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MORAL IMPERATIVE AND MARKET FORCES: LEGISLATION AND CORPORATE SOCIAL RESPONSIBILITY

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MORAL IMPERATIVE AND MARKET FORCES: LEGISLATION AND CORPORATE SOCIAL RESPONSIBILITY

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Summary

This essay explores the evolution of Corporate Social Responsibility (CSR) from being a purely altruistic/philanthropic-driven idea to a more strategic choice that firms may choose to undertake. However, when considered as a strategic choice, it raises a conflict of interest between the firm and the society. A potential solution to this conflict is through regulating CSR. Descriptive evidence based on mandatory CSR spending introduced in the Companies Act of 2013 in India suggests a nuanced understanding of the role of regulation in balancing societal welfare with corporate interests. Regulation is not a one-size-fits-all solution and there is a need for context-specific evaluations of unintended consequences which can arise from regulating CSR.

Introduction

Corporate Social Responsibility (CSR) has significantly evolved over the years. Initially, CSR activities were largely driven by altruism and philanthropy, with companies donating to charities or engaging in community development projects to give back to society. Typically classified as "intrinsic motivation" for engaging in CSR, this form of CSR was independent of core business operations and thus in principle separating the social objective from the shareholders' expectations. However, the motivation for engaging in CSR activities has also evolved. Firms may also be extrinsically motivated to engage in CSR as it has been shown to have long-term benefits including enhanced firm reputation, lower cost of capital, gain of legitimacy, differentiation of products, and hence increased ability to price higher and overall improving the competitive advantage. For instance, Patagonia has been at the forefront of integrating environmental sustainability into its business model, using recycled materials in its products, and committing to fair labor practices. However, not all CSR activities are considered to improve societal welfare in general.

What is Corporate Social Responsibility?

To begin, let's address the question of what we mean by Corporate Social Responsibility (CSR). CSR refers to the idea that businesses have obligations beyond generating profit and should act in a manner that positively impacts society and the environment. CSR encompasses a wide range of activities including but not limited to ethical behavior within organizations, compliance with the laws of the land, preventing environmental damage, and philanthropic efforts. In the process, CSR shifts the fundamental focus of the firm from merely looking at the benefits for shareholders to considering a more diverse group of stakeholders which includes shareholders, employees, customers suppliers, and the community at large. Finally, adopting a socially responsible approach to business is not just about avoiding harm (e.g. preventing damage to the environment), but actively doing good, demonstrating a commitment to making a positive difference in the world beyond the narrow focus of profit-making.

Fundamentally this can be a value-creating process. For one, given that socially responsible firms are typically those that commit to a greater level of transparency and disclosure, it reduces the overall business risk. This can lead to an enhanced reputation for the firm and lead to investors requiring a smaller risk premium which in turn leads to a lower cost of capital. Further, since customers can also be stakeholders, in many cases they may be willing to pay a premium for products that have been produced sustainably.
Having said that, the fundamental shift from maximizing shareholder wealth to thinking more broadly about stakeholders potentially creates a conflict of interest between stakeholders and the firm. Coupled with the fact that it is rather difficult for stakeholders to verify the true benefits of CSR engagement by firms, it creates a potent avenue for firms to potentially mislead stakeholders regarding their CSR commitment.

Greenwashing

Greenwashing, a term coined in the 1980s, describes the practice by some companies of misleading consumers about the environmental benefits of a

product, service, or company practices. This deceptive marketing tactic is used to capitalize on the growing consumer demand for environmentally friendly and sustainable options without making significant efforts to reduce environmental impact. Greenwashing can erode consumer trust and undermine the efforts of genuinely sustainable businesses by creating confusion around what constitutes true environmental responsibility.
A classic example of greenwashing involves the energy sector, where some companies have been accused of overly promoting their investments in renewable energy sources while a significant portion of their business operations still rely heavily on fossil fuels. For instance, an oil company may launch an advertising campaign highlighting its investment in solar energy, despite solar representing only a minuscule fraction of its overall energy production. This can create a misleading impression of the company's overall environmental impact. More recently Apple's claim that the Apple Watch is "carbon neutral" has been considered potentially misleading and hence falls under the category of greenwashing.

