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Abstract

The paper investigates the role of the government and self-regulatory reputation mechanisms to internalise externalities of market operation. If it pays off for companies to invest in a good reputation by an active policy of corporate social responsibility (CSR), external effects of the market will be (partly) internalised by the market itself. The strength of the reputation mechanism depends on the functioning of non governmental organisations (NGOs), the transparency of the company, the time horizon of the company, and on the behaviour of employees, consumers and investors. On the basis of an extensive study of the empirical literature on these topics, we conclude that in general the working of the reputation mechanism is rather weak. Especially the transparency of companies is a bottleneck. If the government would force companies to be more transparent, it could initiate a self-enforcing spiral that would improve the working of the reputation mechanism. We also argue that the working of the reputation mechanism will be weaker for smaller companies and for both highly competitive and monopolistic markets. We therefore conclude that government regulation is still necessary, especially for small companies.

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1 Introduction

In the last decades, ICT has changed the economic and political environment in the Western world. This technological progress imposes great challenges for companies, because their various stakeholders can monitor them much better. This provides opportunities for deregulation by the government. In particular, because of the watchdog function of the media and NGOs, companies are forced to uphold a good reputation. This might reduce market imperfections caused by lack of information. Whereas traditionally the government has the task to regulate the market in order to prevent this kind of externalities, the globalisation of the international market has made such direct regulation increasingly problematic.

The central question in this paper is whether the reputation mechanism provides enough incentives to companies to internalise externalities resulting from lack of information. For this purpose, we focus on the literature on corporate social responsibility (CSR). According to the Social Economic Council (2001a) corporate social responsibility means that an enterprise has sufficient focus on its contribution to public prosperity in the longer run. The contribution to public prosperity consists of value creation in three dimension which is called the Triple P bottom line: Profit (the production of goods and services), People (the consequences for people inside and outside the company) and Planet (the effects on the natural environment).[1] This broad definition of CSR will be used in the rest of this paper. There are two ways through which reputation and CSR are connected. First, one of the conditions for the functioning of the reputation mechanism is that information about the past performance of companies is available. Providing information and offering transparency to the stakeholders is one of the major aspects of CSR, because this contributes to public prosperity. Indeed, a responsible company will respect its stakeholders and therefore not use information advantages to manipulate transactions in its own interest. Therefore, the literature of CSR provides much information about instruments that raise the transparency to stakeholders. A second reason for focussing on the literature on CSR is that a strategy of CSR is itself a way of building up a good reputation. There is indeed much evidence that the reputation of a company is positively related to its CSR effort (Turban and Greening, 1996; Fombrun and Shanley, 1990). If a higher reputation, in turn, leads to higher profits for the company, there is an incentive for the company to engage in CSR. Miles and Covin (2000) find empirical support that being a good environmental steward indeed creates a reputational advantage that enhances marketing and financial performance. Likewise,

[1] Instead of these three dimensions distinguished by the Social Economic Council, Carroll (1993) specifies four types of CSR: philanthropic, ethical, legal and economic. Furthermore, it should be noted that there are many other terms related to CSR, like corporate citizenship, social responsibility and social responsiveness. The various definitions and related terms of CSR stress that there is not a concise definition of CSR.

Williams and Barrett (2000) show that corporate philanthropy may reduce the costs involved with corporate criminal activity. Several other studies that investigated the relationship between CSR and profitability without explicitly considering the role of reputation, also found that CSR really pays off for companies (Simpson and Kohers, 2002; Moore and Robson, 2002; Moore, 2001; Orlitzky, 2001; Ruf et al, 2001; Burke and Logsdon, 1996; Hart et al, 1996; Pava and Krausz, 1996; Zahra and Covin, 1995). This, in turn, would imply that the market has its own incentives to (partly) internalise external effects.

The contents of the paper are as follows. In section 2, we first give a theoretical background of the reputation mechanism and the relation with CSR and government regulation. Following Graafland (2002a), we will hypothesise that the reputation effect is stronger when non governmental organisations (NGOs) are more active and the media is better developed and when the company is more transparent. The willingness to invest in a good reputation depends on the time horizon of the company and on the incentives from the labour market, goods market and financial market. In particular, we will argue that a good reputation is more valuable for a company when it increases the productivity of its workforce, when it increases its sales and when it increases its possibility to attract financial means at the financial market. In section 3 we research the empirical literature on these mechanisms. In section 4 we will distinguish large versus small companies and investigate whether the working of the reputation effect differs across different types of markets. Section 5 will summarize our findings and consider the policy implications of our analysis.

2 Regulation, the reputation mechanism and CSR: a theoretical framework

This section describes the framework of the paper. First, we discuss imperfect information as one of the imperfections of market operation. Next, the role of the reputation mechanism is explained as an alternative to government regulation to reduce market imperfections due to lack of information. Third, we describe the relationship between reputation and CSR. The final section presents the framework and the conditions for an effective reputation mechanism.

Market imperfections and lack of information

One of the conditions for a good operation of free competitive markets is perfect information. The condition of perfect knowledge is often violated in the real world, because information is costly. Virtually every commercial transaction is subject to limited information, certainly any transaction conducted over a period of time. Imperfect information may be particularly harmful if it implies informational asymmetry. Informational asymmetry occurs when one party has more information about the transaction than its counterpart. Opportunistic agents may use this information advantage in their self-interest, because it allows the better-informed party to exploit the less informed party by manipulating the quantity, quality or price in a way that is not easily detectable to the less informed party. This causes market failure. In particular, because of informational asymmetries, the less informed party may purchase his money to goods that he would not have purchased if he were well informed and this is inefficient.

Lack of perfect information may also enforce other market imperfections caused by externalities, bounded rationality, product heterogeneity and trade barriers. For example, lack of information forms the background of prisoner's dilemma's and related coordination problems from externalities and hold-up. The uncertainty due to lack of perfect information may also complicate the decision problem. As agents have limited cognitive abilities, this may diminish the rationality of their decisions. Third, lack of information may increase the heterogeneity in products. In particular, although product differentiation may reflect real differences among products (in function, design or quality), it may also be based only on the belief that there are differences (by advertising or brand names). Lack of information enlarges the possibilities for the latter strategy. Finally, lack of information may introduce trade barriers for other companies. For example, it facilitates illegal price agreements among oligopolists. Because a highly concentrated oligopoly has a relatively small number of firms, it is relatively easy for the managers of these firms to meet secretly or join forces by tacit agreements.

Regulation, transaction costs, implicit contracts and the reputation mechanism

Economic theory describes several institutions that help to overcome the information problem and prevent opportunism. One such institution is a private contract enforced by an independent, impartial judiciary (Bovenberg, 2002). Second, the government can implement public laws that force agents to behave in a cooperative way. As stressed by the new institutional economics (North, 1990; Williamson, 1985), these institutions may, however, be rather costly, because writing down all contingencies in law and enforcement costs may generate many transaction costs varying from negotiations to legal procedures. The idea of transaction costs is that they consist of the costs of arranging a contract ex ante and monitoring and enforcing it ex post, as opposed to production costs, which are the costs of executing the contract (Van de Klundert, 1999). Due to substantial transaction costs, the legal constraints of negotiated contracts and unilaterally imposed laws by the government leave substantial scope for opportunism, so that externalities persist.

