BOSS
HARVARD BUSINESS REVIEW

The new capitalists

Strategist Michael Porter argues that the strongest businesses in future will be those that align making profits with creating social progress

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The capitalist system is under siege. In recent years, business increasingly has been viewed as a major cause of social, environmental, and economic problems. Companies are widely perceived to be prospering at the expense of the broader community.

Even worse, the more business has begun to embrace corporate responsibility, the more it has been blamed for society's failures. The legitimacy of business has fallen to levels not seen in recent history. This diminished trust leads elected officials to set policies that undermine competitiveness and sap economic growth. Business is caught in a vicious circle.

A big part of the problem lies with companies themselves, which remain trapped in an outdated approach to value creation that has emerged over the past few decades. They continue to view value creation narrowly, optimising short-term financial performance in a bubble while missing the most important customer needs and ignoring the broader influences that determine their longer-term success. The presumed trade-offs between economic efficiency and social progress have been institutionalised in decades of policy choices.

Companies must take the lead in bringing business and society back together. The recognition is there among sophisticated business and thought leaders, and promising elements of a new model are emerging. Yet we still lack an overall framework for guiding these efforts, and most companies remain stuck in a "social responsibility" mind-set, in which societal issues are at the periphery, not the core.

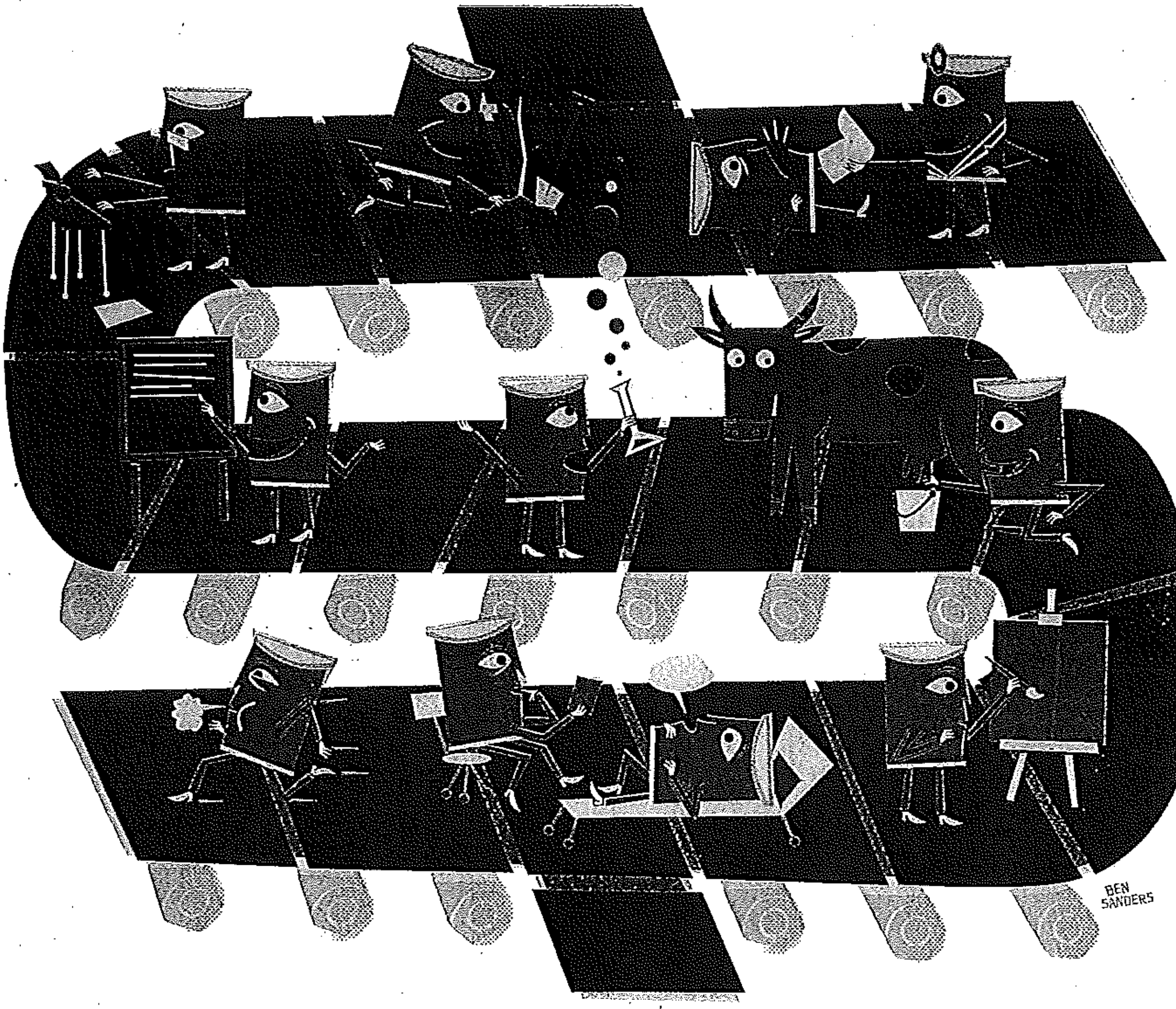
The solution lies in the principle of shared value, which involves creating economic benefits in a way that also creates gains for society by addressing its needs. Businesses must reconnect company success with social progress.