This raises a fundamental question concerning the alignment of interests between the firm and society at large. If the interests of the society are aligned with the firm, then we would expect to see CSR and profitability go hand in hand. However, when the interests of the firm are not aligned with those of society, we are likely to observe a market failure. Under these circumstances, we are likely to see more instances of greenwashing. A potential solution to this problem is to let the government intervene through the regulation of CSR.

Voluntary vs. Mandatory CSR

The debate between voluntary versus mandatory Corporate Social Responsibility (CSR) practices is pivotal in understanding the dynamics and impact of corporate engagement in social and environmental issues. Firms adopting voluntary CSR practices often do so to align with their corporate values, enhance their brand reputation, foster customer loyalty, and attract and retain talent. For instance, tech giants like Google and Microsoft have voluntarily invested billions in renewable energy and carbon offset programs, not just for compliance, but as part of their commitment to sustainability and innovation. The advantages of voluntary CSR include flexibility and the ability to tailor CSR activities to the company's strategic objectives, strengths, and stakeholder expectations. However, the key disadvantage of voluntary CSR has also been the issue of greenwashing.

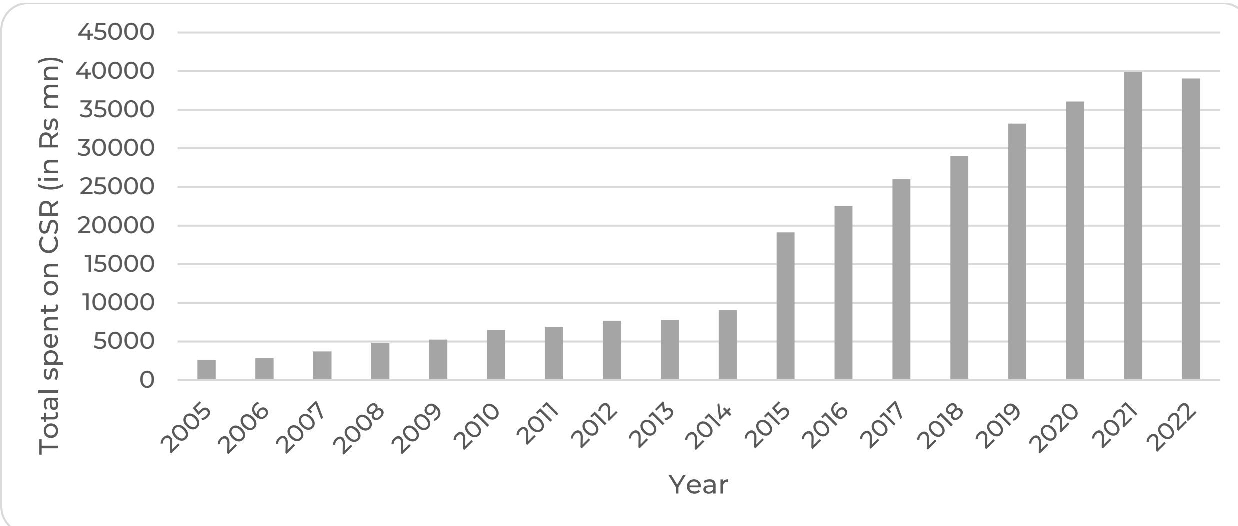
Mandatory CSR, on the other hand, involves legally enforced obligations for companies to engage in certain CSR activities or meet specified CSR standards. The Companies Act of 2013 in India is a prominent example of mandatory CSR, requiring qualifying companies to spend at least 2% of their average net profit of the past three years on CSR activities. The rationale behind mandatory CSR is to ensure a level playing field, where all businesses contribute to societal goals. Several countries such as China, India, Brazil, Denmark, and France, among others, have varying rules and regulations in place for CSR activities.

