

Corporate Social Responsibility vs. Government Regulation: Institutional Analysis with an Application to Russia

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The paper considers corporate social responsibility (CSR) as an institutional alternative to government regulation, which implements Coase-type bargains between corporations and their stakeholders. Comparative analysis of costs and benefits of these two institutions presented in the paper provides basis for explanation and assessment of various CSR models. Russian CSR is used as an illustration; our analysis reveals strong institutional complementarity between CSR, on the one hand, and protection of property rights and availability of social capital, on the other.

1. Introduction

Societies often have a choice between different institutions serving similar purposes, and exercise it depending on costs and benefits of various alternatives. Such costs and benefits evolve over time and vary from one country to another, which could explain institutional change and diversity across the globe.

One example of such selection from an “institutional menu” is corporate social responsibility (CSR) – a contemporary pattern of corporate behavior which requires companies to be guided not only by narrow financial objectives, but by broader societal interests in sustainable development, clean environment, ethical conduct, protection of social and economic rights etc. Corporate social responsibility has become a standard practice in the modern world, and yet its purpose, rationales, mechanisms and outcomes are still intensely debated. The concept of CSR is wrapped in controversy – it does not fall squarely in the conventional textbook vision of the market economy, where commercial firms maximize profits, governments supply public goods and regulate private sector, and philanthropy, if any, is undertaken by private individuals.

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The institutional theory offers a convenient framework for CSR analysis which produces a clearer vision of CSR role in institutional setups of modern societies. CSR is considered as Coasean bargains between companies and their outside stakeholders, reached over externalities that companies produce. CSR is thus treated as a private institutional alternative to government regulation, and the choice between these two options depends on their relative costs and benefits. We identify and analyze several factors that affect comparative advantages of CSR vs. regulation, and offer a simple model to illustrate their interplay.

The proposed approach can be used to explain, assess and map various CSR models, and we consider the Russian case as an illustration. CSR in Russia has a number of distinct features, prominent among them its abnormally large scale. While it is difficult to provide accurate estimates due to a lack of common definition, unclear methodology, incomplete statistical data and low transparency of the Russian corporate sector in general, the available evidences points to what a Russian expert calls “hyper” socially responsible behavior¹. Social investments of Russian firms, measured as percentage of profit and in comparison with philanthropic donations made by individuals, far exceed similar indicators in the West². The paper relates this outcome to the Russian institutional setup, economic profiles, and state of the civil society. Our analysis reveals a strong institutional complementarity between CSR, on the one hand, and property rights protection and stock of social capital, on the other.

The paper is organized as follows. In the next section we present a definition of CSR that will be used through the rest of the paper. Section 3 interprets CSR in Coasean terms and introduces the tradeoff between CSR and government regulation. Sections 4 to 7 analyze various factors that affect the choice between CSR and regulation, and Section 8 presents the model that sheds light on such choice. In Section 9 the preceding analysis is applied to the Russian case. Section 10 concludes.

2. Defining CSR

CSR remains a loosely defined concept – its meanings and interpretations vary in a broad range from corporate philanthropy to strict observance of laws and regulations safeguarding public interest. A good, albeit incomplete, grasp of this concept is summarized by the view that CSR makes companies to take actions which are not

¹ Y. Pappe; see Chirikova et al., 2005, p. 17.

² US corporations donate to charity about 1% of their pre-tax profits, and in Europe such numbers are even less, whereas in Russia corporate social investments made outside of the company could reach, according to various estimates, from 6 to 17% of corporate profits (Polishchuk; 2006; Blagov et al., 2008). Charitable donations of Russian firms in 2003 were estimated by the Russian chapter of Charity Aid Foundation at \$1.5 billion; the same source estimated personal philanthropy in the country in 2003 at \$100 million, or 1/15th of corporate philanthropy (CAF News Centre, July 8, 2004). In the industrialized countries the ratio is almost exactly the opposite – the volume of personal philanthropy exceeds the corporate one in proportion from 10:1 to 15:1.

directly dictated by markets (Baron, 2001), that is, *available* markets where the company sells its products and buys production inputs. Such actions are meant to control companies' non-market impact on various stakeholders, i.e. parties affected by corporate conduct. In other words, a socially responsible company takes into account and controls *externalities* that it causes.

The conventional tool to handle externalities is government regulation, but a socially responsible company does not simply comply with what is mandated by government, but goes beyond the requirements of law. This leads to a more complete definition of CSR as *corporate behavior which is not directly dictated by either existing markets or governments*³. Such behavior usually takes form of self-restraint or sacrifice driven by ethical, social or environmental concerns. There are two partly overlapping modes of CSR – in the first a company adjusts its business decisions to reduce social costs that its operations entail, and in the second it makes social investments to support various public projects, local communities, charities etc.

A commonly invoked justification of CSR is in the idea of *multiple stakeholders* in corporations (Donaldson, Preston, 1995), of which shareholders form only one group. It is argued that companies ought to be cognizant of their responsibilities before various constituencies in the society which are affected, directly or even indirectly, by companies' actions, and respect and take into account interests of such multiple stakeholders.