In view of the costs of the legal system, other more informal institutions have been developed to reduce the market imperfections from lack of information. These informal institutions rely on implicit, self-enforcing contracts in repeated game situations. In particular, opportunistic strategies will be prevented if agents can punish each other after the initial transaction. Whereas bilateral implicit contracts facilitate cooperative behaviour by rewarding and/or punishing of trading partners involved in recurrent transactions, implicit contracts are especially efficient if the information is distributed to all potential future trading partners by a reputation mechanism. The reputation mechanism can help to enforce the implicit contract by extending the bilateral punishment to multilateral or collective punishment. The reputation mechanism only works if several conditions are met (Bovenberg, 2002). First, information about the agent's past behaviour must be available to all other potential trading partners. Second, the agents must have a sufficient long time horizon. That means: they attach a large enough weight to future contacts. Third, the agents must believe that the strategies of the other players depend on their own decisions. There must be the belief of collective punishment and rewarding.[2] This, in turn, requires that the agents have a common perception of what is considered cooperative and non-cooperative behaviour and of how cooperative should be rewarded and opportunistic behaviour punished. These common perceptions can be viewed as part of the social capital of a society.

If the reputation mechanism works well, collective punishment is self-enforcing: neither the government nor the courts have to participate in punishing cooperative behaviour.

The reputation mechanism and CSR

The reputation mechanism is one of the main causes of the current attention of companies to CSR. The attention for CSR results from the need to get a licence to operate from the society. In order to get this licence, firms have to meet the triple P bottom line expressing the expectations of stakeholders with respect to the company's contribution to profit, planet and people (Graafland, 2002b). Firms that do not meet these expectations may see their market shares and profitability go down (McIntosh et al, 1998). Companies only succeed in convincing the stakeholders by investing enough in CSR. Indeed, CSR is very much a way of building up a good reputation. This is illustrated by many cases, in which companies started to pay attention to CSR after an incident that damaged their reputation (Tulder and Van der Zwart, 2003).

CSR comprises all kinds of measures that guarantee that the company will not exploit the stakeholders and misuse information advantages. In this paper, we distinguish between three types of measures. First, CSR relates to measures that protect the interests of stakeholders (like employees, customers and investors). Graafland et al (2003a) gives several examples, like measures to enhance good product quality to protect the interests of customers (by testing procedures and providing reliable information in advertisements) and sound accounting rules to

[2] This is not always necessary. If agents also have social preferences, for example that they like to be admired by others, social reputations may still enforce cooperation when this condition is not met (Bovenberg, 2002).

protect the interests of investors. Second, CSR relates to measures that foster the common good of the society at large rather than the interests of specific stakeholders of the company. Examples are efforts to reduce the environmental damage from the production process of the company. Third, a very important aspect of CSR concerns the transparency offered by the company itself (e.g. Herkströter, 1998). Transparent companies show respect to their stakeholders by informing them. Graafland et al (2003a) mentions several examples like the supply of information about safety, health and environmental aspects of the production process.

The framework

The relationship between regulation, imperfect information, the reputation mechanism and CSR can now be sketched as follows (see Figure 1). If the reputation mechanism works well, a company will have a high incentive to invest in CSR in order to get a good reputation. The reputation mechanism only works well if the three conditions mentioned above are met.[3]

First, the strength of the reputation mechanism depends on the availability of the information about the past performance of the company. The more information is available, the more transparent is the company's performance. The transparency depends on factors that are both external and internal to the company. An important external factor is the intertwined role of the media, NGOs and ICT.[4] Through ICT, the world is becoming a global village in which the media is able to inform people increasingly what firms are doing anywhere on the globe. These better communication networks also strengthen the position of NGOs, as it becomes easier to supply information to the various media. Therefore, the market becomes less anonymous. An important internal factor is the transparency offered by the company. If companies do not provide information about its performance, it is much more difficult for NGOs and market parties to get informed about the economic and social effects of the company. For this reason, external stakeholders often demand that companies be transparent. Companies that are not transparent become under suspicion of hiding negative consequences of their operations. Therefore, transparency is not only a condition for the functioning of the reputation mechanism, but has also become one of the constituting elements of a good CSR reputation (see above).

Second, as a good reputation only pays off in the future, investing in CSR will only be more important to the company if it has a long time horizon. If the company is especially interested in short term profits, the company has less incentives to build up

[3] For a theoretical model of these effects on reputation and CSR efforts, see Graafland (2002a).
[4] It is beyond the scope of this article to investigate other relevant external factors such as the cultural context in which the company operates. For example, whereas transparency is an important procedural norm in Western society, the Asian culture is much more confidential in nature so that transparency is much harder to obtain.

a good reputation and therefore to engage in CSR efforts, for the company has to make short term costs to get a better reputation that will lead to long term profits.

Third, the reputation mechanism is more effective if a good reputation is collectively rewarded and a bad reputation collectively punished. This depends on the reactions of various types of stakeholders on the labour, goods and capital market. First, a good reputation may attract highly qualified workers, whereas also current workers will have a higher productivity when the company invests in its reputation.