In this essay, we will look more closely into the regulation introduced in India in 2013. The Indian Companies Act of 2013 which came into force in April 2014, introduced a mandatory CSR (Corporate Social Responsibility) spending requirement for large companies. Specifically, Section 135 of the Act applies to both publicly traded and privately held companies that meet any of the following three criteria:

- Companies with a net worth exceeding INR 5 billion (approximately USD 63 million).
- Companies with a turnover (i.e., sales) exceeding INR 10 billion (approximately USD 125 million).
- Companies with net profits exceeding INR 50 million (approximately USD 0.63 million).

Under this law, firms are also required to establish a CSR committee. The board of directors of the affected company must then approve the CSR policy recommended by the CSR committee and ensure the following. The company should allocate a minimum of 2% of the average net profits before tax over the last three financial years for activities outlined in the firm's CSR policy for any given financial year. There are also disclosure requirements concerning the contents of the CSR policy, which has been developed and implemented, in the Board's report and on the company's website. If a company fails to meet the mandated spending requirement, the Board must provide reasons for this shortfall in its CSR report, as required under Section 134 of the Companies Act. Non-compliance with the Companies Act can result in penalties. At the outset, a simple question that we can ask is – Did the law lead to increased CSR spending?

Figure 1: Total CSR spending over time



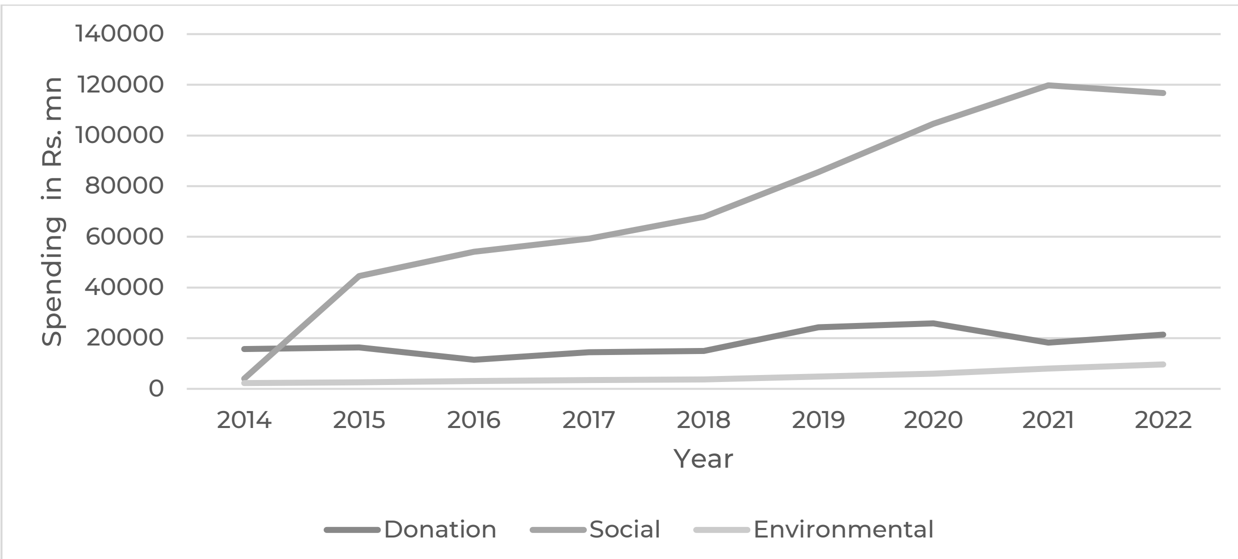
The graph above shows the total spending (across all firms) on CSR activities in India. The data is drawn from the Prowess Database maintained by the Centre for Monitoring the Indian Economy (CMIE). As seen in the graph above, we see a substantial increase in CSR spending starting in 2015 which is the first year where reporting requirements were mandatory. Subsequently, we see a steady growth in spending on CSR activity. This evidence suggests that overall, the primary goal of the regulation seems to be met. However, one can ask: Is this simply a tax levied on firms?