Shared value is not social responsibility, philanthropy, or even sustainability, but a new way to achieve economic success. It is not on the margin of what companies do but at the centre. It can give rise to the next major transformation of business thinking. A growing number of companies known for their hard-nosed approach to business – such as GE, Google, IBM, Intel, Johnson & Johnson, Nestle, Unilever, and Wal-Mart – have already embarked on important efforts to create shared value by reconceiving the intersection between society and corporate performance.

Capitalism is an unparalleled vehicle for meeting human needs, improving efficiency, creating jobs and building wealth. But a narrow conception of capitalism has prevented business from harnessing its potential to meet society's broader challenges. The moment for a new conception of capitalism is now; society's needs are large and growing, while customers, employees, and a new generation of young people are asking business to step up.

The purpose of the corporation must be redefined as creating shared value, not just profit per se. This will drive the next wave of innovation and productivity in the global economy. It will also reshape capitalism and its relationship to society. Perhaps most importantly, learning how to create shared value is our best chance to legitimise business again.

MOST COMPANIES REMAIN STUCK IN A 'SOCIAL RESPONSIBILITY' MIND-SET, IN WHICH SOCIETAL ISSUES ARE THE PERIPHERY, NOT THE CORE



BEYOND TRADE-OFFS

Business and society have been pitted against each other for too long. That is in part because economists have legitimised the idea that to provide societal benefits, companies must temper their economic success. In neoclassical thinking, a requirement for social improvement – such as safety or hiring the disabled – imposes a constraint on the corporation. Adding a constraint to a firm that is already maximising profits, the theory says, will inevitably raise costs and reduce those profits.

A related concept, with the same conclusion, is the notion of externalities. Externalities arise when firms create social costs that they do not have to bear, such as pollution. Thus, society must impose taxes, regulations, and penalties so that firms "internalise" these externalities – a belief influencing many government policy decisions.

This perspective has also shaped the strategies of firms themselves, which have largely excluded social and environmental considerations from their economic thinking. Firms have taken the broader context in which they do business as a given and resisted regulatory standards as invariably contrary to their interests. Solving social problems has been ceded to governments and non-government organisations. Corporate responsibility programs – a reaction to external pressure – have emerged largely to improve firms' reputations and are treated as a necessary expense. Anything more is seen by many as an irresponsible use of shareholders' money.

Governments, for their part, have often regulated in a way that makes shared value more difficult to achieve. Implicitly, each side has assumed that the other is an obstacle to pursuing its goals and acted accordingly.

The concept of shared value, in contrast, recognises that societal needs, not just conventional economic needs, define markets. It also recognises that social harms or weaknesses frequently create internal costs for firms – such as wasted energy or raw materials, costly accidents, and the need for remedial training to compensate for inadequacies in education. And addressing societal harms and constraints does not necessarily raise costs for firms, because they can innovate through new technologies, operating methods and management approaches – and as a result, increase their productivity and expand their markets.

Shared value, then, is not about personal values. Nor is it about "sharing" the value already created by firms – a redistribution approach. Instead, it is about expanding the total pool of economic and social value. A good example of this difference in perspective is the fair trade

CORPORATE SOCIAL RESPONSIBILITY	CREATING SHARED VALUE
VALUE: DOING GOOD	VALUE: COMPANY AND SOCIETY GAIN RELATIVE TO COST
Citizenship, philanthropy, sustainability	Joint company and community value creation
Discretionary or in response to external pressure	Integral to competing
Separate from profit maximisation	Integral to profit maximisation
Agenda is determined by external reporting and personal preferences	Agenda is company specific and internally generated
Impact limited by corporate footprint and budget	Realigns the entire company budget
Example: Fair trade purchasing	**Example:** Transforming procurement to increase quality and yield

movement in purchasing. Fair trade aims to increase the proportion of revenue that goes to poor farmers by paying them higher prices for the same crops. Though this may be a noble sentiment, fair trade is mostly about redistribution rather than expanding the overall amount of value created.