Such opinions, however, contradict the traditional view of the corporation as a vehicle to create value for shareholders. This view implies that corporate managers' fiduciary duty is solely to further the interests of shareholders – under the assumption that other stakeholders' interests are taken care of and protected by laws and regulations with which companies have to comply in their pursuit of profit. Burdening companies with other objectives beyond profit maximization within confines of the law would adversely affect their efficiency and thus diminish social welfare – hence the famous dictum of Milton Friedman (1970) that “the social responsibility of business is to increase its profits”.

Contemporary interpretation of CSR reconciles these seemingly contradictory positions by concluding that socially responsible behavior is in companies' ultimate self-interest – it allows corporations “to do well by doing good”. Such affinity could be of two types. The first, known as “free lunch” (Reinhardt, 1999) is a direct “coincidence of wants”, when actions that companies take in pursuit of their immediate business objectives cause *positive* externalities and thus just happen to be in other stakeholders' interests as well (e.g. investments in the labor force or local economic infrastructure that the company needs for its operations). Such behavior, while socially beneficial, cannot be considered as “socially responsible” in the strict sense of the word, because social gains are merely unintended, even if fortunate, by-products of actions taken by self-interested businesses.

In the second type social responsibility has *strategic* motivations: it is intended to trigger or prevent a response of company's counterparts in a way desirable for the company, so

³ Similarly McWilliamds and Siegel (2001) define CSR as “... actions that appear to further some social good, beyond the interests of the firm and that which is required by law” (p. 117).

that in either case socially responsible behavior pays off. Without anticipated counterparts' reaction *direct* consequences of such behavior would be detrimental to the company – hence the appearance of a sacrifice for the sake of public interest.

Positive responses that strategic CSR is intended to produce reward the company by increasing its sales and profits, facilitating access to markets and production inputs, strengthening brand and ensuring loyalty of customers, employees, business partners and other stakeholders. Negative responses that a company is seeking to prevent are sanctions against the company that could be imposed by “injured parties”, should they suffer when the company acts in a “socially irresponsible” manner – such actions could involve boycotts, media campaigns, protest actions, law suits, and advocacy to seek government intervention.

3. CSR and regulation: Coase re-visited

Externalities explain the first part of the definition of CSR as an activity which is not directly dictated by markets. Externalities are ordinarily taken care of by government regulations which either directly limit corporate discretion or impose taxes (provide subsidies) that make companies internalize true social costs and benefits of their actions. However CSR is defined as behavior which is prescribed by neither markets *nor* government, and thus presents a *private alternative* to conventional government regulation of externalities⁴.

For numerous reasons laws and regulations are imperfect tools: they are “incomplete contracts” and leave multiple lacunae where meaning of the law remains unspecified; they are indiscriminate and thus “blunt” instruments that often ignore essential realities on the ground; they can be captured by vested interests, including regulated industries and firms, and, instead of serving the public, turned into sources of rent; their administration could be costly and ineffective; and laws and regulations can be delayed. These shortcomings of official laws and regulations could give a competitive edge to alternative ways to maintain order in society, such as CSR (Webb, 2004; Husted, de Jesus Salazar, 2006).

Since the seminal work of Ronald Coase (1960) private alternatives to regulation are extensively debated in economic literature. In his famous theorem, Coase posits that when transaction costs are low, the involved parties – those that emit externalities and those that are affected – could privately negotiate a mutually acceptable and (Pareto) efficient solution, rendering government involvement unnecessary. From this perspective CSR can be seen as a modern implementation of Coase's idea which allows settling externalities through bargaining between corporations, represented by their shareholders, and, save the agency problem, management, on the one hand, and other stakeholders, on the other.

⁴ An indirect evidence that regulation and CSR substitute for each other can be seen in the fact that ‘... advocates of the free market oppose CSR for the same reasons they oppose government regulation ... whereas advocates of a regulate market favor CSR’ (Ludescher, McWilliams, Siegel, 2008), p. 325).

Parties to Coasean bargains not only coordinate their actions but also agree on sharing the gains of cooperation through side payments; in the case of CSR the latter take form of corporate social investments which can be considered as remedies for possible transgression against stakeholders' "natural rights"⁵. Importantly, such side payments usually go in one direction – from the company to stakeholders, and not vice versa⁶.

Sometimes bargaining that underpins CSR takes explicit form of consultations, roundtables, public hearings, stakeholder forums etc. which lead to obtaining a "social license to operate", i.e. consent of the society and endorsement of the company's *modus operandi* (Porter, Kramer, 2006). Such "license" can also be secured implicitly, when self-restraint and social investments win stakeholders' tacit approval⁷.

Private settlements à la Coase present an alternative to government regulation, but not necessarily a superior one. Indeed, over time societies resorted to different means to maintain order in the economy (Djankov et al, 2003). In traditional societies private orderings prevailed, based on mutual agreements, reputation, social networks etc, but early on litigation emerged as an alternative institution which proved to be more conducive to economic development (Greif, 1994). Industrialization and concentration of production and wealth posed serious challenges to fairness and effectiveness of the justice system, paving way to government regulation as somewhat better protected from influence and capture (Glaeser, Shleifer, 2003). Today's popularity of CSR manifests "the second coming" of the private ordering – apparently this traditional mechanism in its modern version has a number of advantages over regulation, as envisaged by Coase.

