes, and through the World Trade Organization and the specific agreements on TRIPS, TRIMS. In these instruments we find states have bound themselves to treat investments fairly and equitably, to give them full security and protection, and to guarantee against unlawful expropriation. Investors have increasingly sought to use these provisions not just against government policies, which aim to expropriate them, but equally against any government policies which affect their profitability. As one eminent international lawyer concludes, the `fair and equitable' standard of treatment has taken on a life of its own with `an exceptionally wide interpretation …greatly favouring investors' (Lowe, 2002, p.455). He argues that there must be a category of government actions, which are so far removed from deliberate interference with investments that, even though committed by the government and even though they entail losses to investors, they should be beyond the reach of investment-protection treaties. The very fact of this argument highlights the extent to which international law has shifted to endorse investors' rights. Alongside these muscular and enforceable protections of the rights of companies, the existing multilateral regime of constraints remains weak.

Those who have tried to balance investors' rights with those of local communities have found several difficulties. An illuminating case is proffered by the Convention on Biological Diversity 1992 which requires pharmaceutical companies to share some benefit with local communities from whom they seek `traditional knowledge' and remedies as a shortcut towards the research and development of new products (Hayden, 2003a; see also Hayden, 2003b). A further degree of protection of local know-how has also been attempted in WIPO initiatives on the protection of traditional knowledge. The CBD Convention creates responsibilities on investors (in this case pharmaceutical companies) to direct some benefits to the local communities whose labours and knowledge they are exploiting. On the other side of the coin, the CBD treaty enshrines rights for investors to work without unreasonable restriction. Yet the Convention has had problems on both sides. The US has steadfastly opposed it on the grounds that it contravenes rights acquired by commercial actors in the WTO and in TRIPS. From the local communities' side the treaty regime has provoked problems and tensions at the local level which have made it difficult constructively to channel its benefits (United States Council For International Business, 2003a). Softer international conventions and commitments do not create robustly enforceable rights, yet as we noted at this outset of this article, there is a strong argument that they have other effects which contribute to the effectiveness of self-regulatory systems. International standards assist in mobilizing civil society within and across countries by creating standards and expectations that such standards might be upheld (Keck & Sikkink, 1998). This is captured in the UN Global Compact which seeks to encourage learning and best practice among participating companies who have all committed to existing international standards on human rights, environmental protection and suchlike.

Finally, both governments and international firms who face increasing pressures to provide public goods are turning to international cooperation and institutions. As discussed earlier, individual developing country governments fear competition by other countries competitively devaluing their corporate governance requirements so as to attract investment. Here inter-state agreements and cooperation can assist in levelling the playing field. Meanwhile international companies – most obviously in oil and gas exploration – are increasingly finding that in many countries and regions they are being required to take on public goods responsibilities. The provision of security, health, education, and other elements crucial for a community to function is falling to multinationals who need to create an environment within which they can work but have little expertise or capacity to take on these public goods functions. For this reason, international firms need effective cooperation between governments, development agencies, international aid arrangements, and other investors. That cooperation can in turn be fine-tuned better to enhance the effectiveness of appropriate government regulation and corporate self-regulation.

IX. Conclusion

This paper set out to examine the conditions under which corporate self-regulation might be effective in developing countries. Our analysis of market pressures highlights the importance of information, transparency and disclosure – pre-requisites for holding corporations to account for their pledges of self-restraint or voluntary compliance. Yet corporate commitments of transparency and disclosure are not sufficient. Market pressures create too many alternative incentives and collective

action problems within industry. Companies may simply find it rational to continue life as before with a little more investment in public relations. If disclosure is to alter the incentives faced by firms, governments need to mandate and enforce it. Furthermore, because of the unevenness of market responses to disclosure, transparency will not always shift incentives better to meet the social goals and public goods to which governments aspire. This is particularly true where firms are operating in developing countries – far from the eyes of their headquarters, regulators, and investors. That being the case, we have nevertheless explored measures, which might strengthen the incentives faced by corporations to comply with their own codes of self-regulation.

Although developing country governments are weak there are three factors, which together might enhance the effectiveness of self-regulatory codes in developing countries. The first is disclosure – a pre-requisite for the market and other social pressures outlined in this paper. Governments need to mandate standards of disclosure and to work with partner governments in investor home countries to enforce such standards. We have not detailed what forms international or cross-border enforcement of disclosure standards might take. However, we see this as an important question of law and governance at the global level. A second important force towards compliance with self-regulatory codes is social pressure. Local mobilization can draw attention to non-compliance and bolster the position of regulators vis-à-vis investors. This does not mean governments have little role to play. Far from it. Social mobilization is likely to be most effective where governments uphold freedoms of association and speech, and create institutions, which can respond to social pressures. Finally, international institutions and instruments are important in creating conditions for effective self-regulation. At present, trade and investment treaties create an unbalanced system, which robustly protects the rights of foreign investors (who in turn have strong commercial incentives to enforce those rights). The correlate responsibilities of investors towards workers, consumers and communities are much weaker. That legislation and the interpretation of investor rights need careful re-examination. In the interim, we have noted that even the unenforceable soft law standards play a role in helping to mobilize social pressures within and across states. That pressure, however, depends heavily on governments providing the necessary framework for disclosure and social mobilization.

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