Instead, a shared-value perspective focuses on improving growing techniques and strengthening the local cluster of supporting suppliers and other institutions in order to boost farmers' efficiency, yields, product quality and sustainability. This leads to a bigger pie of revenue and profits that benefits both farmers and the companies that buy from them.

Early studies of cocoa farmers in Ivory Coast, for instance, suggest that while fair trade can increase farmers' incomes by 10 per cent to 20 per cent, shared value investments can raise their incomes by more than 300 per cent. Initial investment and time may be required to implement new procurement practices and develop the supporting cluster, but the return will be greater economic value and broader strategic benefits for all participants.

Companies can create economic value by creating societal value. There are three distinct ways to do this: by reconceiving products and markets, redefining productivity in the value chain, and building supportive industry clusters at the company's locations. Each of these is part of the virtuous circle of shared value; improving value in one area gives rise to opportunities in the others.

PRODUCTS AND MARKETS

Society's needs are huge – health, better housing, improved nutrition, help for the ageing, greater financial security, less environmental damage. Arguably, they are the greatest unmet needs in the global economy. In business, we have spent decades learning how to parse and manufacture demand while missing the most important demand of all. Too many companies have lost sight of that most basic of questions: Is our product good for our customers? Or for our customers' customers?

In advanced economies, demand for products and services that meet societal needs is rapidly growing. Food companies that traditionally concentrated on taste and quantity to drive more and more consumption are refocusing on the fundamental need for better nutrition. Intel and IBM are both devising ways to help utilities harness digital intelligence in order to economise on power usage. Wells Fargo bank has developed a line of products and tools that help customers budget, manage credit, and pay down debt. Sales of GE's "ecomagination" products reached $18 billion in 2009 – the size of a *Fortune* 150 company. GE now predicts that revenues from ecomagination items will grow at twice the rate of total company revenues over the next five years.

In these and many other ways, whole new avenues for innovation open up, and shared value is created. Society's gains are even greater, because businesses will often be far more effective than governments and nonprofits at marketing that motivates customers to embrace products and services that create societal benefits, like healthier food or environmentally friendly products.

Equal or greater opportunities arise from serving disadvantaged communities and developing countries. The societal benefits of providing appropriate products to lower-income consumers can be profound, while the profits for companies can be substantial.

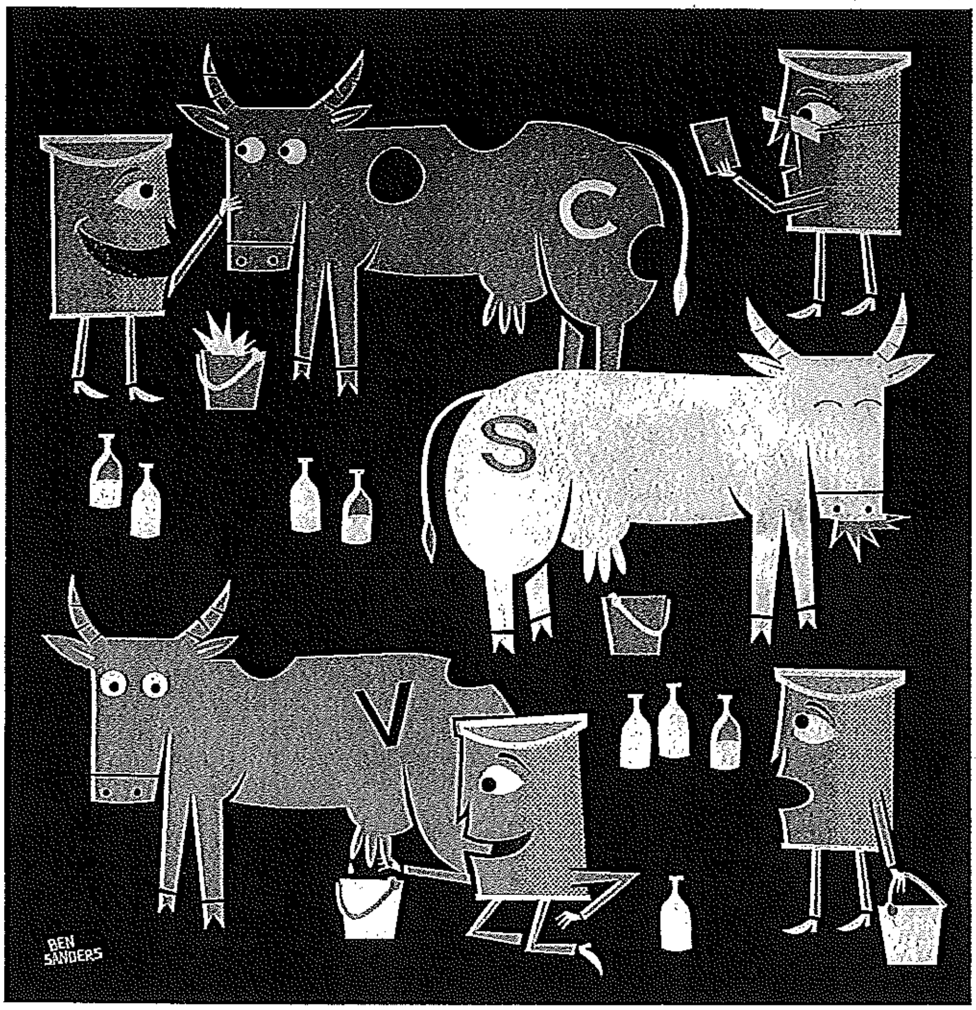
For example, low-priced mobile phones that provide mobile banking services are helping poor people save money securely and transforming the ability of small farmers to produce and market their crops. In Kenya, Vodafone's M-PESA mobile banking service signed up 10 million customers in three years; the funds it handles now represent 11 per cent of that country's GDP. In India, Thomson Reuters has developed a promising monthly service for farmers who earn an average of $2000 a year. For a fee of $5 a quarter, it provides weather and crop-pricing information and agricultural advice. The service reaches an estimated 2 million farmers, and early research indicates that it has helped increase the incomes of more than 60 per cent of them – in some cases even tripling revenues.

