

Sustainability and System Change

Wal-Mart's Pioneering Strategy

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On October 24th, 2005, Lee Scott, CEO of Wal-Mart, gave one of the most important business speeches ever. In it, he committed the largest company in the world to making zero waste, using 100% renewable energy and selling sustainable products. The implications are huge. These goals cannot be achieved without broad systemic changes in areas including supply chain, regulatory and consumer awareness. To achieve its goals, Wal-Mart is integrating system change efforts into its sustainability strategy. By doing so, it is pioneering what may be the first sustainability strategy that actually has the potential to achieve sustainability (sustainability relates to ensuring society survives and prospers over the long-term).

This article discusses the need to better address systemic issues that essentially compel all firms to negatively impact society. It also describes why sustainability will be *the* competitive advantage strategy of the 21st century and how Wal-Mart is capitalizing on this opportunity.

System-Watch

All companies produce negative environmental and social impacts. As companies impact the closed Earth system, pushback from the system is inevitable. This pushback can take the form of activist campaigns. As the largest company in the world, Wal-Mart has high environmental and social impacts. Several activist efforts have arisen in response to these impacts, including the recent film *Wal-Mart: the High Cost of Low Price*. Activist efforts probably were one factor in Wal-Mart's decision to adopt an aggressive sustainability strategy.

Activist campaigns have driven large improvements in society. Many of the environmental and social improvements over the past 50 years were initiated by such efforts. Now it appears a partial refocusing of activist efforts on systemic issues (ie: a System-Watch) is needed. Companies can improve in many ways. Activist pressure to encourage this should continue. However, firms cannot mitigate many of their impacts mainly because overarching economic and political systems essentially make it impossible to do so.

To illustrate, the criticisms made in the recent Wal-Mart film could be made of many other companies. Because Wal-Mart is so large, it appears to be getting blamed for even larger systemic problems. For example, the demise of small-town America began long before Wal-Mart opened its doors. Sadly, the US has many small towns in decline. The vast majority of these don't have Wal-Marts. The spread of chain stores contributes to the closing of local businesses. But this mostly cannot be blamed on Wal-Mart. Wal-Mart is simply the most successful at playing by the current rules of the game, rules that largely do not account for the closing of small businesses and many other negative impacts.

The much larger driver of the demise of small-town America, as well as nearly all other environmental and social problems, is our society's embrace of a system that does not adequately balance economic with other interests. Failing to focus on this creates frustration for all and ensures little progress in protecting future generations. No CEO wants to hurt society or leave a legacy of environmental destruction. The strong intention of CEOs is to enhance society by ensuring their companies provide maximum value to

customers/citizens. It is only by doing this, that the company can prosper and thus maximize value to shareholders.

The problem is not lack of strong sustainability efforts or good intentions. The situation usually is well-intentioned business leaders trying to do the right thing in a system that often compels them to do the wrong thing. For example, if we tell business leaders to take care of five things (the environment, children, employees, communities and shareholders), but then say, we're only going to measure and reward you for one thing (taking care of shareholders), of course problems will be created in the other four areas. Going further, if we say you'll be fired and possibly sued if you put anything ahead of shareholders, we guarantee that anything other than shareholders will always take a distant second in priority.

Mitigating negative impacts and acting more responsibly can enhance profitability and provide many business benefits. However, this is only true up to a point. Beyond a certain point, impact mitigation increases costs and weakens competitive position. If a company continues too far down the responsibility path by eliminating too many of its negative impacts, it will put itself out of business. In other words, current economic and political systems create a situation where corporate survival often demands that firms damage the environment and society. This is not sustainable because firms ultimately will not survive if they consistently degrade the environmental and social realms that support them.

Nearly all efforts in the corporate sustainability movement have focused on perhaps 20 percent of the problem – company level issues (ie: reducing pollution, making safe products, taking care of workers, acting responsibly in developing countries, etc.). However, probably 80 percent or more of the unsustainability problem is related to system level rather than company level issues. In one sense, systemic issues are nearly 100 percent of the problem. If rules were changed in a practical and reasonable way that held firms fully responsible for the cost of negative impacts, then full responsibility and sustainability would become the profit-maximizing path. Firms would do the right thing because it would also be the most profitable thing.