Arguments against Mandatory CSR

Reduced Flexibility and Innovation
One of the key criticisms of mandatory CSR is that it can reduce corporate flexibility in determining the most effective and efficient ways to contribute to societal goals. When companies are required to allocate resources to predetermined CSR activities such as in the case of India where a list of qualifying activities is provided, they may have less opportunity to innovate or to invest in social or environmental initiatives that align more closely with their core competencies or strategic interests. In effect, it would seem more like a tax in this case.

In the case of India, it would be interesting to investigate the data to try and describe if there is evidence to this effect. The various categories of spending in the context of India can be distributed into three groups a) Spending for environmental actions b) Spending for social causes and c) Donations. Next, we break down the total spending into these categories and plot that data over time for firms that were impacted by the regulation.

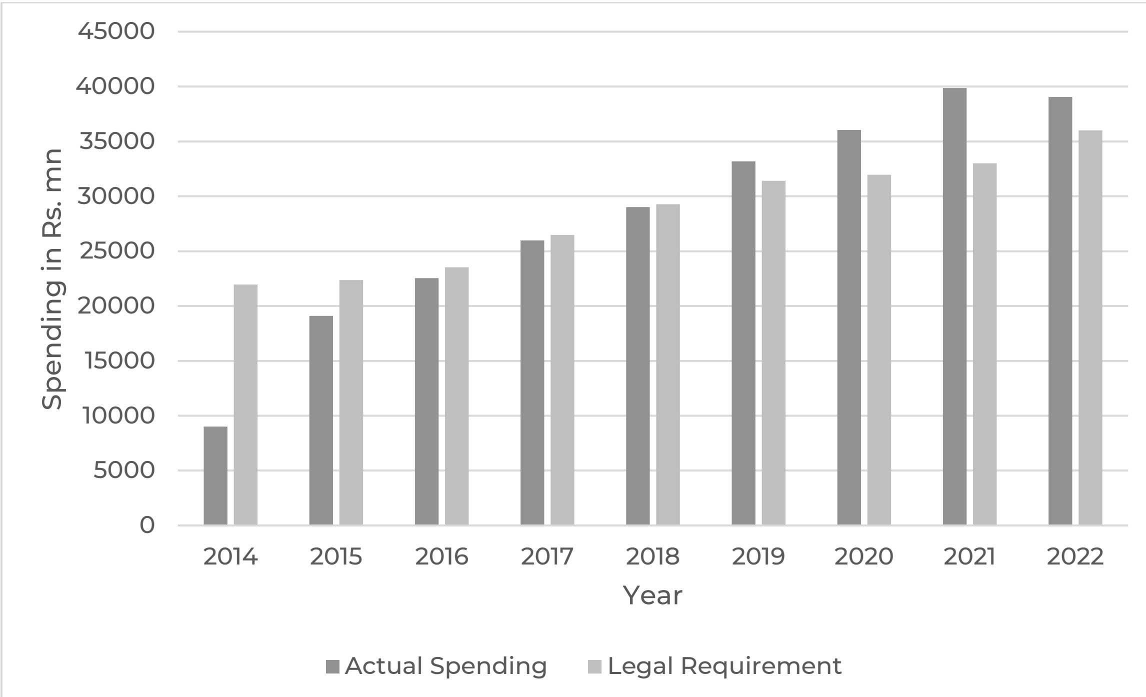
Figure 2: Breakdown of spending post-law over the three categories



As can be seen from the graph, most of the spending was for social causes. The levels for donations and environmental spending were relatively flat over time, indicating that most firms seem to be utilizing spending on social causes (e.g. welfare programs, and investment in education among others). While spending on donations was lower in general it may still be construed as a "tax" as some firms seemed to use donations to satisfy the stipulations of the law.