As capitalism begins to work in poorer communities, new opportunities for economic development and social progress increase exponentially. Microfinance, for example, was invented to serve unmet needs in developing countries. Now it is growing rapidly in the United States, where it is filling an important gap that was unrecognised.

PROFITS INVOLVING A SOCIAL PURPOSE REPRESENT A HIGHER FORM OF CAPITALISM – ONE THAT WILL ENABLE SOCIETY TO ADVANCE MORE RAPIDLY

THE VALUE CHAIN

A company's value chain inevitably affects – and is affected by – numerous societal issues such as natural resource and water use, health



and safety, working conditions and equal treatment in the workplace. Opportunities to create shared value arise because societal problems can create economic costs in a firm's value chain. Many so-called externalities inflict internal costs, even in the absence of regulation or resources taxes. For example, excess packaging of products and greenhouse gases are costly to the environment and businesses. Wal-Mart addressed both issues by reducing its packaging and rerouting its trucks to cut 160 million kilometres from its delivery routes in 2009, saving $200 million, even as it shipped more products. And innovation in disposing of plastic used in stores has saved millions in disposal costs to landfills.

The new thinking reveals that the congruence between societal progress and productivity in the value chain is far greater than previously believed. The synergy increases when firms approach societal issues from a shared-value perspective and operate in new ways to address them. So far, however, few companies have reaped the full benefits in areas such as health, safety, environmental performance, and employee retention and capability.

But there are unmistakable signs of change. Efforts to minimise pollution were once thought to inevitably increase business costs – and to occur only because of regulation and taxes. Today there is a growing consensus that major improvements in environmental performance can often be achieved with better technology at nominally incremental cost and can even yield net cost savings through enhanced resource utilisation, process efficiency and quality. A deeper understanding of productivity and a growing awareness of the fallacy of short-term cost reductions (which often lower productivity or make it unsustainable) are giving rise to new approaches.

LOCAL CLUSTER DEVELOPMENT

No company is self-contained. The success of every company is affected by the supporting companies and infrastructure around it. Productivity and innovation are strongly influenced by "clusters", or geographic concentrations of firms, related businesses, suppliers, service providers and logistical infrastructure in a particular field – such as IT in Silicon Valley, cut flowers in Kenya, and diamond cutting in Surat, India.

Clusters include not only businesses but also institutions such as academic programs, trade groups and standards organisations. They also draw on the broader public assets in the surrounding community, such as schools and universities, clean water, fair-competition laws, quality standards and market transparency.

Clusters are prominent in all successful and growing regional economies and play a crucial role in driving productivity, innovation and competitiveness. Capable local suppliers foster greater logistical efficiency and ease of collaboration. Stronger local capabilities in such areas as training, transportation services and related industries also boost productivity. Without a supporting cluster, productivity suffers.