Comparative advantages and disadvantages of CSR over institutional alternatives evolve over time and differ from one society to the other. Such variations and change can be used to map, explain and assess observed CSR models and patterns. Economic and social structure, political and cultural tradition, working of government and legal system, and overall institutional setups and path dependencies affect costs and benefits of CSR vis-à-vis regulation. Below we identify some of such factors that influence CSR models by tilting, one way or another, the choice between CSR and regulation, and use the Russian case as an illustration.

⁵ Legal theory distinguishes between *property rules* and *liability rules* (Calabresi, Melamed, 1972) – in the former case property rights can only be transgressed if the owner sanctions such violation, being satisfied by the proposed remedies, whereas in the latter case violation of property rights is possible without a prior sanction of the owner, whose rights are protected ex post through a court-assigned compensation for caused damages. Since socially responsible conduct is not ordered by courts (although is sometimes a means to preempt legal actions against the company), one can conclude that the property rule regime is a better fit for CSR.

⁶ Sometimes firms charge higher prices for "socially responsible" products, such as "fair trade coffee", which could be considered as a transfer from the society to the firm. However this practice is shown to be a price discrimination strategy (Polishchuk, Firsov, 2006) and as such cannot be considered as a reward for socially responsible conduct.

⁷ See (Ludescher, McWilliams, Siegel, 2008) for a discussion of various types of corporate legitimacy secured via CSR by creating benefits for stakeholders, obtaining tacit support and offsetting potential challenges, or 'being socially constructed in discursive processes' (p. 317).

4. Regulatory agenda and capacity

Effectiveness of government regulation depends on the *complexity* of problems that regulation is to address, and on the *capacity* of regulatory bodies to handle such problems. The more complex are regulatory issues and the poorer the regulatory capacity, the better, all else equal, are the chances of CSR to present a viable alternative.

Government regulation, especially in developing and transition countries, works well only if it deals with relatively straightforward matters which require simple regulatory tools. Informational asymmetry often complicates the task of regulators – in such cases regulation can be misguided, wrongly targeted, could unnecessarily suppress market incentives or create rent at the expense of the society (Laffont, Tirole, 2002) and otherwise cause significant “collateral damage”. Informational asymmetry is a factor that could favor CSR over regulation because firms and other stakeholders are better informed than the government of the nature of the problem and relevant facts of the matter, and are thus in a better position to handle such problems directly.

Regulatory capacity of the state is of equal significance. It includes the ability to choose appropriate regulatory tools, pass necessary government decisions in a timely manner and implement those decisions professionally and impartially. All of the above requires adequate regulatory and policy-making expertise; well-functioning policy-making process; transparent and accountable government; a reliable and readily accessible dispute resolution system; and a cadre of skilled and duly motivated civil servants.

Another matter of importance is the allocation of regulatory prerogatives between levels of government. Many regulatory issues are local in their nature, which gives regional and municipal governments at least two important advantages over central authorities in handling such matters (Oates, 1972). First, subnational governments can customize their regulatory interventions to local needs and conditions, whereas the best thing that the national government can do is to choose standardized policies that would be accurate “on the average” and still significantly deviate from what is required in particular regions. Second, subnational governments are “closer to the ground” and thus are in a better position than central authorities to handle informational asymmetries. Therefore excessive centralization of regulation makes the case for CSR stronger; especially since CSR policies and investments primarily deal with local matters.

In Russia, as in many other developing and transition nations, the regulatory agenda is vast and complex. This is in large part due to immaturity of essential markets – fewer markets mean more externalities that require non-market treatment. Informational asymmetry is also very high, given the rapid changes in the economy and society, a lack of data and track record, and notoriously low transparency in the private and public sectors.

Russian government’s capacity to regulate remains a matter of concern. A large number

of essential reforms have been put on hold, leaving numerous regulatory voids. Enforcement of existing regulations raises multiple complaints of corruption and red tape, and opportunities to seek redress from mishandling of the regulatory system often remain only on paper. Turning to CSR as an alternative to regulation is clearly consistent with such sentiments.

Furthermore recent years witnessed a far-reaching re-centralization of regulatory and spending authority in Russia, leaving regions still responsible for economic development and social welfare, but with sharply curtailed budgets and regulatory powers. Such development increases significance of CSR both as a means to address and correct locally numerous regulatory failures, and as a substitute for dwindling regional government revenues (Chirikova et al., 2005). An interesting phenomenon observed in Russia that illustrates such substitution is greater tolerance by regional authorities, which exercise significant influence over revenue collection efforts in their regions, of tax evasion by commercial firms in exchange for such firms' social investments in local infrastructure and programs. This "collusion" is a rational behavior, since a lion's share of locally collected taxes is centralized in the federal budget, whereas corporate investments stay in the region (Haaparanta, Juurikkala, 2007).

