Strategic CSR and Competition in the Tourism Industry.
A Theoretical Approach.

Evangelos Mitrokostas* and Alexandros Apostolakis**

*Corresponding author, Dept. of Economics, Portsmouth Business School, University of Portsmouth, Richmond Building, Portland Street, Portsmouth PO1 3DE
email: evangelos.mitrokostas@port.ac.uk,
tel.: 0044 (0)23 92844133, fax: 0044 (0)23 9284 4037

and

**Dept. of Economics, Portsmouth Business School, University of Portsmouth
Richmond Building, Portland Street, Portsmouth PO1 3DE
email: alex.apostolakis@port.ac.uk

Abstract

The present paper aims to shed some light on tourist firms' incentives to engage in corporate social responsibility activities in an imperfectly competitive environment. The focus on CSR in the tourism sector has emerged due to the existence of a critical mass of consumers' willingness to pay a premium for such initiatives. A problem however emerges in the production of corporate social responsibility activities from the supply side. This is because entrepreneurs exhibit a strong free riding behaviour in their provision. The theoretical results illustrate that the existence of voluntary certification schemes would provide firms a more efficient framework to undertake CSR efforts.

Keywords: Corporate Social Responsibility, Information Asymmetries, Certification Schemes

Strategic CSR and Competition in the Tourism Industry.

A Theoretical Approach.

Abstract

The present paper aims to shed some light on tourist firms' incentives to engage in corporate social responsibility activities in an imperfectly competitive environment. The focus on CSR in the tourism sector has emerged due to the existence of a critical mass of consumers' willingness to pay a premium for such initiatives. A problem however emerges in the production of corporate social responsibility activities from the supply side. This is because entrepreneurs exhibit a strong free riding behaviour in their provision. The theoretical results illustrate that the existence of voluntary certification schemes would provide firms a more efficient framework to undertake CSR efforts.

Keywords: Corporate Social Responsibility, Information Asymmetries, Certification Schemes

1. INTRODUCTION

The present paper aims to develop a theoretical model in order to examine tourist firms' economic incentives to engage in Corporate Social Responsibility activities. Corporate social responsibility can be defined as "a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis" (European Commission, 2001). According to Frey and George (2010), corporate social responsibility efforts may include a wide range of activities in line with the stakeholders' interests. Corporate social responsibility activities of this type are difficult - if not impossible - to be inferred by consumers, through search or consumption. In this context, the paper argues that the socially responsible attributes attached to the tourism product, through firms' corporate social responsibility activities, are classified as credence good (Auriol and Schillizzi, 2003).

The vast majority of theoretical models in the field focus mainly on the environmental impact minimization aspects of corporate social responsibility (Blanco et al., 2009). In fact the majority of the literature demonstrates that tourist entrepreneurs would have a strong incentive to under invest in voluntary environmental upgrading actions (see for instance, Calveras and Vera-Hernandez, 2005; Candela and Cellini, 2006; Pintassilgo and Albino, 2007). The main reason for this is free riding behavior. Yet, corporate social responsibility by definition encompasses a much broader set of activities. Ostrom (1990) formalizes Hardins's (1968) model on the "tragedy of the commons" in a game theoretic context. His main finding is that in equilibrium, due to the prisoner's dilemma predicament, no firm has an incentive to engage in costly actions that can improve the environment. Blanco et al. (2009) extended Ostrom's (1990) model. They found that under full information disclosure conditions regarding voluntary environmental activities, and assuming asymmetric firms regarding the cost

of CSR for certain parametrical values, there exist a number of asymmetric equilibria in which a firm can engage in CSR actions.

1.1 Research questions

The present paper focuses on firms' incentives to engage in corporate social responsibility (CSR henceforth) activities in an imperfectly competitive environment, where strategic interactions between competing firms may arise. More specifically we attempt to address the following questions:

- First, what are the main factors that influence tourist firms' decisions to strategically engage in CSR activities?
- Second, what are the policy measures that must be implemented in order to enhance CSR activities by firms?

The rest of the paper is structured as follows: the next section deals with the theoretical background of the model. Section 3 considers the role of the information disclosure mechanism. Section 4 discusses some policy implications, while section 5 concludes the discussion.

2. THEORETICAL BACKGROUND

In this section we propose a theoretical model to demonstrate the factors that influence firm decisions regarding CSR activities. More specifically, the paper extends the theoretical model proposed by Blanco et al. (2009) by relaxing three important assumptions.