Deficiencies in the framework surrounding the cluster also create internal costs for firms. Poor public education imposes productivity and remedial-training costs. Poor transportation infrastructure drives up the cost of logistics. Gender and racial discrimination reduce the pool of capable employees. Poverty limits the demand for products and leads to environmental degradation, unhealthy workers and high security costs.

However, as companies have increasingly become disconnected from their communities, their influence in solving these problems has waned, even as their costs have grown.

When a firm builds clusters in its key locations, it also amplifies the connection between its success and its communities' success. A firm's growth has multiplier effects, as jobs are created in supporting industries, new companies are seeded and demand for ancillary services rises. A company's efforts to improve framework conditions for the cluster spill over to other participants and the local economy. Workforce development initiatives, for example, increase the supply of skilled employees for many other firms as well.

At Nespresso, Nestlé worked to build clusters, which made its new procurement practices far more effective. It set out to build agricultural, technical, financial, and logistical firms and capabilities in each coffee region, to further support efficiency and high-quality local production.

Nestlé led efforts to: increase access to essential agricultural inputs such as plant stock, fertilisers and irrigation equipment; strengthen regional farmer co-ops by helping them finance shared wet-milling facilities for producing higher-quality beans; and support an extension program to advise all farmers on growing techniques. It also worked in partnership with the Rainforest Alliance, a leading international NGO, to teach farmers more sustainable practices that make production volumes more reliable. In the process, Nestlé's productivity improved.

THE NEXT EVOLUTION

Shared value holds the key to unlocking the next wave of business innovation and growth. It will also reconnect company success and community success in ways that have been lost in an age of narrow management approaches, short-term thinking and deepening divides among society's institutions.

Shared value focuses companies on the right kind of profits – those that create societal benefits, rather than diminish them. Capital markets will undoubtedly continue to pressure companies to generate short-term gains, and some companies will surely continue to reap profits at the expense of societal needs. But such profits will often prove to be short-lived, and far greater opportunities will be missed.

The moment for an expanded view of value creation has come. A host of factors, such as the growing social awareness of employees and citizens and the increased scarcity of natural resources, will drive unprecedented opportunities to create shared value.

We need a more sophisticated form of capitalism, one imbued with a social purpose. But that purpose should arise not out of charity but out of a deeper understanding of competition and economic value creation. This next evolution in the capitalist model recognises new and better ways to develop products, serve markets and build productive enterprises.

Creating shared value is not philanthropy, but self-interested behaviour to create economic value by creating societal value. If all companies individually pursued shared value connected to their particular businesses, society's overall interests would be served. And companies would acquire legitimacy in the eyes of the communities in which they operated, which would allow democracy to work as governments would set policies that fostered and supported business. Survival of the fittest would still prevail, but market competition would benefit society in ways we have lost.

Shared value represents a new approach to managing that cuts across disciplines. Because of the traditional divide between economic concerns and social ones, people in the public and private sectors have often followed very different educational and career paths. As a result, few managers have the understanding of social and environmental issues required to move beyond today's CSR approaches, and few social sector leaders have the managerial training and entrepreneurial mind-set needed to design and implement shared-value models.

Most business schools still teach the narrow view of capitalism, even though more and more of their graduates hunger for a greater sense of purpose and are drawn to social entrepreneurship. The results have been missed opportunities and public cynicism.

Therefore, business school curricula will need to broaden in a number of areas. For example, the efficient use and stewardship of all forms of resources will define the next-generation thinking on value chains. Customer behaviour and marketing courses will have to move beyond persuasion and creation of demand, to the study of deeper human needs and how to serve non-traditional customer groups. Clusters and the broader locational influences on company productivity and innovation will form a new core discipline in business schools; economic development will no longer be left only to public policy and economics departments.

In addition, business and government courses will examine the economic impact of societal factors on enterprises, moving beyond regulation and macro-economics. And finance will need to rethink how capital markets can support true value creation in companies – their fundamental purpose – not just benefit financial market participants.

There is nothing soft about the concept of shared value. These proposed changes in business school curricula are not qualitative and do not depart from economic value creation. Instead, they represent the next stage in our understanding of markets, competition, and business management. In the process, businesses can earn the respect of society again. B

THE MOMENT FOR AN EXPANDED VIEW OF VALUE CREATION HAS COME. WE NEED A MORE SOPHISTICATED FORM OF CAPITALISM

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