5. Market structure

When a large firm dominates local economy, provision of infrastructure, social services and other local public goods becomes an "internal matter" for such firm, which prompts it to act, especially when local governments fail to adequately fulfill such role. When regional economies are diversified, incentives for businesses to invest in local infrastructure are weaker due to the free-riding problem. This means that social and infrastructure investments by corporations are more likely to be observed when local economies exhibit high concentration of production.

It was argued earlier that such investments are driven by companies' immediate self-interests and thus cannot be considered as CSR proper. However, concentration of production makes the case for "strategic" CSR stronger as well, because both the region and the dominant company need to make and secure "specific investments" in their relationship, and thus become dependent on each other. A large company is a key player in regional economic development, commensurate in its role and significance with the local community and government. It is natural that the main parties enter in dialog with each other, and CSR becomes an implementing tool of reached agreements.

Russia has inherited from the Soviet Union an economy with high concentration of production, and economic development and welfare of cities and regions often hinge upon a single industry or even a single mega-enterprise. In the Soviet times such "city-forming" companies were responsible for provision and maintenance of economic and social infrastructure facilities, including public transit, local utilities, health care, education, residential housing etc. After the collapse of the command economy in Russia

a number of large firms attempted to divest themselves of such auxiliary assets and responsibilities that were supposed to be taken over by local governments or, when appropriate, by emerging private sector firms. Such expectations often failed to materialize, since local governments were lacking resources to adequately replace big companies as providers of infrastructure and social services, and in order to avoid collapse of vital facilities and programs, dominant firms had to maintain their traditional roles of public service providers (Haaparanta et al., 2003). CSR becomes a modern “reincarnation” of such practice (Chirikova et al., 2005), which is a joint outcome of economic necessity and lasting path dependencies.

6. Legitimacy and security of property rights

Property rights are essential in shaping the pre-CSR “default point” out of which a company and external stakeholders negotiate a Coasean bargain. When shareholders’ property rights are respected by all parties and not challenged, CSR is about reconciling these rights with the rights of other stakeholders affected by company’s operations. If, however, shareholders’ basic property rights lack legitimacy and proper legal protection, they too could become negotiable in the CSR process. Two key components of private property rights – rights for control and rights for returns – can be on the table, the former – when outside stakeholders attempt to press upon companies “socially responsible” decisions, such as creation of redundant jobs, dealing with designated partners, etc., and the latter – when companies are under pressure to provide funding for various public and private sector projects and programs⁸. Insecurity of property rights makes companies more pliant to such pressure and increases the scale and scope of CSR.

The likely flip side of this “greater quantity” of CSR is its lower quality, because when CSR becomes a tool of property rights erosion, it can no longer be expected to produce efficient outcomes. Such conclusion is consistent with the Coase theorem where efficiency is contingent upon low transaction costs, which in its turn requires clear assignment of property rights prior to negotiations.

In Russia security of property rights remains low; the International Property Rights Index for Russia in 2008 was 4 out of maximum 10, which ranked the country 92 among 115 covered by in the International Property Rights Index Report (2008); the country scored particularly poorly in terms of legal and political environment for property rights protection (102nd out of 115). Corporate raiders’ attacks on businesses are common, and existing legislation and its enforcement offer little protection against such attempts (Radygin, Symachev, 2005). Property rights are also threatened by government which can take property in lieu of damages for alleged violations of tax, corporate and other laws. Such vulnerability gives the federal and regional governments formidable bargaining power in dealing with companies and coercing them into CSR (Polishchuk, 2006).

⁸ ‘...if society does not regard the economic benefits provided by the provision of employment, sale of products and tax proceeds to be sufficient benefits [for rights and privileges granted to the corporation], then it may demand additional contributions’ (Ludescher, McWilliams, Siegel, 2008, p. 335).

One cause of property rights insecurity is a lack of legitimacy of the existing ownership structure in the eyes of public opinion. In Russia private property rights have been established by sweeping privatization of heretofore state-owned companies in the early 1990s. The privatization was fraught with massive irregularities and produced a heavily concentrated ownership structure with a bulk of production assets owned by a small group of business moguls known as the “oligarchs”. The Russian society in its vast majority views such outcome as profoundly unfair and illegitimate (Polishchuk, op.cit), which casts clouds over the property rights regime in the country. The “original sin” of questionable privatization has a strong lasting effect, and Russian companies resort to social investments, such as provision of local public goods and other types of CSR, as a means to improve legitimacy of their owners’ property rights and thus reduce social and political risks (Frye, 2005). Such investments are made in response to the prevailing social sentiments expressed in a popular catchword – *delitisia nado* (one ought to share [the wealth]).

7. Social capital

Scale and efficiency of CSR depend on the society’s capacity to articulate and protect its interests in dealing with corporations. Such capacity in its turn depends on whether consumers and other stakeholders value clean environment, sustainable development, ethical behavior etc., whether they are sufficiently informed on how companies handle such matters, and whether they are willing to act accordingly.