First, we introduce consumers' heterogeneity regarding CSR activities. We assume

that consumers differ regarding their social-environmental consciousness and therefore their willingness to pay for such initiatives (Moutinho, 2000; Poon, 1994; Dodds and Joppe, 2005 and PATA, 2007. More specifically, we assume that consumers are homogeneous towards the physical characteristics of the touristic product (they all enjoy the same levels of utility by visiting the same destination) but heterogeneous towards CSR activities connected to the destination (a socially conscious consumer will exhibit a higher willingness to pay for accommodation services provided by CSR oriented firms).

Second, following Porter and Kramer (2006) and Bottega and De Freitas (2009), we treat CSR as a credence good. More particularly, we assume (the existence of) information asymmetries in the consumption and production stages of the tourist product/service. Thus, consumers cannot identify CSR related production approaches, even post – consumption (Frey and George 2010). In this context this paper argues that the socially responsible attributes attached to the tourism product, through firms' CSR activities, are classified as credence good (Auriol and Schillizzi, 2003). Hence, socially conscious consumers may not be in a position to distinguish which firms are truly engaging in CSR activities without a credible information disclosure mechanism (CIDM henceforth). The credence aspect of CSR activities generates a *moral hazard* problem. Once consumers have been convinced that a firm has undertaken CSR efforts, the firm has an incentive to renege on this promise and avoid any spending on costly CSR activities (Besley and Ghatak, 2007).

Third, based on empirical results from Goodman (2000) and Rivera (2002) we assume that socially conscious consumers are only willing to pay a price premium to firms

that are connected to CSR activities. Therefore, under the existence of perfect information about firms' social responsibility initiatives, consumers will not be willing to pay a price premium to firms that are not connected to CSR activities. As a consequence, and in contrast to Blanco et al. (2009), we argue that there cannot be any free ride markup pricing by firms that have not engaged in CSR activities.

Given the above analysis, on the demand side, we assume that there is a unit mass of consumers. A fraction $0 \le a \le 1$ of more socially conscious consumers are willing to pay a higher price for the tourist product connected to CSR initiatives. Similarly, a fraction (1-a) of consumers are not willing to pay a premium price for CSR related touristic firms. On the supply side, we assume for simplicity that we have N firms offering the same quality of tourism services in the same destination. Indicatively, this assumption could be taken to imply that all tourist firms offer hospitality services at the same destination.

Following Blanco et al (2009), the price in which firm i sells its product is given by:

$$p_i = A + k_i \tag{1}$$

Where p_i is the overall price charged to consumers, A is the part of price that is not connected to CSR activity and, k_i is the premium on price to the firm believed by the consumers to engage into CSR activities. Here, we assume that socially conscious consumers will only increase their willingness to pay for the product of the firm that engages in CSR. Due to the credence attribute of CSR, we also incorporate all the positive demand effects from CSR activities to the parameter k_i to including the benefit to the firms that free ride on other firms' CSR activities. This assumption does

not change the results qualitatively, since the benefits from free riding are measured separately as in Blanco et al. (2009). Yet, the possibility that firms engaging in CSR and still free ride is also incorporated in our model.

Hence, the profit function of firm *i* is given by:

$$\pi_i = \begin{cases} aq_i(A+k_i)-c_i-c_A-F_i, \, for \, 0 \leq a \leq 1, \, if \, the \, firm \, undertakes \, CSR \\ (1-a)q_iA-c_A, \, for \, 0 \leq a \leq 1, \, if \, the \, firm \, does \, not \, undertake \, CSR \end{cases}$$

(2)

Where, c_i, F_i are the corresponding values of the variable and fixed costs related to costly environmental action, and c_A the cost of the firm that is not connected to CSR. q_i is the quantity sold by firm *i*. Equation (2) formalizes the idea that CSR has two opposite effects on profits. More specifically, engaging in CSR activities may increase the willingness to pay for the group of consumers that are socially conscious. On the other hand, engaging in CSR activities may include actions that increase the variable costs of the firm, such as using environmentally friendly inputs, or pay fair wages to employees. Moreover, it may include fixed costs such as green investments that reduce pollution (Frey and George, 2010).

3. THE ROLE OF THE INFORMATION DISCLOSURE MECHANISM

3.1 Strategic incentives for CSR without a CIDM.

In this section we demonstrate firms' incentives to undertake CSR initiatives given the context described above. We assume that there is no CIDM regarding firms' CSR activities. Therefore we allow for the possibility that some firms will choose to pretend CSR orientation and therefore free ride on other firms' CSR efforts. However, given that the final outcome is obvious to consumers,, if no firm has engaged in CSR, then there is no positive contribution on the common pool resource and therefore

there is no possibility for free riding.