Activist efforts provide a valuable service to society by pushing firms to act more responsibly. However, when activists blame companies for impacts that essentially are systemically mandated and thus beyond the control of firms, everyone gets frustrated. Business leaders try hard and want to do better, but can't. Activists want more progress, but don't get it.

Highlighting the fact that companies cannot mitigate many of their negative impacts does not relieve them of responsibility for these impacts. Instead it encourages a more practical approach to sustainability by partly shifting the focus from the corporate level to the system level. As companies recognize that systemic issues force them to damage society and the environment in many ways, they have an obligation to work for system change.

Activist efforts can more effectively promote sustainability by simultaneously encouraging firms to aggressively mitigate impacts wherever possible and also encouraging them to aggressively work for system change whenever impact mitigation is not possible. To ensure the survival and prosperity of current and future generations, system change must become a major focus of business and society.

System Change

Evolving economic, political and social systems in a way that maximizes the well-being of current and future generations is by far the most difficult challenge facing business and society. There are no easy answers. Probably no single person or group knows how to do it. Effective solutions can only be

developed in a collective, collaborative manner. Three principles can help in guiding system change efforts – systems thinking, responsibility and practicality.

Systems Thinking. Einstein said we could not solve our largest problems from the level of thinking they were created. Existing economic and political systems were developed from a reductionistic perspective that does not take the whole system into account. As a result, they are inherently flawed. To evolve these systems in a way that eliminates conflicts between what's best for business and what's best for society, a systems perspective must be adopted. This increases complexity hugely. Nevertheless, success probably can only be achieved through this higher level of thinking.

Humans are surrounded by an almost infinite level of complexity, in our bodies and in nature. Being part of nature, we have the capacity to operate at a much higher level of complexity and sophistication than that reflected in our current economic, business and political systems. The issue is not can we do it, but rather can we develop the will to do it. Reality will greatly assist in this area. Human systems operate at odds with nature in many ways. If we don't find ways to voluntarily abide by the laws of nature, we will be involuntarily adjusted until we do comply. Environmental and social problems are manifestations of humanity's failure to think and act systemically. As these problems continue to increase, pressure to think systemically and evolve our systems into sustainable forms will also increase.

Responsibility. There are many different economic, political and social system flaws that compel firms to operate unsustainably. Most of these could be rolled up into one overarching system flaw – the failure to hold firms fully responsible for their negative impacts on society. In a competitive market, firms cannot voluntarily go beyond compliance and mitigate impacts completely. Costs would become too high relative to firms that were not fully mitigating. Only when all firms are held fully responsible will sustainability and full responsibility be a viable option in a competitive market.

Practicality. Holding firms fully responsible will be difficult. Quantifying impacts, especially longer-term intangible impacts, is hard. Existing regulations are already burdensome. Altering large, entrenched economic and political systems could be destabilizing to society if it is not done well. Finding practical, reasonable, incremental ways to hold companies more responsible over time is critical to success. For a system change strategy to work, it must respect and operate within existing systems. The strategy should seek system evolution, rather than revolution. Understanding and respecting existing systems in effect means corporate system change efforts must be profit-enhancing or, at worst, profit-neutral. (A sustainability approach called Total Corporate Responsibility, developed by this author, provides a practical, profit enhancing method of driving system change through collaborative efforts.)

Sustainability and Competitive Advantage

The sustainability movement includes corporate, activist and other efforts to ensure that future generations are able to survive and prosper. The movement has been growing rapidly in response to increasing environmental and social concerns. In the social area, technological advances, economic expansion, and increasing media and Internet access provide many benefits, but also dilute and disrupt traditional ways of life. This combined with population growth, a widening gap between rich and poor, and other factors are driving increasing social distress and turmoil in many regions.

Environmentally, population growth and rising living standards are driving rapid depletion of the world's finite resources. Increasing pollution and resource consumption have put every life support system in decline (ie: clean air, clean water, forests, fisheries, wetlands, topsoil, aquifers, biodiversity, etc.), with some regional exceptions. Synthetic chemicals and carbon illustrate how modern lifestyles threaten current and future generations. Industry produces over 80,000 synthetic chemicals. Very few have been tested for safety by an independent third party. Basic physics tells us many of these will disperse into the

land, air and water and accumulate in humans when used. The human body did not evolve in the presence of these chemicals. As a result, many of them are contributing to increasing cancer, reproductive problems and other illnesses.