All of the above depends on the stock of *social capital* in the society, which includes norms, values, trust, cooperation and capacity for self-organization and collective action (see e.g. Keefer, Knack, 2005). Norms and values underpin public awareness and are important to produce grassroots demand for CSR, whereas collective action is required to deal with companies on matters of public significance. When a company acts in a socially responsible manner, it provides public goods for the society (or refrains from producing public bads), and private enforcement of such behavior could be hampered by free-riding. If the society cannot properly resolve the collective action problem in its dealing with the private sector, efficacy of CSR suffers. This too is consistent with the Coasean view of CSR – a failure of society to self-represent itself vis-à-vis corporations increases transaction costs of CSR bargains, and efficient outcomes are not any longer assured.

When social capital is lacking, CSR is not driven by encompassing societal interests, and this clears ground for better-organized interest groups that can “capture” the institution of CSR. Narrow interests have advantages in self-organization (Olson, 1965) and often command significant economic and political resources that can be deployed to achieve desired corporate response. In fact, even under the best of circumstances companies are rarely confronted with entities representing society at large, and deal primarily with particular stakeholder groups, often one at a time – hence the pragmatic interpretation of CSR as “stakeholder management” (Clarkson, 1995)⁹. CSR bargains reached between

⁹ Such practice is justified by the assumption that issues of concern for the society at large are addressed by

corporations and narrow interests can still be (Pareto)-efficient, but only for the immediately involved parties. Those not represented in such bargains are likely to suffer, as does overall social welfare, and CSR could degenerate into collusion between private firms and their better-organized counterparts that extract rent at the expense of the rest of society. Social capital provides safeguards against such abuse through public awareness, civic activism, grassroots monitoring of corporate conduct, etc.

The impact of social capital on the *scale* of CSR is thus undetermined: on the one hand strong social capital helps society to take a consolidated pro-active position that prompts businesses to respond; on the other hand however insufficient social capital gives free rein to special interests which can vigorously pursue their needs. In that latter case, however, the *quality* of CSR, measured by social welfare, is likely to suffer.

In Russia social capital is either in short supply or exists in obsolete traditional forms inconsistent with modern society (Rose, 2000). The Soviet legacy did not bode well for civic activism, and the chaotic transition made people preoccupied with personal problems and immediate economic needs, eroding trust and putting matters of public significance on the backburner. As a result, Russian civil society is not playing a significant role in the CSR process. Not surprisingly, social expectations of CSR revealed by surveys vastly differ from Russian firms' actual social investments (Polishchuk, 2006).

The void is filled by government, which is the pre-eminent partner of Russian corporations in matters concerning CSR (Litovchenko et al., 2004). Such practice is particularly widespread at the regional level (in part due to the reasons stated earlier in the paper), where subnational governments set quasi-mandatory quotas for nominally "voluntary" corporate social investments and ensure compliance by threat of various economic sanctions, such as denied access to local resources and markets, prosecution for real or alleged violations of law, bankruptcy proceedings, etc. Available sources (Litovchenko et al, op. cit.; Ivchenko et al., 2003; Chirikova et al., 2005) indicate that such practices are common and firmly entrenched.

Coerced CSR is not the only mode of government involvement in the process. Major firms' bargaining power is commensurable with that of regional governments, and on such occasions the two sides negotiate with each other mutually acceptable deals whereby corporate support to projects of high significance for bureaucrats is traded for various exclusive privileges, leniency to violation of laws and regulations, protection from competitors etc. (Polishchuk, 2006). Such agreements are often presented as "public-private partnerships" – a misinterpretation of the concept which is increasingly popular in modern Russia¹⁰.

laws and regulations, and communication with stakeholders fills gaps on the margin that are of significance for narrower-based interests (Clarkson, op. cit). This logic does not apply when CSR substitutes government regulation on matters of major public significance.

¹⁰ The conventional definition of public-private partnership means participation of commercial firms on contractual basis in construction and management of public infrastructure facilities (see e.g. Grimsey, Lewis, 2004)

8. The model

The above discussion suggests that the choice between CSR and its institutional alternative – government regulation involves a number of tradeoffs which depend on the rest of institutional setup and socio-economic background. We illustrate the work of such factors by a simple model where regulatory inflexibility due to asymmetric information and/or excessive centralization is weighed against lack of social capital.

There is a unit continuum of communities in the model, each comprising a unit continuum of customers. Every community is served by a firm which sells only within the community; each customer consumes one unit of firm's product¹¹ and derives utility u_0 . The selling price $p < u_0$ is set exogenously (e.g. all firms are subject to the same price regulation) and normalized to unity.

All firms have identical technologies and emit negative externalities; externality $a \in [0, a_{\max}]$ causes each consumer a utility loss ξa , where $\xi \geq 0$ is consumers' sensitivity to the externality. Sensitivity to externality is the same for a given community, but varies across communities and is distributed with cumulative function $\Phi(\xi)$. Cost of production $c(a)$ depends on the externality (for simplicity we assume zero marginal cost); function $c(a)$ is monotonically decreasing, convex ($c''(a) > 0$) and such that $c(0) < 1$ (the firm can completely eliminate externality and still remain viable) and $c'(a) \rightarrow 0, a \rightarrow a_{\max}$; $c'(a) \rightarrow -\infty, a \rightarrow 0$.