Therefore a firm's strategy space contains the following choices: *First,* to engage in CSR activities, by undertaking the corresponding costs and aiming to capture the positive demand effects through the price premium that socially conscious consumers are willing to pay. *Second*, not to undertake any environmentally friendly activities and aim to the residual demand from the group of consumers that are not willing to pay a premium for tourist products connected to CSR activities. If the firm opts for the second strategy, due to the credence attribute of CSR activities and the existence of information asymmetries between firms and consumers, it can then also choose to free ride on other firms' CSR activities. That is, not to undertake any costs related to CSR activity, but claim to do so, in order to benefit from the price premium.

Following Blanco et al. (2009) we assume that each firm produces one unit of output ($q_i=1$) and A, c_A are common to all firms since the product is homogeneous. Moreover, for simplicity, we reduce the number of players to two. Given the outcome of each firm's strategy we obtain the following table:

Table 1: Payoff matrix without a CIDM.

		FIRM 2	
		CSR	NO
FIRM 1	CSR	$\pi_1 = a(A+k_1) - c_1 - c_A - F_1$ $\pi_2 = a(A+k_2) - c_2 - c_A - F_2$	$\pi_1 = a(A+k_1) - c_1 - c_A - F_1$ $\pi_2 = a(A+k_2) - c_A$ or $\pi_2 = (1-a)A - c_A$
	NO	$\pi_1 = a(A+k_1) - c_A$ or $\pi_1 = (1-a)A - c_A$ $\pi_2 = a(A+k_2) - c_2 - c_A - F_2$	$\pi_1 = a(A+k_1) - c_A$ or $\pi_1 = (1-a)A - c_A$ $\pi_2 = a(A+k_2) - c_A$ or $\pi_2 = (1-a)A - c_A$

By illustrating the Nash equilibrium conditions in this game, the following observations are in order:

Since, $a(A+k_i) - c_i - F_i \leq a(A+k_i)$ for all $c_A, F_i \geq 0, i = 1, 2$, then engaging in CSR is strictly dominated strategy for each firm, since profits from undertaking costly CSR activities are always lower as compared to the profits arising from free riding. Hence, this result implies that in equilibrium, firms would never choose to engage in CSR activities. This is because costs associated with CSR compliance outweigh any possible benefits.

Now firms have to choose between pretending to be CSR oriented and avoid undertaking any of the costs associated with CSR activities, or not engaging in CSR at all. By taking in to consideration the time consistency of the game, the only possible outcome is that no firm will actually engage in CSR. Assuming that the price premium is high enough, both firms will have a strong incentive to pretend to be CSR oriented in order to benefit from the price premium and then avoid undertaking any of the costs associated with CSR activities. The equilibrium outcome in this case actually corresponds to Akerlof's (1970) "Market for Lemons" problem. More

specifically, consumers rationally believe that firms have undertaken no CSR activities and the market for CSR collapses, since, given their anticipations, the fraction of consumers that are willing to pay for a price premium related to firms' CSR activities is reduced to zero. Therefore, both firms will choose not to engage in CSR at all. The rationale behind this result lies on the absence of a credible information path that would allow firms not connected to CSR to benefit from the positive demand effects associated with CSR activities.

Hence, in contrast to Blanco et al. (2009), we find that due to the existence of asymmetric information there are no incentives for firms to engage in CSR activities. This is in line with the prisoner's dilemma situation presented by Ostrom (1990). Note that we do not exclude the possibility of firms deciding or even pretending to engage in CSR, or asymmetric equilibria in which one firm decides not to pretend to be CSR oriented, while the rival does. This will depend on factors that will be analyzed in the next subsection.

3.2   Strategic incentives for CSR with a CIDM.

Let us now assume that there is a CIDM through which firms communicate their CSR activities. This mechanism could be a certification body run by firms or the local authorities. Following Bottega and De Freitas (2009), we make the additional assumption that monitoring is almost perfect, i.e., the probability that the certifier identifies the cheating firm is almost one. This means that consumers that observe the CSR certification of a product are aware that the certified firm is socially responsible and complies with imposed standards. Hence, due to certification there is no possibility that firms can free ride on other firms' CSR actions. Therefore, firms'

strategic options are now reduced to the following choices: engage in CSR activities, or not. Given the outcome of each firm's strategy we obtain the following table:

Table 2: Payoff matrix with a CIDM.