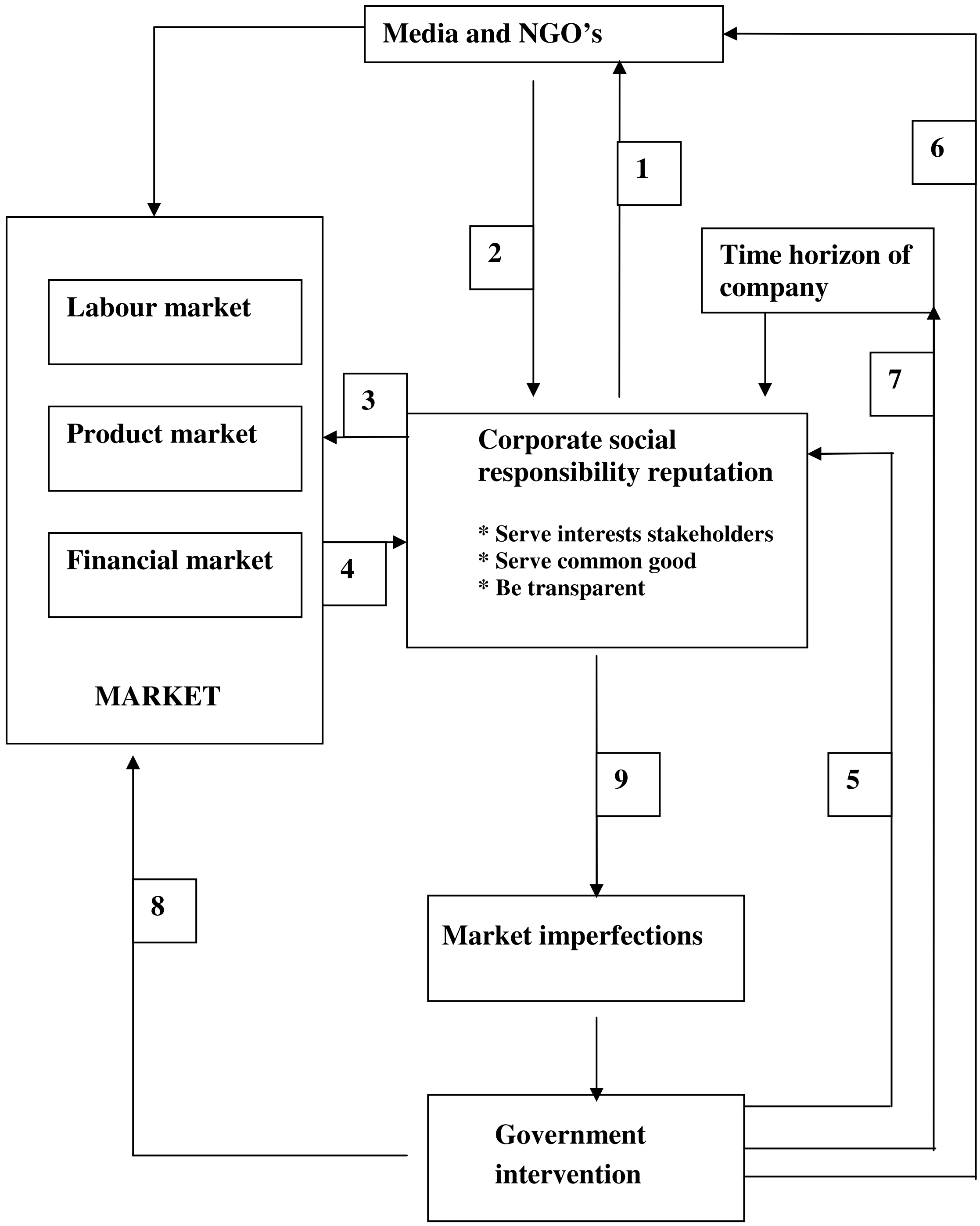

Figure 1: Reputation, CSR and regulation: a framework

Second, a good reputation could benefit the company on the goods market, in the sense that customers are more prepared to buy products from companies with a good reputation than companies with a bad reputation. A third market where a good reputation could benefit the company is the financial market. In particular, companies with a better reputation will be able to fund their investments more easily. It is our purpose to investigate whether this collective punishment and rewarding is indeed present in these three types of market.

If all conditions for the reputation mechanism are met, companies will have a strong incentive to reduce market imperfections by pursuing an active CSR policy (arrow 9), including the transparency offered by companies. An increase in the transparency will again enforce the reputation mechanism, because it raises the access of the media and NGOs (arrow 1) and other market parties (arrow 3) to information about the past performance of the company and therefore enables these parties to put more pressure on companies to improve their CSR reputation (arrow 2 and arrow 4). In this way, a self-enforcing spiral may result towards stronger reputation mechanisms and growing transparency of companies. If the incentives for companies to invest in CSR efforts are not strong enough, this process may not take place and all kinds of market imperfections resulting from imperfect information may persist. In that case, the government could intervene in four different ways. First, the government could directly regulate the CSR efforts of companies (arrow 5). Especially enhancing the transparency of companies, for example by forcing social and environmental reporting, could be very important, for transparency also have a positive impact on two other important conditions of a well-functioning of the reputation mechanism. Second, the role of NGOs and the media could be improved by subsidizing them (arrow 6). Third, as companies with a stakeholder view tend to have a longer time horizon than companies with a shareholder view (see section 3.3), the time horizon of the company could also be made longer, by, for example, setting selection criteria for commissioners that foster a focus on the interests of other stakeholders than shareholders only (arrow 7). In 2001, the Social Economic Council (SER) issued an advice that states that the Worker's Council should nominate one third of the total board of commissioners (SER, 2001b). Another possibility would be to force companies to have some commissioners that are representatives of NGOs. All those adaptations imply a better representation of the society at large in the board of commissioners. A fourth approach could be to stimulate collective rewarding and/or punishment by providing incentives to the market (arrow 8). Introducing subsidies and taxes can do this. For example, tax exemptions for investments in green funds will provide an incentive to investors to invest in responsible companies. This, in turn, will encourage companies to invest in CSR efforts. Also public law may help by coordinating views in society about which type of behaviour is non-cooperative and should be punished through social and economic sanctions (Bovenberg, 2002).

3 Empirical research: an overview

In this section, we will more closely research the empirical relevance of each of the relations of this framework on the basis of the literature. First of all, we will investigate the effectiveness of the watchdog function of the media and NGOs. Next, we look directly at the CSR effort of Dutch companies as far as the transparency offered by companies is concerned. Third, we look at empirical evidence about the time horizon of companies. Finally, we research the strength of punishing and rewarding on the labour market, goods market and capital market.

3.1 The role of the media and NGOs

For the reputation mechanism to work, information about the actions of companies should be communicated to the public. In this respect, the role of the media and NGOs has become very important. The role of the media and NGOs has risen due to the changes in the economic environment during the last decades (Grolin, 1998). The technological development has increased communication possibilities and made it easier for the media and NGOs to communicate with the public and the companies. As a result, stakeholders are sooner or more often being informed about the actions of companies.

Pressure groups act as a countervailing power to business (Smith, 1990). Kaler (2000) distinguishes between NGOs and campaigning groups. Campaigning groups, in contrast to the other NGOs, have fundamentally only a moral orientation. Other NGOs, for example trade unions and consumer organisations, do not have just a moral orientation but are vehicles to promote the sectional self-interest. Especially Transnational Corporations (TNCs) are targets of the NGOs, in particular those that are brand-based and most vulnerable to consumer boycotts. Whereas, as a consequence of globalisation, companies have more power and freedom, they have also been more frequently targeted by NGOs, who have adopted increasingly sophisticated strategies in dealing with them (Fabig and Boele, 1999).

That the media and NGOs really seem to have an impact on the actions of a company can be highlighted by various cases, like the Kenosha case of Chrysler (McMahon, 1999), the Brent Spar case of Shell (Grolin, 1998; Graafland, 2002b) and the Dolphin-Tuna case (Wright, 2000). Educated through the NGO efforts, the news media played a key role in shaping the public opinion in this kind of cases (Iyengar and Kinder, 1987). A final recent Dutch example of the impact of the media is the Zembla Television program on 16 November 2001 about illegal price agreements in the Dutch construction sector. This not only activated the political parties, but also made companies more aware of CSR (Graafland, 2003a).[5]

[5] For examples of the role of the media and NGOs in the textile sector, see Graafland (2002c).

The strategy of NGOs, however, seems to have changed in recent years (Kong et al, 2002). Whereas they used to use the strategy of confrontation with the companies (they still use this strategy), now there is a trend to the strategy of innovative and pro-active partnerships with the business/industry (Gruiters, 2000). Because NGOs are capable of giving valuable information to the companies about what matters in society, they will enable the companies to internalise the external effects of production in a better way, what will enhance social welfare. Campaigning groups have an expertise in tapping into public opinion that business do not have (Kaler, 2000).

It should be noted that the media and NGOs do not always contribute to public prosperity by providing information. For example, a company can be unfairly accused by an NGO. In the case of the Brent Spar, Greenpeace overestimated the environmental damage. Moreover, as NGOs have no democratic basis and only represent their members (with a strong focus on social and environmental values), one can question the legitimacy of NGOs when they induce firms to CSR (Edwards, 1999).

Finally, it is important to note that the impact of the media and NGOs is interrelated to the other factors influencing the strength of the reputation mechanism. In particular, the possibility of NGOs to pressure companies is both related to the transparency offered by the company as well as to the attitude of employees, consumers and investors regarding the actions of the company. If a company is not transparent, the NGOs do have a harder job to come to know about the (bad) actions of the company. And if, for example, consumers are more inclined to help an NGO with boycotting a company, an NGO can pursue more pressure. These other factors will be discussed below.