Social optimum

In the social optimum the first-best level of externality in community ξ minimizes total losses $c(a) + \xi a$ and equals $a^* = g(\xi)$, where $g = (-c')^{-1}$. First-best aggregate welfare of the economy is $u_0 - E L(\xi) = u_0 - \int L(\xi) d\Phi(\xi)$, where $L(t) \equiv \min_a [c(a) + t a]$. Notice that L is monotonically increasing and concave, and $L(0) = 0$.

Regulation

If emission of externalities is regulated by government, and regulatory standards can be set separately for every community and each community's sensitivity to externality is

¹¹ The product is assumed to have no substitutes. Relation between CSR and market power is somewhat ambiguous. Baumol and Bekman (1991) argue that competition rules out corporate altruism – market discipline leaves no room for “wasteful spending”. However, in the case of “strategic” CSR the role of competition is exactly opposite. Companies with significant market power can safely ignore the damage their activities cause to customers, suppliers and other stakeholders, unless disciplined by government regulation or civil society. Neglect of stakeholders' concerns is similar to extracting rent through inflated monopoly pricing and is made possible by a lack of competitors. When markets are contestable, CSR becomes one of competitive strategies (Vogel, 2005; Polishchuk, Firsov, 2006).

known to regulators, then firm that serves community ξ will be required to have $a = g(\xi)$. However if regulators cannot differentiate among communities due to the inability to observe ξ , or perhaps because regulatory rules do not allow such flexibility, the second-best regulatory standard will be set at $\hat{a} = g(E\xi)$, with the resulting aggregate welfare $u_0 - L(E\xi)$. Since L is concave, informational asymmetry and/or regulatory centralization and inflexibility result in aggregate welfare losses, which grow bigger with increasing variation of local conditions (e.g. when one distribution of ξ second-order stochastically dominates another).

Corporate social responsibility

Suppose that externalities are left unregulated by government, but a community can reach an implicit or explicit CSR agreement with the serving firm whereby the firm will commit to a socially responsible conduct, and such commitment could include a specified level of externality and, possibly, additional social investments (side payments to the community). In what follows the community sensitivity to externality ξ is given and known to both parties, so unlike government regulation, CSR is not hampered by informational asymmetry.

If no such agreement is reached or the firm reneges on its promises, it will be sanctioned by customers all or some of whom will be boycotting the firm¹². The share of boycotting consumers equals $\min(1, \xi a H)$, where $H \geq 0$ is the measure of social capital in the community. Notice that individual protest brings no material reward to a consumer, as she would just forgo consumer surplus of $u_0 - 1$ without denting firm's profit and thus affecting its behavior. This is typical of a collective action problem when participation is costly and brings limited, if any, individual benefits, so such decisions should be motivated by intrinsic social values, such as the sense of civic duty¹³, which comprise social capital.

The above functional form obtains by assuming that a community is heterogeneous and social values z are distributed across community members according to a uniform distribution $F_H(z) = \min(1, zH)$, so that a community member with values z participates in a boycott if damage ξa caused to the community exceeds her "pain threshold" z . Notice that increase in H shifts the distribution to the left (in the first-order stochastic dominance sense), so with more social capital a larger number of consumers join in to impose a collective sanction against a "socially irresponsible" firm. Alternately one could assume that social values are uniform across the community, and consumers participate in boycott randomly with probability $\min(1, \xi a H)$.

¹² This reflects the assumption that a properly negotiated CSR agreement gives the firm a "social license to operate" and prevents consumer boycott.

¹³ For similar models of social capital's impact on individual behavior see e.g. Benabou, Tirole, 2006. To reconcile social capital with utility maximization, it is often assumed that acting contrary to internalized norms and values would result in utility loss. J. Andreoni (2006) argues that such "moral regrets" (or their opposites known as "warm glow") should not enter in social welfare calculations.

The default point, out of which the community and the firm start Coasean bargaining, obtains as follows. The firm unilaterally selects the externality level by taking into account consumers' reaction, and minimizes the total of production costs and lost revenues: $\min_a [c(a) + \xi a H]$. The optimum will always be interior and equals $\tilde{a} = g(\xi H)$, leaving the firm with profit $\tilde{\pi} \equiv 1 - L(\xi H)$. Consumers' aggregate utility at this default point is $\tilde{u} \equiv (u_0 - 1)(1 - \xi \tilde{a} H) - \xi \tilde{a}$. Notice that such outcome is always suboptimal, since some consumer surplus is lost, and with $H \neq 1$ the level of externality is wrongly chosen.

Coasean CSR bargain will be a Pareto improvement over the default point, but it will not always reach the efficient level of externality $a^* = g(\xi)$. To see why, recall that CSR allows only unidirectional side payments, i.e. from the firm to the community. With $a^* = g(\xi)$ both sides maximize their aggregate gains over the default point, but to share these gains (e.g. equally, as per the Nash bargaining solution), transfers in either direction might be required¹⁴. If the firm has to compensate the society, then the socially optimal outcome obtains (Fig. 1a), but if not, the CSR agreement will fall short of social optimum, and externalities will be in excess of a^* (Fig. 1b; A and B denote on both figures resp. the default point and bargaining outcome).