		FIRM 2	
		CSR	**NO**
FIRM 1	**CSR**	$\pi_1 = a(A+k_1) - c_1 - c_A - F_1$ $\pi_2 = a(A+k_2) - c_2 - c_A - F_2$	$\pi_1 = a(A+k_1) - c_1 - c_A - F_1$ $\pi_2 = (1-a)A - c_A$
	NO	$\pi_1 = (1-a)A - c_A$ $\pi_2 = a(A+k_2) - c_2 - c_A - F_2$	$\pi_1 = (1-a)A - c_A$ $\pi_2 = (1-a)A - c_A$

By considering the above, each firm would engage in CSR only if the corresponding profits are higher than not engaging in CSR activities. Therefore, the following condition must hold:

$$a(A+k_i) - c_i - F_i > (1-a)A, \ i = 1, 2 \tag{3}$$

From (3), the following observations are in order: The group of consumers that are socially conscious (a) and therefore exhibit a higher willingness to pay for the tourist product connected to CSR, is positively related to firms' profits from CSR activities. This means that these consumers are also positively associated with the firm's incentives to engage in CSR. The level of the mark up on the price that firms can charge because of their CSR activities also increases the profits associated with CSR. Consequently, the motivation to engage in CSR activities increases accordingly. However, the higher the corresponding cost of CSR activities, the lower the firm's

incentive to engage in CSR activities.

Due to the elimination of information asymmetries and the existence of a CIDM, it is possible to obtain equilibria in which both firms will choose to engage in CSR activities. This will allow firms to realize possible benefits from CSR due to positive demand effects from socially conscious consumers. However, such equilibria will only emerge if there is a critical mass of consumers that are willing to pay a relatively high mark up on price for such activities in order to compensate firms for the corresponding costs. Of course asymmetric solutions, in which one firm actually engages in CSR actions while the other is not, cannot be excluded as a possible equilibrium. Assuming asymmetry of operational costs and the investments needed in order to engage in CSR activities, it is most possible that firms that actually are in a position to undertake CSR are those with lower operational costs (Khanna 2001).

4. POLICY IMPLICATIONS

The results above give rise to some interesting policy implications. Since by definition CSR is taken to imply engagement in environmental and social activities above the requirements of the law, there is no room for command and control measures. However, there is a portfolio of policy instruments that can still be used to enhance firms' environmental and social over compliance.

First, practitioners should create or support a CIDM regarding CSR. Voluntary certification schemes for instance can impose certain CSR standards that firms must comply with in order to be certified as socially and environmentally friendly. The scheme above could communicate the information to socially and environmentally conscious consumers and therefore could trigger the positive demand effects on firms'

CSR related products. Furthermore, voluntary certification schemes could prevent any future attempts for free riding behaviour by firms that do not comply with the standards. Voluntary certification standards such as ISO 26000 are examples of realization of the above analysis. This measure is in line with the empirical evidence by Rivera (2002, 2004) on Costa Rican Certification scheme for Sustainable Tourism.

Second, the authorities should also support activities that would reduce the cost of the investment associated with CSR actions. Such examples could be collective solutions such as tourism collaborations and partnerships for sustainability (see for instance WTO, 2001, 2002). Joint CSR investments could create economies of scale at an individual firm level. Moreover, the exchange of knowledge between firms on CSR related strategies could help them implement more efficient managerial practices in order to achieve effective environmental and/or social levels.

Furthermore, common expenditure in communicating such activities may increase consumers' social consciousness. Correspondingly, such an activity could generate positive effects on firms' demand levels by increasing the relative size of the socially conscious consumers in the market. While it is true that in most industries firms try to communicate their CSR activities through advertising and publishing CSR reports, yet these are not always considered trustworthy by the consumers (Tsoutsoura, 2004; Porter and Kramer, 2002). Therefore, communicating CSR activities to consumers through an independent third body such as collective organizations or certification organizations could potentially reduce the cost of advertising by individual firms and provide a more trustworthy source of information to consumers. Potentially, this is an area that governments could become more active by evaluating and testing the

relevance, accuracy and truthfulness of the relative message reaching the consumer.

5. CONCLUSIONS

In this paper we have developed a theoretical model to examine tourist firms' economic incentives to engage in costly CSR activities. Our main findings contribute to the debate by Blanco et al. (2009) on tourist firms' strategic incentives to engage in CSR. We find that under the existence of information asymmetries regarding CSR activities, firms do not have an incentive to engage in CSR. However, if a credible information disclosure mechanism exists that communicates to consumers all the necessary information about firms' CSR activities, then it is possible that firms would have an incentive to engage in such actions.

In this case, the factors that influence firms' decision would be the size of the group of socially conscious consumers, the level of the price premium that firms can charge to CSR conscious consumers, and the costs underlying CSR activities. In this direction the paper makes recommendations on a set of managerial practices that would enhance firms' incentives to engage in CSR, such as certification of CSR activities by tourism firms, and initiatives that would provide tourism firms a more efficient framework to undertake CSR efforts.