3.2 Transparency offered by the company

In this section we investigate the transparency offered by companies. We first consider financial reporting. Next, we discuss the transparency with respect to other issues.

Financial transparency

In recent years, large Dutch companies have improved their financial transparency by implementing some of the advices of the Commission-Peters. However, most annual reports lack a systematic analysis of the financial risks in the future. Furthermore, the transparency is sometimes lowered by the use of new, creative definitions of profitability and an improper use of the item ‘special costs’ (Van de Merwe, 2002). Because companies can choose between permitted alternative accounting rules, it is tempting to manipulate the accounts in the interest of the top management of the company (Blake et al, 2000).

Indeed, the financial scandals in the United States and in the Netherlands (Ahold and earlier Worldonline, KPN, Getronics and Baan) have made clear that the financial transparency of companies is still vulnerable. According to Frentrop (2002), the financial control of large Dutch companies is insufficient. Especially the interests of the shareholders of these companies are not secure. As a result, the probability of misuse is relatively high. According to De Vries, 7 of the 25 AEX funds made financial mistakes (NRC, 24-4-2003).

Transparency with respect to other issues

Transparency with respect to other issues like social and environmental issues can be reached through different channels. In this section we focus on four instruments: public code of conducts, certifications and labelling, an active dialogue with NGOs, and social reporting and auditing.

First, the company could explicitly state its basic responsibilities towards its stakeholders in a public code of conduct (Kaptein and Wempe, 1998; SER, 2001a). This will enable the stakeholders to hold the company responsible for its actions. In the Netherlands, the use of a code of conduct by companies is quite modest but rising. In a recent research of KPMG (2002) 43% of the companies in the three Northern provinces are found to have a code of conduct, but this might rise to 70% in the next three years. For the Southern provinces Brabant and Zeeland Graafland et al (2002d, 2003b) find that 51% of the large companies uses a code of conduct.[6] In another recent research for 58 large Dutch companies Graafland et al (2003a) find that 48% has a public code of conduct. In the chemical and banking sector almost 2 out of 3 companies have a code of conduct, whereas for the retail sector only 18% has a public code of conduct. This might be explained by the fact that retail companies are relatively small compared to chemical companies and financial banks. Unfortunately, many codes of Dutch companies are not very concrete, which hampers the verification the compliance of the company with the code (Van Tulder, 2000).

Second, the company could voluntarily subject itself to independent certification standards like the various ISO standards (Rondinelli and Vastag, 2000) and the SA8000 standard (www.cepaa.org). Those standards can be considered as labels with respect to the company's performance. The number of Dutch companies that do have a particular certificate is highly sector specific. For example, Graafland et al (2003a) find that 80% of the construction and chemical companies has a ISO9001/9002/9003 certificate (measuring product quality standards) against 14% respectively 10% for

[6] This is similar to the findings of Ulrich et al (1998) for 550 large German and 224 large Swiss companies. However, as their study is already some years old, we expect that the share of companies having a public code of conduct in their sample is higher by now.

retailers and financial banks. Similarly, whereas 83% of the chemical sector has an ISO 14001 certificate (measuring environmental standards), this only holds for 23% of the construction companies, whereas the number of ISO14001 certificated retail and financial banks is negligible. The SA8000 certification (measuring labour standards) is least common and only held by about 10% in the sample of Graafland et al (2003a).[7] The company could also enhance transparency by subjecting its product to a label. The labelling of products plays a role of increasing importance as a technique to reveal, with adequate certification, the content of a product in both a psychical and moral sense by reporting on a certain aspect of the product (Keyzer, 2002). Examples of labels in the Netherlands are the so-called green label for sustainable electricity, certificated by the association of energy companies (Van der Tak, 1998) and the Max Havelaar label established by NGOs (Van Beuningen, 2000; De Lange and Winkler, 2000). Because these labels make it easier for stakeholders to identify the actions of the company, labelling will enhance the working of the reputation mechanism.

A third instrument to raise the transparency of the company is an active dialogue with its stakeholders. In the Netherlands, chemical companies regularly engage in active dialogue with NGOs. However, other companies are in general seldom engaged in active dialogue with the NGOs and do not think this is important (Graafland et al, 2003a). An active dialogue could also enhance the working of the code of conduct, because it seems that an active dialogue sharpens the code of conduct (Van Tulder, 2000).

Finally, the company could issue environmental and social reports. Clarke and Gibson-Sweet (1999) show that corporate social reporting by UK companies escalated in recent years. Particularly in industries that are environmentally sensitive, such communication is apparent. In a Canadian study, Nitkin and Brooks (1998) found that 51 of the 174 surveyed companies issue an environmental progress report to the public. They, however, recognize the fact that just few of the investigated companies issue the full text of their audits (just 10 out of 51). They conclude that companies in Canada are not yet convinced of the advantages of sustainability accounting and auditing. Moreover, as Nitkin and Brooks note, there is little standardization of the reports they investigated. This means that it is difficult to compare the various companies with respect to their environmental actions. For the Netherlands, Lamoen and Van Tulder (2001) find from a sample of 16 companies that 62 percent of the Dutch traded companies issue a separate social or ecological report. 19 percent of these companies only issue an environmental report and 19 percent only a social report. Almost 25 percent issue both an environmental and a social report. Especially companies in environmental sensitive industries, like chemical companies, issue an

[7] Of which 20% of the chemical sector and 10% of the retail sector. The number of construction and financial companies with a SA8000 certificate was zero.

environmental report (Graafland et al, 2003a). Public social reports, on the other hand, are most of the times issued by labour intensive companies, like in the construction sector. Some firms also include social aspects in the annual financial report. Just as Nitkin and Brooks find for Canada, the environmental and social reports of Dutch companies show a lot of differences, which makes it difficult to compare the performance of different firms. Standardization seems important to judge whether a company performs well or not. Moreover, just as in Canada, Dutch companies seem not yet convinced of the advantages of sustainability accounting and auditing. Some large Dutch companies have recently even reduced their effort in social reporting (Lamoen and Van Tulder, 2001).

Environmental and social reporting is especially useful for raising transparency if independent auditors check the information that the company offers. External verification of the actual environmental performance does, however, not take place normally. The ISO14001 certification, for example, only implies that companies have good environmental management systems to deal with environmental impacts, but there is no way of externally verifying the actual environmental improvements. Except for some best practices like Shell, this is not the case for most Dutch companies. For the public in general it is often not possible to check whether or not a company gives a true picture of its actions. For example, out of a questionnaire of 30 questions Graafland et al (2003a) were only able to verify 10 questions on the basis of public information (newspaper articles, internet sites and annual report). Also Scholtens (1998) find in his research that the transparency of Dutch companies is not very high. Therefore, verifying the information of companies is difficult.

3.3 Time horizon of the company

A good reputation implies increased long run profits for the company (Roberts and Dowling, 2002). But in order to build a good reputation, the company has to make costs in the short run. The incentive to invest in a good reputation will therefore depend positively on the time horizon of the management of the company (Francois and Roberts, 2003; Bovenberg, 2002).