A second element that one can look at is whether firms are spending more than the legal minimum specified CSR amount. If firms are spending more than the required minimum, it might be suggestive that firms simply don't view the law as being a tax. As can be seen from the graph below, in more recent years we have seen an increase in actual spending as compared to the legally required level. This again is suggestive that it may be viewed as more than just being a tax.

Figure 3: Breakdown of actual CSR spending vs. mandatory requirements

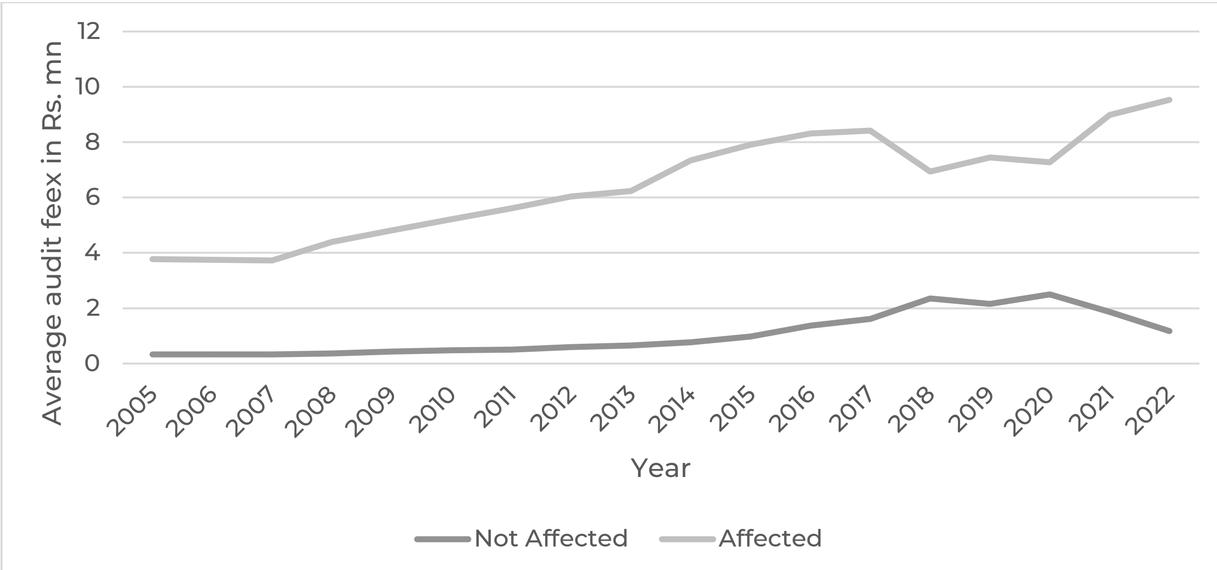


Administrative Burden and Costs

Implementing mandatory CSR activities can impose significant administrative burdens and costs on companies, particularly small and medium-sized enterprises (SMEs) that may not have the same resources as larger corporations. The need to document and report CSR activities to comply with regulations can divert resources from other areas of the business, potentially impacting competitiveness and growth. Moreover, the additional financial burden of mandatory CSR spending can be seen as an indirect tax, which might discourage investment or reduce profitability.

Evidence of this effect can be examined by looking at the cost of audit fees. Since auditors play a central role in ensuring that the firm meets its disclosure and compliance requirements, it would be an interesting example to look at to answer the question of additional administrative costs. Specifically, we look at the audit fee trends for firms that were impacted by the regulation versus firms that were not impacted by the regulation.