Our findings also provide guidelines for future empirical work in examining the effects of tourist firms' CSR activities on their market performance. First, do CSR certified firms perform better as compared to those that are not? Second, what kind of certification mechanism (facilitating information disclosure) leads to higher price premium? This is an important question that has direct implications to the

management of these schemes. Last but not least, future empirical work should examine consumers' preferences for future or hypothetical policy initiatives related to certification schemes. This is an equally significant task because it could inform managerial and practitioner decision making based on the examination of consumers' future preferences.

Bibliography:

Akerlof, G. (1970), 'The Market for 'Lemons: Quality Uncertainty and the Market Mechanis', Quarterly Journal of Economics, vol.84, No.3, pp.: 488–500

Auriol, E., Schilizzi, S. (2003), 'Quality signaling through certification. Theory and an Application to Agricultural Seed Markets', Institut d' Economie Industrielle (IDEI), Toulouse, IDEI Working Paper, No. 165

Besley, T., Ghatak, M. (2007), 'Retailing public goods: The economics of corporate social responsibility', Journal of Public Economics, vol. 91, pp.: 1645-1663.

Blanco E., Ray-Maquiera J., and Lozano J. (2009), 'Economic Incentives for Tourism Firms to Undertake Voluntary Environmental Management', Tourism Management, vol. 30, No. 1, pp.: 112 - 122

Bottega, L., De Freitas, J. (2009), 'Public, private and not for profit environmental regulation', Journal of Economics and Management Strategy, Vol. 18, pp.: 105-123

Calveras, A., and Vera-Hernandez, M. (2005), 'Quality Externalities Among Hotel Establishments: What is the Impact of Tour Operators?', Tourism Economics, vol. 11, pp.: 571–593.

Candela, G., and Cellini, R. (2006), 'Investment in Tourism Market: A Dynamic Model of Differentiated Oligopoly', Environmental and Resource Economics, vol. 35, pp.: 41–58.

Dodds, R., and Joppe, M. (2005), 'CSR in the tourism industry? The Status of and Potential for Certification, Codes of Conduct and Guidelines', I.C. Department, International Finance Corporation, World Bank Group.

European Commission, (2001), 'Promoting a European Framework for Corporate Social Responsibility', Green Paper and COM 366, Brussels.

Frey, N., George, R. (2010), 'Responsible Tourism Management: The Missing Link Between Business Owners' Attitudes and Behavior in the Cape Town Tourism Industry', Tourism Management, Vol. 31, pp.: 621–628.

Hardin, G. (1968), 'The Tragedy of the Commons', Science, Vol.163, pp.:1243–1248

Hiscox, M.J. Smyth, N.F.B. (2006), 'Is There Consumer Demand for Improved Labor Standards? Evidence from Field Experiments in Social Product Labeling', Working Paper, Harvard University

Moutinho, L. (2000), 'Trends in Tourism', In L. Moutinho (Ed.), *Strategic Management in Tourism* (pp. 3–16), Wallingford: CABI Publishing.

Ostrom, E. (1990), (17th ed.), 'Governing the Commons: The Evolution of Institutions for Collective Action', Cambridge University Press: New York

PATA, (April 2007), 'Asia Travel Intentions Survey', Pacific Asian Travel Association

Pintassilgo, P., and Albino, J. (2007), 'Tragedy of the Commons in the Tourism Accommodation Industry', Tourism Economics, Vol. 13, pp.: 209–224.

Poon, A. (1994), 'The New Tourism Revolution', Tourism Management, Vol. 15, pp.: 91–92.

Porter, M.E., Kramer, M.R. (2006), 'Strategy and Society: The Link Between Competitive Advantage and Corporate Social Responsibility', Harvard Business Review, Vol. 84, pp.: 76-92.

Porter, M.E., Kramer, M.R. (2002), 'The Competitive Advantage of Corporate Philanthropy', Harvard Business Review, Vol. 80, pp.: 56-68.

Rivera, J. (2002), 'Assessing a Voluntary Environmental Initiative in the Developing World: the Costa Rican Certification for Sustainable Tourism', Policy Sciences, Vol. 35, pp.: 333–360.

Rivera, J. (2004), 'Institutional Pressures and Voluntary Environmental Behavior in Developing Countries: Evidence from the Costa Rican Hotel Industry', Society and Natural Resources, Vol. 17, p.: 779–797.

Tsoutsoura, M. (2004), 'Corporate Social Responsibility and Financial Performance', Center for Responsible Business, Haas School of Business, University of California at Berkeley. Working paper No 7