Transfers from the community to the firm would be required whenever the firm's default profit $\tilde{\pi}$ is greater than its *immediate* (before transfers) profit at the social optimum $1 - c(a^*)$, i.e. whenever

$$L(\xi H) < c(a^*).$$

Since L is monotonically increasing and $L(0) = 0$, we conclude that with insufficient social capital CSR does not achieve the first-best socially optimal outcome; e.g. when social capital is altogether absent, the firm will simply set $a = a_{\max}$ and no bargaining will ensue. The equation $L(\xi H) = c(a^*)$ gives a cutoff level \underline{H} such as with $0 < H < \underline{H}$ CSR will not lead to social optimum.

Transfers to the firm *will not* be required whenever the community's default utility \tilde{u} is greater than its utility $u_0 - 1 - \xi a^*$ at the social optimum, i.e. whenever

$$a^* > \tilde{a}[1 + H(u_0 - 1)].$$

The right-hand side of the above inequality equals $\tilde{a} + \frac{u_0 - 1}{\xi} \tilde{a} c'(\tilde{a})$, and due to convexity of the cost function is less than $\tilde{a} + \frac{u_0 - 1}{\xi} [c(0) - c(\tilde{a})]$. That last expression tends to zero (alongside \tilde{a}) as $H \rightarrow \infty$, and therefore there is another cutoff level \overline{H} such that for all $H > \overline{H}$ CSR produces social optimum. In such case with ample social capital

¹⁴ For a similar reasoning see Shleifer, Vishny, 1994.

the default level of externality $\tilde{a} = g(\xi H)$ is inefficiently low (recall that function g is monotonically decreasing), since the firm is trying to avoid crippling sanctions, and it obtains a “social license to operate” at the efficient level of externality by reimbursing the community through social investments.

In the intermediate range $\underline{H} < H < \overline{H}$ social optimum *could* be achieved if the society has sufficient bargaining power vis-à-vis the firm, but such outcome can no longer be assured.

The model confirms that regulatory rigidity and informational asymmetry invite CSR as, ceteris paribus, a potentially more efficient institutional alternative. On the other hand insufficient social capital compromises social efficiency of CSR and reduces its attractiveness as an alternative to regulation.

Fig. 1a

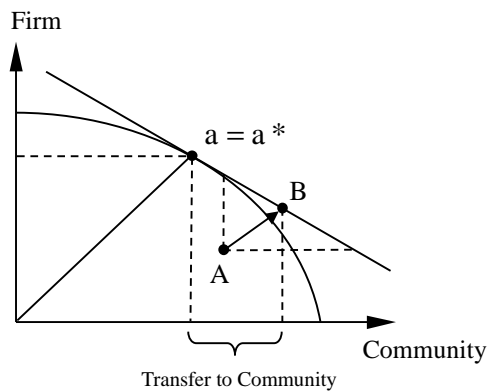
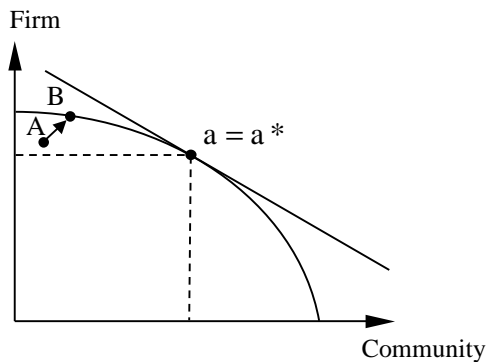


Fig. 1b



9. Assessment of Russian CSR

The above analysis suggests that there are a number of powerful CSR drivers at work in Russia, which is consistent with the abnormally large scale of social investments observed in the country. CSR appears to be a natural and appropriate, even if somewhat unanticipated, institutional reaction to numerous gaps and imperfections of the legal and regulatory setup; excessive centralization of government; complexity of economic, social, environmental etc. problems faced by the country; immaturity of Russian markets; and high concentration of production and wealth. Russian CSR blends modern trends and practices in corporate governance brought to the country by foreign companies and investors, with the (post)Soviet tradition of “paternalistic” enterprises responsible for infrastructure, social services and overall well-being of employees and local residents.

CSR in Russia differs from industrialized nations not only in its massive scale, but also in patterns, mechanisms and driving forces. Such institutional adjustment could be efficiency-enhancing, as shown by successes and failures of various institutional transplants (see e.g. Rodrik, 2007); but there is a risk that adjustment goes too far and diverts the institution of CSR from its initial purpose.

CSR in Russia provides “quick fixes” for unresolved systemic problems in public administration and finance, some of which are questionable surrogates of conventional policy instruments. For example, corporate social investments and contributions to social programs are poor substitutes for regular tax revenues and public expenditures, because co-existence of two channels of funding – public and private – violates two key principles of efficient public finance – wholeness (integrality) and accountability. The first principle provides for allocation between expenditure categories and items of all budget revenues in their entirety in accordance with government spending priorities and in the due course of a budgetary process. Discretionary earmarked corporate contributions, often in lieu of “written off” taxes, are clearly at odds with this requirement. Public sector accountability suffers as well, since a significant part of de facto public expenditures are made off-budget and thus exempt from budgetary scrutiny and control. Finally, unrestricted access to corporate purses “softens” budget constraints of regional and local administrations, which adversely affects incentives for good governance and prudent fiscal management and delays badly needed government and public finance reforms.