Carbon emissions from human activities (mainly burning fossil fuels) have increased carbon in the atmosphere to more than 30% higher than at any point in the past 400,000 years. Ice core samples from around the world show that global temperatures closely track atmospheric carbon concentrations. Large climate shifts, such as the onset of ice ages, have coincided with much smaller changes in atmospheric carbon than the change being caused by humans. Given this, it is highly likely that human society is initiating a major climate shift that will cause more frequent and severe storms, coastal flooding, droughts and substantial economic losses. Beyond passing on a degraded environment to future generations, another ethical issue arises. Human society is removing fossil fuels from the Earth's crust about 10,000 times faster than they were placed there. Does this generation have the right to use up oil and other resources, leaving little for future generations?

Business provides many benefits to society, but also plays a major role in the decline of environmental and social conditions. Historically, many of the negative environmental and social impacts of firms have been difficult to identify and quantify. As a result, firms often are not held responsible for impacts. However, as the scale of human activity increases in the finite global system, impacts are becoming more obvious and firms are coming under growing pressure to assume responsibility for them. This pressure can take the form of increasing regulations, lawsuits, market rejection and activist campaigns.

Growing pressure to assume responsibility for negative impacts is making environmental and social issues more financially relevant to firms. Increasingly, firms that are more proactive than peers in addressing these issues gain many benefits, including enhanced reputation and brand value, increased ability to attract and retain a high quality workforce, improved employee morale and productivity, better product and service quality, reduced energy and material costs, lower finance and insurance rates, enhanced community and stakeholder relations, and facilitated access to resources and new markets – all combining to yield enhanced profitability, market share and competitive position.

Rapidly increasing human impacts in a closed system drive shortening feedback loops and make it increasingly clear that everything on the planet is part of one interconnected system – something confirmed by quantum physics and other branches of science. As the world in effect becomes smaller, the ability to think systemically and act responsibly will become the primary driver of business success in the 21st Century.

Wal-Mart's Sustainability Strategy

As corporate impacts increase in a finite system, environmental and social problems are becoming business problems. This is especially true for a company of Wal-Mart's size. As the largest retailer of many types of products, supply constraints driven by environmental and social problems seriously threaten Wal-Mart's ability to prosper.

Wal-Mart has always been a pioneer, going against conventional wisdom in the business community. The company is a leader in thinking outside the box, anticipating market opportunities and executing effective strategies to capitalize on them. It has revolutionized business approaches in areas including supply chain, logistics and serving rural areas. Now Wal-Mart is capitalizing on the sustainability opportunity. By using business power to improve environmental and social conditions, it will enhance its own prosperity.

This approach is highly consistent with Wal-Mart's founding values. More than anything else, Wal-Mart's unprecedented success is driven by a strong and enduring commitment to providing high value and service to its customers. The focus on sustainability is an evolution of the company's values. It is the recognition that serving the customer goes beyond providing high quality, low cost products. It also includes doing so in a responsible and sustainable manner.

Wal-Mart has implemented an aggressive sustainability strategy over the past year and a half. Its rapid progress is due largely to excellence in strategy execution and the strong commitment of senior management. Lee Scott has made it clear that working on sustainability projects can accelerate careers within Wal-Mart. Compensation schemes are being adjusted to provide substantial incentives for improving sustainability performance.

In pursuit of its ambitious environmental goals, Wal-Mart has established many sub-goals and initiatives. Examples include:

- Increase truck fleet efficiency by 25 percent over three years and double it within ten years (which would save over \$300 million per year).
- Design and open a new store prototype within four years that improves energy efficiency and reduces greenhouse gas emissions by up to 30 percent in these stores.
- Reduce greenhouse gas emissions from existing stores, clubs and distribution centers by 20 percent within seven years.
- Establish a US program within 18 months that gives preference to suppliers who aggressively reduce emissions.
- Implement a China program that gives preference to environmentally-responsible suppliers.
- Aggressively pursue regulatory and policy changes that promote energy efficiency and renewable energy.
- Reduce solid waste from US stores and clubs by 25 percent within three years.
- Work with suppliers to reduce packaging, increase recycled content, and expand recycling of packaging.
- Eliminate PVC packaging from private label brands within two years.