There is empirical evidence that a long time horizon contributes to long-term profitability (Richardson and Waegelein, 2002; Keil et al, 2001). Compensation of executives not based on the long-term performance of the company, will ultimate lead to decisions that are detrimental to shareholder wealth (Vogel and Lobo, 2002). But that does not guarantee that managers do have a long-term focus.

So the question is: Is there evidence that companies are mainly concerned about the long-term? Or are they mainly interested in the short term? Short-termism can be defined ‘as representing decisions and outcomes that pursue a course of action that is best for the short term but sub optimal over the long term’ (Laverty, 1996). According to Laverty, there are five (partly overlapping) explanations why short-termism could exist in a company: managerial opportunism, stock market myopia, flawed management practice, fluid and impatient capital and information asymmetry. Some empirical evidence corroborates the first mechanism of managerial opportunism. For example, Harrison and Fiet (1999) find a positive relationship between CEO succession and organisational performance. An explanation is that new CEOs feel pressure to perform well in a relative short term to secure their position and therefore tend to cut expenditures on long-term investment area's like R&D and pension funding. Especially in large public companies this problem is apparent, because leaders of the company change more often than in small and family owned companies. There are, however, also studies that found no relation between managerial opportunism and short-termism. Bizjak et al (1993), for example, failed to find any evidence that companies with CEOs near retirement were foregoing long-term investments. The empirical literature on the influence of managerial opportunism on short-termism is therefore ambiguous.

A second cause of short-termism is stock market myopia. Recently, there have been claims that U.S. companies are either unwilling or unable to make investments that are necessary for the future but that require a sacrifice of short-term profits. A very often-called reason for this is the pressure from the stock market (Segelod, 2000). The pressure from the stock market to perform in the short run causes firms to invest in a more short-term manner than is advisable. According to Laverty (1996), however, other studies indicate that the stock market will also reward companies if they invest in R&D, a long-term investment. Furthermore, Laverty argues that the lack of discipline by the stock market appears to allow managers to be more short-term oriented. Therefore, again, an unambiguous conclusion is not possible.

For the other explanations of short termism - flawed management practice, fluid and impatient capital or information asymmetry - Brown and Higgins (2001) found that especially in the U.S. managers manage earnings surprises to raise the stock price. Large information asymmetries in the U.S. may be creating incentives for a short-run management style detrimental to long-term competitiveness. Also fluid capital can foster short termism. Segelod argues, for example, that short-termism of U.S. companies can be attributed to the fact that the largest groups of shareholders in the U.S. are institutional investors and that these investors are short run maximisers. Moreover, the U.S. shareholders have more voting rights than in the Netherlands. (Moerland, 1997). As many investors seem to have a short time horizon (Van Hoesel et al, 2001), more voting rights imply that U.S. companies may have more difficulties to pursue a long-term strategy. This in contrast to companies in Germany and the Netherlands (e.g. Gradus et al, 2000), where a stakeholder's model is more actual and where companies are often controlled by stable owners who are well informed about their company and have a long-term commitment to the firms they control (De Jong, 1996; Kester, 1992). In this model, employees do have more influence, as well as the banks, and the orientation on the capital market is less strong than under the Anglo-

Saxon model (De Jong, 1996; Gradus et al, 2000). All those characteristics of the stakeholder model will lengthen the time horizon of the company. On the other hand, the controlling power of large shareholders that are not part of the Board of Commissioners (Cremers, 1999) is relatively weak in the Netherlands. This may create room for managerial opportunism. The time horizon of Dutch companies may even become shorter when more small investors are given more voting power (DeJong et al, 2001). Indeed, some Dutch CEOs indicate that the short time horizon of especially the small investor makes it more difficult for the company to carry out a long-term strategy and therefore shortens the time horizon of the company (Hilgers et al, 2001). Still, we conclude that the time horizon of Dutch companies is relatively long compared to U.S. companies. This is confirmed by research of Segelod (2000) who finds that managers think that American firms indeed have the shortest time horizon, whereas Japanese firms have the longest time horizon and European companies take the intermediate position.

3.4 Reputation and the labour market

The pay-off from a good reputation depends crucially on the reactions of various stakeholders. In this section, we will consider the impact of a good reputation of the company on the labour market. We will first research the reputation effects of good human resource management (HRM) policies on the hiring of new employees and on the commitment of current employees. Next, we discuss the effects of a good ethical culture on employees.

HRM reputation and quality of the labour force

A good HRM reputation may be rewarded both by potential employees as well as by the current working force. The worth of the company depends for a great extent on the satisfaction and quality of the workforce of the company. More satisfaction of the workforce, in turn, will lower turnover rates and increase the readiness of employees to invest in relation-specific assets (Boot, 2000). This will benefit the company. There is indeed empirical evidence that companies with a good HRM reputation are able to attract better employees (Albinger and Freeman, 2000; Turban and Greening, 1996). This especially holds for companies that target at highly educated workers. It seems that by evaluating the company, the potential employees weigh the organisations' performance on employee issues most heavily. Therefore managers should invest in the working environment.

Besides the reputation effect on potential employees, investment in good HRM will also have a direct favourable influence on the performance of the company by stimulating the commitment of workers to the company. Commitment can be defined as the feeling of responsibility for the company's common goals independent of any direct revenue that the worker obtains. A famous research confirming the existence of commitment is Akerlof (1982), who showed that some groups of workers contributed substantially more than was required. Good HRM stimulates this natural source of energy. Commitment of employees cooperating in a network of relational contracts within the company is one of the key success factors that other firms cannot easily copy, because developing such a company culture takes a long time (Kay, 1993; Pfeffer, 1994; Becker and Gerhart, 1996). Good relational contracts with and between its workers and commitment to the company's goal stimulate a cooperative ethical attitude. Individual workers are prepared to subject their own interest to the common goal of the company, based on the trust that other workers will do the same and that everybody will share in the additional common revenues of the company made possible by the commitment of all workers (Hosmer, 1996). This makes it possible that internal prisoner's dilemmas are optimally solved from the perspective of the group. When the trust between the company and the workers or between workers for some reason disappears, the organisation needs more formal mechanisms and explicit contracts to direct the behaviour of employees. These formal instruments may be more expensive and might induce non-cooperative behaviour and inflexibility.

Many empirical researches find a positive correlation between HRM and company performance (Delaney and Huselid, 1996; Huselid et al, 1997; Stanwick and Stanwick, 1998; Ahmad and Schroeder, 2003). Investments in a good HRM reputation therefore pay off in the labour market and therefore there is an incentive for the company to set up such a program. Besides these direct tests, the positive relationship between HRM and profitability is also confirmed by indirect tests. For example, Huselid (1995) and Brouwer et al (2001) find that attention to the problems of older workers reduces the number of workers that leave the company. This reduces the costs involved with the selection and training of new employees. As many workers have unique and valuable competencies that are difficult to copy, it might be hard and costly to find new suitable candidates.

Ethical climate and job satisfaction

Whereas a good HRM reputation will have a direct impact on the hiring of new workers and the commitment of current employees, the quality of the workforce may also be positively influenced by the company's ethical standards. In particular, several studies have found a positive relationship between the ethical climate in a company and job satisfaction (Deshpande, 1996; Viswesvaran and Deshpande, 1996, Sims and Keon, 1997, Koh and Boo, 2001, Viswesvaran and Ones, 2002). The term 'ethical climate' can be conceptualised as those perceptions in organisations that affect decisions that bear ethical content (Victor and Cullen, 1987, 1988). Examples are perceptions with respect to caring (concern for the well being of the people in the company), law and code (acting in accordance with professional laws and standards), the company’s rules, commitment to the company’s interest and independence (act in accordance to individual morals and conscience).