As for companies, the practice of coerced “social responsibility” subjects them to de facto additional taxes which are levied selectively, unpredictably, have narrow bases and thus also violate principles of efficient public finance. Such practices devalue and derail tax reform which had as its stated objectives reduction of tax rates with broader tax base, and transparency and stability of tax rules and policies. Russian CSR thus provides an example of the *seesaw effect* (Acemoglu et al., 2008), whereby public officials sidestep restrictions imposed by a policy reform by using other avenues to achieve the same ends.

Hypertrophied role of government in Russian CSR is another matter of serious concern. Weakness of Russian civil society allows the public only a residual role in shaping CSR of Russian firms, and leaves the government in the position of the chief “CSR customer”

in the country. This contradicts the basic premises of CSR as a grassroots alternative to conventional economic regulation, whereas governments deal with businesses through conventional fiscal and regulatory tools. One can argue that such pro-active and paternalistic role of government could still be appropriate, given the inability of society alone to effectively deal with businesses directly. This however begs the question of why in such case the government does not resort to regulation as a more natural and transparent instrument.

Another issue is the quality of representation of social interests by government officials. While dealing with companies politicians and bureaucrats (most of them unelected) could be driven by their own political and economic agendas which do not necessarily coincide with those of the society. Corporations in their turn could be attracted by the opportunity to trade loyalty and “right” investments for good relations with government and promise of exclusive privileges vis-à-vis competitors; indeed 94% of corporate executives surveyed in (Blagov et al., 2008) expressed the opinion that corporate social investments should be “materially rewarded” by government¹⁵. Such transactions which are usually shielded from public eyes could be detrimental for economic efficiency and social welfare (Shleifer, Vishny, 1994) and provide fertile ground for corruption. CSR offers a convenient “institutional offshore” to conduct such exchanges: it emerges in the *private sector* but is not subject to conventional rules and principles of commerce, and deals with problems that are usually assigned to the *public sector*, but is not subject to conventional public sector control and oversight. Indeed, oftentimes Russian companies do not publicly disclose information about their social investments (Litovchenko, 2004) – such modesty is incomprehensible from the traditional view of CSR as a public relation tool, but can be easily understood if CSR is a cover and mechanism for quid pro quos not serving public interests.

10. Conclusion

Analysis of CSR in Russia and elsewhere highlights driving forces of institutional change and outcomes. Growing complexity of regulatory issues in the modern world and sufficient stock of social capital resulted in massive proliferation of CSR practices which interact with and often substitute for government regulations. Civic awareness and activism are key drivers of this process, which illustrates spontaneous emergence of a new institution (or reincarnation of an old one) in response to evolving needs and capabilities of societies. Transparency and accountability in public and private sectors and security of property rights have been important ingredients of CSR success in the industrially developed world.

CSR was brought to Russia by a confluence of trends and forces, including emulation of Western corporate governance standards; continuation under a new name of old pre-

¹⁵ Baumol and Beckman (1991) viewed involvement of corporations in solving social problems as potentially at odds with principles of democracy and government accountable to people.

transition practices; and massive structural distortions and pressing needs of an economy and society in transition. One important distinction of this unusual combination of tradition and modernity from the international mainstream was a barely noticeable presence of civil society and, on the contrary, strong presence of government. Another essential factor was poor protection of property rights. Both of these irregularities resulted in a significant diversion of CSR, Russian style from its conventional role, and have a strong detrimental effect on CSR outcomes in the country. This is a striking example of *institutional complementarity* (see e.g. Aoki, 2001) when performance of one institution (CSR) depends on the state of other institutions, in the present case protection of property rights and the culture of civic awareness and activism. A mismatch between fast-moving (corporate governance) and slow-moving (norms and values) institutions (Roland, 2004) left Russian CSR unrooted and prone to capture.

Institutional dynamics of CSR in Russia also differs from the conventional scenario. In industrialized countries CSR competes with fully developed government regulation and public expenditure system, whereas in Russia such system is riddled by various gaps and imperfections. In the short run CSR helps alleviate such shortcomings, but in the long run it weakens incentives to modernize public sector, and thus prolongs caught-in-the-middle hiatus of incomplete reforms. It is argued in (Hellman, 1998) that unfinished reform provides vested interests with rents extracted from the rest of economy and society. CSR, Russian style fits in this vision as it offers opportunities and tools for rent extraction through collusion between businesses and bureaucracy.

The global recession that began in 2008 will have profound implications for CSR throughout the world, including Russia. On the one hand, corporations' growing concerns about their "bottom-lines" will sharply reduce resources available for social investments. On the other hand at the time of fiscal austerity pressure of society and governments on companies to contribute will likely grow stronger. The comparative framework proposed in this paper could help to analyze the implications of these two trends, but such task is left for future research.

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