Figure 4: Average Audit Fees paid for firms that were affected vs. not affected by the law



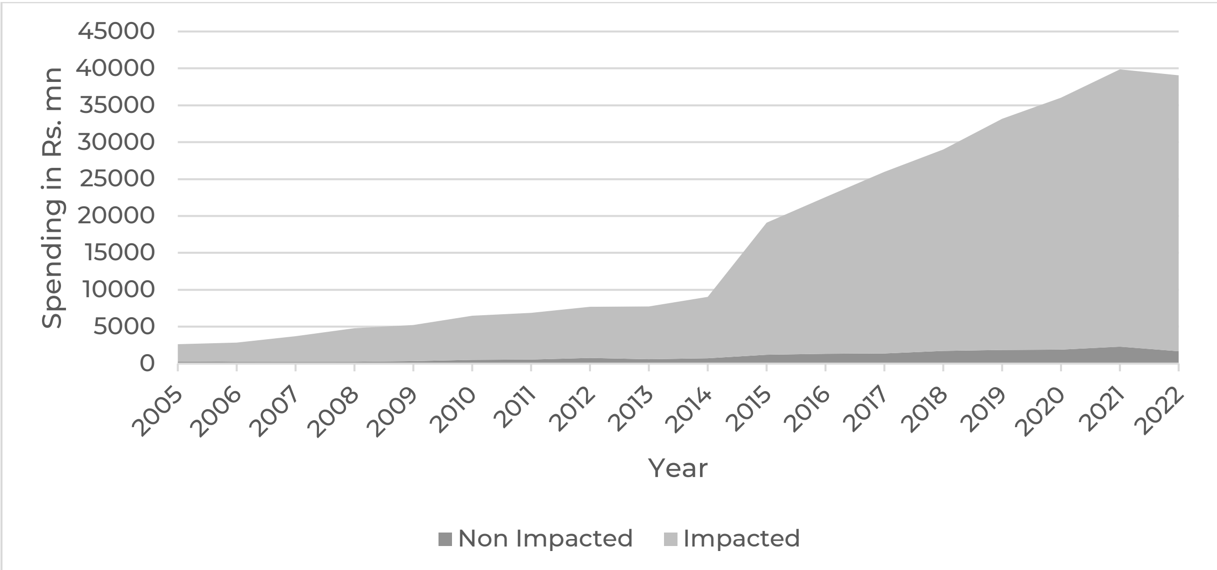
As can be seen from the graph, average audit fees for firms that are not impacted on average is lower than the firms that are impacted which could simply reflect the size effect (larger firms are more likely to be impacted by the law). However, the interesting trend is the gap between the fees for impacted vs. non-impacted firms. We note that this difference has grown since the law was introduced. This evidence seems to suggest that administrative costs indeed seemed to have increased.

Potential for Inequity

Mandatory CSR requirements can also create inequities among businesses, particularly disadvantaging smaller firms that may not have the financial or operational capacity to meet the same standards as larger corporations. This can exacerbate competitive imbalances and potentially drive smaller companies out of the market or discourage entrepreneurship.

There is some evidence that this might indeed be the case. Specifically, the data suggests that most of the spending on CSR is by firms that are affected by the regulation. Thus, if these investments are likely to generate gains for the firms, this is likely to drive a deeper wedge between the firms impacted by the regulation and those that are not in terms of competitive advantage. This could indeed promote further inequity.

Figure 5: Total CSR spending by firms that were affected and not affected by the law



In summary, while mandatory Corporate Social Responsibility (CSR) policies are rooted in the well-meaning objective of guiding corporations towards contributing to the welfare of society and the protection of the environment, their enactment is not free from significant challenges and the possibility of unintended adverse outcomes. Thus, a central question is: should other countries such as the United States, for instance, consider regulating CSR spending? The answer to this is multi-faceted. Prima facie it may not be an ideal solution considering the economic history of the United States where market forces are quite efficient and effective in governance. However, if one were to think along the lines of regulating CSR, it would be imperative to evaluate the unintended consequences of regulating CSR. For instance, if we go by the cutoff thresholds on profits set in India, it will translate to roughly $650,000 in terms of profits for U.S. firms which could mean that a vast majority of small to medium-sized enterprises are likely impacted. This could also potentially be detrimental to growth in entrepreneurial intent. Overall, a comprehensive evaluation must consider the characteristics of the industry sector, the varying sizes and operational scopes of the corporations involved, and the precise societal aims that the CSR endeavors seek to fulfill.