A good ethical climate can impact the quality of the workforce in several other ways. First, as Barnett and Schubert (2002) show, a good ethical work climate leads to more trust in the company (Ruppel and Harrington, 2000), higher commitment of the employee, lower absenteeism and turnover, higher profitability and productivity, and more favourable job attitudes and behaviours (Koh and Boo, 2001; Sims and Keon, 1997). Second, a good ethical climate also reduces misconduct of employees (Treviño et al, 1998; Weaver and Treviño, 1999; Vardi, 2001). Third, a good ethical reputation may indirectly contribute to job satisfaction and lower turnover of employees by invoking positive reactions from external groups (Riordan et al, 1997). When external groups appreciate the company, the employee is more likely to enjoy his or her job and less likely to quit.

3.5 Reputation and the product market

A good reputation does not only invoke rewarding behaviour from employees, but may also have a favourable impact on the customers of the company. But how effective is this mechanism? To answer this question, we investigate the behaviour of consumers. This section is divided in two parts. First, we will research whether or not consumers punish companies that harm the own interests of consumers and reward companies that meet their expectations. Second, we will investigate whether or not consumers have a preference for buying goods that contribute to the common good and are prepared to pay an additional premium for these products.

Reaction to damage of customer’s interest

Evidence shows that customers indeed punish companies if they damage customer’s interests. Archer and Wesolowsky (1996) find that owners of durable goods tend to have a tolerance towards single negative incidents with regard to product or manufacturer loyalty, but are not tolerant towards more than one such incident. Also Landon and Smith (1997) find that, whereas short term changes in quality hardly impact the price that consumer are willing to pay for a product, persistent movements in quality do have an impact. Furthermore, positive experiences of consumers can counteract negative critical incidents. This implies that a good reputation can help to reduce the damage from a critical incident. Kimes (1999) finds a direct relationship between product quality and operational performance. In her research, Kimes finds that defective hotels earn less per available room than non-defective hotels. Furthermore, another research shows that a one-point increase in the consumer satisfaction index of a Business Week 1000 firm has been calculated to be worth about $94 million or 11.4% of the average return on investments (Anderson et al, 1994). This indicates that the consumers will reward companies with more reliable products.

The willingness to reward products that protect the interests of consumers is also confirmed by the rise in the consumption of biological produced products. Consumers have become more aware of the potential health hazards of agricultural products produced on a traditional mass scale. Notwithstanding the fact that the price of biological produced products is 20 to 30 percent higher than regular produced products (Van de Kolk, 2002), the total market for biological products increased with 23 percent to 355 million euro in 2001.

It should be noted, however, that the effectiveness of the reputation mechanism through consumer reactions is limited if the consumers have a relatively short memory. An example is the Ford Pinto case. In this case, Ford had deliberately chosen for a dangerous position of the gas tank in the Ford Pinto, causing the death of many motorists in the seventies. When this became publicly known, the American consumer was furious and Ford had to terminate the production of the Pinto (Velasquez, 1998). However, the incident was soon forgotten and caused no permanent damage to the reputation of Ford. As Graafland (2002a) argues, this may reduce the incentive to internalise externalities from safety hazards of the product.

Demand for goods with high social value

Goods with a high social value that serve the interest of the society at large may both generate a quantity premium as well as an additional price premium. We first discuss the effects on the demand of such products. Second, we investigate the price premium that consumers are willing to pay for this type of goods.

Several empirical studies show that a good social reputation of a company facilitates the support of consumers by buying or not buying the goods, especially in the retail sector (Alexander, 2002; Maignan, 2001; Brown and Dacin, 1997; Handelman and Arnold, 1999; Marymount University, 1999). In addition to the direct impact on the buying decisions of customers, the social reputation of a company exerts an influence on product evaluations and consumers responses to new products through their influence on the corporate evaluation. There is evidence that a negative social reputation ultimately can have a detrimental effect on overall product evaluations, whereas a positive social reputation can enhance the product evaluations (Brown and Dacin, 1997). Also Handelman and Arnold (1999) and Maignan (2001) show that marketing actions with a social dimension generate consumers' support for the organisation. These findings confirm the appropriateness of CSR as a marketing instrument.

Besides rewarding responsible companies by additional product demand, customers can also punish companies that produce goods that are damaging for the common good. As Smith (1990) notes, over the last fifteen years consumer boycotts have become more frequent, better organized, and identified with a much broader range of issues. At least 300 consumer boycotts in the US had been reported in 1990 alone. This represents an increase of 769% from the 39 reported in 1984 (Koku et al, 1997). Smith (1990) concludes that the cases are illustrations of consumer boycotts being used in the social control of business. This shows that consumer boycotts in reaction to a poor social reputation can operate as a social control mechanism. Also other studies provide empirical evidence for social purchasing behaviour. For example, Marymount University (1999) finds that if consumers are aware of a retailer that sold garments made in sweatshops, 76% would avoid shopping at that store.

A good social reputation may also impact the price of the product. Indeed, consumers seem quite willing to pay for social product features (Auger at al, 2003). Marymount University (1999) finds that 86% of the thousand consumers surveyed would be willing to pay a 5% mark-up to ensure sound production practices. Also Bird and Hughes (1997) find evidence of the consumer's willingness to pay a premium for products of companies with a good social reputation. In one survey, 5% of the surveyed consumers is a totally committed social shopper, 18% claims to try to buy social products 'as far as possible', 56% are slightly social and 17% expressed no interest in social products. The premiums the 'social' consumers wanted to pay ranged between 10 and 18 pence in the pound.

However, in the Netherlands and other European countries there is still a significant group of consumers that does not value a social product position. Only 2 to 3 percent of the coffee-consumers is prepared to pay for Max Havelaar coffee. This relatively low market share can be explained by the fact that many consumers seem not prepared to pay substantially more for fairly traded coffee and that Dutch consumers are in general quite brand loyal (De Lange and Winkler, 2000). Furthermore, while the range of fairly paid products is regularly extended (with for example chocolate), the growth of the number of consumers of these products is quite modest (Van Beuningen, 2000). This also holds for other sectors, like the textile sector. Elliot and Freeman (2001) found that activists only have limited success in catalysing consumers and companies to change their behaviour to improve sweatshop conditions. Consumers seem not prepared to pay a substantial price differential for the sake of a more socially and environmentally sustainable method of production (Graafland, 2001, 2003b). Because of these experiences, most Western retailers are not pro-actively fostering innovation in the environmental aspects of the clothing. The commercial benefits are too uncertain. Only a small proportion of committed consumers is prepared to pay for social and environmental issues linked to clothing. In Germany the 'green' market niche accounts for about 1-2% of the clothing market (Robins and Humphrey, 2000).

This passive attitude of customers is maybe due to a lack of information. Many consumers seem still quite ignorant of the social features that comprise the products they consider and purchase (Auger et al, 2003). Maybe a better transparency, for example by labelling products, will make consumers more prepared to pay for these products. Another explanation is that the additional price to be paid for these ‘social’ goods provides an incentive to free riding of most consumers: although they value the positive social consequences of these goods, their self-interest is more served if other consumers pay the price for these goods. In that case, there is still a market imperfection, although not due to a lack of information. A final explanation is that citizens (and thus consumers) are not really interested in the positive social effects of these goods. In that case, the low market shares of social goods do not signal a market imperfection.