Sustainability initiatives in the social area include:

- Sourcing: establish independent monitoring of Wal-Mart's factory certification program; separate the factory certification and buying functions; cease doing business with supplier factories that fail to meet Wal-Mart's ethical standards; collaborate with industry, government and NGOs to improve sourcing in developing countries.
- Healthcare: make healthcare insurance available to all employees for \$23 per month or less and their children for \$15 per month; put healthcare clinics in stores for employees and customers; provide volume discounts on healthcare insurance to small businesses; collaborate with business, government and others on US healthcare reform with the goal of lowering costs by as much as 25 percent.
- Wages: support an increase in the US minimum wage; continue paying market wages.
- Communities: enhance existing community engagement processes with the goal of building mutually beneficial partnerships and better meeting community needs.
- Diversity: increase the percentage of women and minorities in management; tie management compensation to achieving diversity goals; use Wal-Mart scale to assist and grow minority-owned businesses.

This is just the tip of the iceberg. Sustainability is not a separate initiative at Wal-Mart, as it is at many other firms. Sustainability is being integrated into all parts of the business. Beyond its own operations,

an analysis of Wal-Mart's environmental impacts revealed that about 90 percent of them occur in the supply chain. As a result, Wal-Mart has established business networks in several areas, including buildings, fleet, waste, packaging, food & agriculture, seafood, wood products, electronics and apparel. The goal of these networks is to work with suppliers and other stakeholders to drive substantial improvements in sustainability performance. Suppliers proactively working to improve performance have the potential to receive preferred access to Wal-Mart.

Wal-Mart has over 65,000 suppliers. Many are largely or completely dependent on the company for their continued success. As a result, Wal-Mart has unprecedented power to drive change in many industry sectors. It is seeking opportunities to use its scale to drive commercialization of more efficient technologies in areas including transport, refrigeration, lighting and HVAC. The company's size and aggressive approach can help make sustainability a major focus of business in the 21st century.

In today's markets, the healthiest, most sustainable products, such as organic foods, are often too expensive for many consumers. Wal-Mart is working to make these products affordable for everyone. By increasing demand, it plans to lower costs for many types of sustainable products. For example, it is placing large orders for organic cotton and requiring that all US shrimp farms supplying Wal-Mart receive third-party sustainability certification. This approach is not only good for the planet, but also strengthens Wal-Mart's competitive position. Selling sustainable products will attract new customers, many of whom will have higher disposable incomes.

Probably the most important aspect of Wal-Mart's sustainability strategy is the willingness to address system change in a practical way. In the business networks, Wal-Mart and other network partners will consider systemic barriers to sustainability and develop practical ways of addressing them. Actions might include seeking regulatory change, raising public awareness, and working with suppliers to develop more sustainable products.

Wal-Mart's pioneering approach to sustainability has the potential to lead the sustainability movement to a new level. By improving its own operations, forming business networks and addressing systemic issues in a practical way, the company is implementing what may be the first sustainability strategy that actually has the potential to achieve sustainability. They are also modeling what is likely to be the primary strategy for achieving business success in the 21st century.

Frank Dixon advises businesses, governments and other organizations on sustainability, system change and enhancing financial performance through increased corporate responsibility. For seven years, he was the Managing Director of Research for Innovest Strategic Value Advisors, the largest corporate sustainability research firm in the world. At Innovest, he developed financially-focused models and methods for assessing corporate environmental and social performance and helped institutional investors develop high-performing socially-responsible investing products. His work overseeing the sustainability analysis of more than 2,000 firms made it clear that systemic issues compel all firms to operate unsustainably by making full impact mitigation impossible. To engage business and investors in driving the system changes needed to achieve sustainability, he developed a new sustainability approach focused on system change, called Total Corporate Responsibility. He is advising Wal-Mart and other firms on sustainability. He has an MBA from the Harvard Business School. Frank Dixon can be contacted at fdixon@GlobalSystemChange.com.

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