3.6 Reputation and the capital market

A third market where a company could profit from its good reputation is the financial market. In this section, we will first investigate the empirical evidence of investor’s reactions to companies that neglect the interests of investors. Second, we will investigate whether or not investors have a preference for ethical investments and are prepared to pay an additional premium for these shares.

Reaction to damages of investor’s interest

There is substantial evidence that companies are penalized in the financial markets for behaviour that may harm the interests of investors (Gunthorpe, 1997; Rao and Hamilton, 1996; Davidson III et al, 1994; Badrinath and Bolster, 1996; Folmer, 1998; Soppe (2000)). A possible explanation for this penalizing is that the profitability may decline due to huge fines or compensation payments. However, there also seems to be an additional reputational penalty, because the loss in investor returns is normally much bigger than expected on the basis of the expected fines and compensations (Soppe, 2000). The explanation for a lower share price could be that investors perceive more risk of the stock (Badrinath and Bolster, 1996). Soppe (2000) shows that especially fraud of a company implies a negative return of the Dutch companies and therefore a decrease of the worth of the company.

Most well known are the cases of unethical behaviour of companies because of illegal activities, like the current gulf of companies that violated financial reporting rules. Davidson III et al (1994) find that their shareholders will punish companies when they engage in illegal activities. Specific types of crime such as bribery, tax evasion, theft of trade secrets, financial reporting violations and violation of government contracts were associated with abnormal negative stock market returns. Also illegal price agreements belong to this category. A recent Dutch example is the fraud in the construction sector. Just after a television program that showed that well-known large Dutch construction companies regularly participate in secret price agreements, the stock values of these companies fell by more than 10% (Graafland, 2003a). Even more dramatic was the reduction of the stock value of Ahold after the publication of unsound accounting practices in the U.S.

The crucial question is, however, whether these reactions are serving as a deterrent for the companies. Out of the 96 companies that committed crimes in the 70s, 49 allegedly committed crimes in the 80s. This could indicate that a stock price penalty is not always a sufficient deterrent. This could be explained by the fact that the learning effect is just for a short time, because the management changed in the time period (Davidson III et al, 1994).

Ethical investment

Ethical investment is one of the fastest growing areas of finance (Sparkes, 2001). Ethical investment can be defined as the exercise of ethical and social criteria in the selection and management of investment portfolios, generally consisting of company shares. In contrast, the sole purpose of normal investments is to maximize financial return.

Also in the Dutch financial markets the importance of ethical investment has increased (Otten and Koedijk, 2001; Soppe, 1998). Especially from 1996, the number of ethical savers in relation to normal savers increased. This is probably the consequence of the introduction of a tax exemption for so called ‘green savers’. This can be concluded when comparing the Netherlands with Belgium, where no tax stimulation exists. In Belgium, ethical saving is less popular (Benijts and Scholtens, 2001). Another motive for ethical investing is that the risk of these funds are lower than the risks of non-ethical funds (Otten and Koedijk, 2001).

Besides the financial motives, ethical investment may also be motivated by social and ethical concerns of the investors (Rivoli, 1995). However, whereas ethical investors have ethical concerns, most of them are not prepared to sacrifice their financial requirements to meet these concerns (Mackenzie and Lewis, 1999). There is, however, also evidence that ethical investors keep those investments even if they perform badly (Webley et al, 2001). Furthermore, several studies show that people who have pro-environmental attitudes are prepared to take a small loss in order to invest in companies labelled as environment-friendly (Pava and Krausz, 1996; Mackenzie and Lewis, 1999).

Likewise, the evidence of punishment of alleged unethical behaviour is mixed. Gunthrope (1997) finds that the financial markets will on average impose a statistically significant one-day penalty of approximately 1,3% and a 2,3% penalty over a seven-day period for publicly traded companies that engage in unethical behaviour. Rao and Hamilton (1996) show that the actual stock performance for those companies that are reported to act unethically was lower than the expected market adjusted returns. This means that there is evidence that the company is being punished for bad behaviour[8]. However, information about environmental damage or discrimination of the company does not always lead to structural negative returns for the company. Only if the company is fined for their environmental damage, the stock price will fall (Badrinath and Bolster, 1996). Also Warren (2002) finds that shareholders are sometimes not very concerned about the company's unethical actions.

4 Size and market form

In the previous section, our analysis of the working of the reputation mechanism was rather general. In this section, we investigate in more detail the impact of the size and the impact of market form in which the company operates.

Size

In the Netherlands, the market share of large companies was around 50% in 1998. The other part consisted out of the medium and small companies (De Boer, 1999). Therefore it is important to investigate whether there is a difference in the behaviour of small companies and the behaviour of large companies.

There are a number of key differences between small and large companies. First, NGOs will have few incentives to scrutinize small companies, because it is practically not possible for them to look after each small company. It is more interesting for NGOs and the media to focus on large companies with their limited power, because this will attract more public attention. Second, small companies will generally use less formal instruments to pass information to the public. Graafland et al (2003b) find that large Dutch companies make more use of instruments that foster the transparency of companies, like a code of conduct, ISO certification and social reporting. Also Jeucken and Van Tilburg (1999) found that large Dutch companies do more often have an ISO14001 certification than small companies. On the other hand, because small companies are often operating on a limited local scale, they have more direct contacts with their stakeholders which facilitates the transparency of the company. So there is also less need for those companies to use formal instruments to disseminate information. Third, with respect to the time horizon, there are also several contrasting forces at work. On the one hand, large companies may have strategic assets that reduce the competition and enables them to have a long-term view. Indeed, research indicates that large multinationals seem to have a longer time-horizon than other companies in their industry (Segelod, 2000). Furthermore, larger companies are, in contrast to smaller companies, normally forced to have a board of commissioners,

[8] Sometimes, companies are punished by NGOs who bought shares of the company to have some voting power. Such a campaign was done in the Brent Spar case in 1997 (Sparks, 2001).

which could also lengthen the time horizon. On the other hand, as argued in section 3.3, companies with a quotation on the stock market may be more subject to short-term pressure from the capital market and face more CEO rotation. Therefore, it is not a priori clear whether a small company would have a shorter or longer time horizon than a large company. An ambiguous conclusion also holds for the reward of a good reputation on the labour market, product market and financial market. Whereas small companies are less visible and more anonymous than large companies on the labour market and product market at large, small companies may be less anonymous at the local level. At the financial market, the incentive to reputation building will probably be lower because a small company is normally not traded at the stock market. However, if there would be punishment, the learning effect in small companies will probably be higher, because there is less CEO rotation.

On average, empirical research seems to point that the reputation mechanism works less well for small companies than for large companies. For example, Spence et al (2000) find that the possibilities of a market conform environmental policy are limited for the small entrepreneur, because the company will find it difficult to get its environmental efforts rewarded by the market. Furthermore, Jeucken and Van Tilburg (1999) found that large companies are more active in caring for the environment. Graafland et al (2002) find that large Dutch companies have a more positive perception about the impact of a good CSR reputation on long-term added value for the company than small companies. They also find that large companies perform better with respect to a number of concrete measures including the provision of individual training programs to employees, provision of information about safety and environmental effects to employees, prevention of disability, controlling the labour conditions of suppliers, supply of sustainable product in product assortment, share of profits invested in reduction of environmental damage, and share of profits used for social local projects. Apparently, large companies feel that the reputation effect from high CSR efforts is worthwhile the cost.

We therefore conclude that the reputation mechanism will be stronger for larger than for smaller companies. We therefore suspect less self-regulation in the MKB sector and therefore it could be a task for the government to foster collective forms of self-regulation at the branch level that stimulate internalisation of externalities.

Market form

Unfortunately, we found no empirical information about the relationship between market form and the strength of the reputation mechanism. Therefore, the analysis of this section is mainly theoretical.

As Milgrom and Roberts (1992) argue, reputation is more important in markets where there is more need for trust, companies have a longer time horizon and if companies are more visible and have larger size. In sectors that approximate perfect competitive markets, the reputation mechanism is not necessary, because perfect competitive markets are not subject to imperfect information about the quality and price of the product. Therefore, indirect information about the product offered by the past performance of the company is superabundant. Indeed, the reputation mechanism is just one of the ways to correct for lack of information on imperfect markets in order to approach perfect competition. Moreover, in a perfect competitive market, the companies are more anonymous because of the large number of competing firms. Non-anonymity is, however, one of the conditions for reputation.

For monopolies, the reputation mechanism will probably also be relatively weak, because the reputation mechanism only works if stakeholders can punish the company. As the consumers do not have any alternative, the costs for boycotting the company may be very high for them. The net benefits of a good reputation for a monopolistic company is therefore less than for a non-monopolistic company in the customer market. Transparency will probably also be lower, because there is less need to. Moreover, as investors face a lower risk of consumer boycotts, they will be less inclined to react to changes in the reputation of the company. Only on the labour market employees are still able to reward and punish monopolists for their reputation. We suspect, therefore, that in a monopolistic product market the reputation mechanism will be too weak to internalise economic, social or ecological externalities.

Reputation effects will probably be more important for monopolistic competition. Whereas consumers have the market power to punish companies, reputation may pay, in particular if the heterogeneity of product is based on perceived differences (by advertising or brand names) rather than by real differences in product function, design or quality. Still, because of the large number of companies operating in a monopolistic competitive market, the risk of being damaged by NGO-led actions is relatively small. Therefore, we expect that the reputation mechanism is still relatively weak.

The reputation mechanism will therefore be most relevant for oligopolistic markets. Whereas competition is apparent here, the companies in this type of market are very visible and easy targets for NGOs. Furthermore, companies in these sorts of markets are normally quite big. Therefore, this seems the market where the investment in reputation will be greatest.

5 Summary and policy implications

Table 1 summarizes the main findings of this paper and gives some examples of possible government actions.

First, our research indicates that the media and NGOs work relatively well. Their role has increased as a result of ICT. However, the possibilities of these countervailing powers are still hampered by a lack of transparency by companies. The government could (and already does) strengthen the role of NGOs by providing subsidies directed to their watchdog function.

Second, the transparency of companies in the Netherlands seems to be rather weak and therefore an important condition for a well-functioning of the reputation mechanism is not completely met. One way to stimulate financial transparency is by self-regulation by commissioners, for example by voluntary codes of conduct. Reducing the number of commissionerships per commissioner can also increase the control. Third, reduction of the options of the top management may reduce the incentive to boost the profitability in the financial report (Van de Merwe, 2002).[9] Also social and ecological transparency can be stimulated by an increase in codes of conduct, certifications, environmental and social reporting and an active dialogue with NGOs. The government could set some minimum standards for codes of conduct (Kolk et al, 2001) and foster standardization of social reports, which enables the stakeholders to compare the various companies. Too much regulation to improve the transparency of companies may, however, be too costly and generate additional transaction costs.

Table 1 Reputation mechanisms and policy implications

Determinant	Strength of effect	Examples of government actions
Media, NGOs and ICT	Media and NGOs are active in watching companies	- Subsidize countervailing power of NGOs
Transparency companies	Rather weak	- Standardization of reporting
Time horizon company	Dutch companies have relatively long time horizon compared to U.S. companies	- Change the composition of the board of commissioners and voting rights of large stable shareholders.
Labour market	Incentives are quite strong	- Provide information about HRM efforts of employers
Product market	Evidence is ambiguous	- Subsidize consumer organisations or labelling systems
Financial market	Evidence is not overwhelming	- Improve voting rights large shareholders - Subsidize ethical investments

Third, the time horizon of Dutch companies seems relatively long in the Netherlands. It is, however, difficult to determine whether the time horizon of the

[9] Another issue is the independency of accountants. This can be improved by the following measures: let the relationship between accountant and company only last 7 years maximally; let the board of commissioners choose the accountant instead of the management of the company; forbid a combination of accountancy and other services delivered by the accountancy bureau to the company; make the revenues of the controlling accountant publicly known in the annual report of the company.

companies is long enough (in absolute terms). In order to stimulate a long time horizon, more active long-term forms of shareholding should be encouraged. Large shareholders should be under a duty to be more active and vocal in corporate governance processes. The government should change the composition of the board of commissioners and improve voting rights of large and stable shareowners. More voting rights for small shareholders may, however, hamper the working of the reputation mechanism.

Fourth, our research indicates that the labour market provides a number of incentives to invest in a good HRM reputation and ethical climate. The government could enhance the reputation mechanism by giving information about HRM policies of employers. The council of Social Affairs and Employment in the Netherlands, for example, have developed an employability index which enables employees to look which sector gives employees the best possibilities to develop their own employability (De Grip et al, 1999).

Fifth, the incentives from the consumer market are less obvious. Although consumers are sometimes prepared to punish companies with a bad reputation and to reward companies with a good reputation, there remains a large portion that does not react whereas the duration of consumer responses is relatively short. A traditional way of government intervention is to provide subsidies for ethical produced products and tax products that generate damage (Kruitwagen et al, 2002). In addition, the government could stimulate the provision of information about ethical products. Curlo (1999) shows that the provision of negligence information heightens consumer concerns for safety and firms' ethical behaviour, and increases the proportion of consumer choices in favours of the brands sold by manufacturers with a favourable track record for quality. Furthermore, a relevant task of the government could be to watch that the information about products is reliable. This can be reached be helping companies or sectors to set up a reliable product or process label.

Sixth, the financial market seems to provide modest but growing incentives to the reputation mechanism. There is substantial evidence that the loss of a good reputation reduces the stock value of the company (in particular in the case of illegal actions). However, it is uncertain whether this really induces companies to prevent this kind of actions in the future. Furthermore, although ethical investment is growing, the largest share is still invested in normal funds. The government could enforce these incentives in several ways. For example, it could encourage long-term investment and improve the voting rights of large and stable investors (see above). In addition, it could subsidize ethical investments.

Overall, we conclude that the reputation mechanism certainly helps to reduce market imperfections. This especially holds for large companies operating in oligopolistic markets and markets characterized by monopolistic competition. For small companies and companies operating in monopolistic markets, the strength of the reputation mechanism is less obvious. Too much faith in the self-enforcing working of the reputation mechanism is unwarranted for these companies. Hence, government regulation remains important, especially with respect to the creation of transparency. A well ordered law system will also help private agents to determine what kind of behaviour should be rewarded or punished.

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