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## **Corporate Social Responsibility or Government Regulation**

### **An Analysis of Institutional Choice**

*The article presents an economic theory of corporate social responsibility (CSR) and analyzes economic, social, political, and institutional factors that could affect the comparative advantages of CSR over government regulations. A discussion of the Russian CSR model emphasizes the importance of property protection rights for the efficient implementation of CSR, and cautions against excessive government involvement in CSR processes.*

Various institutions often perform similar functions in an economy and society. In that case, the choice of an institution is determined by its relative advantages over others. The institutions' relative advantages, in turn, depend on the level of development of the economy, the condition of the society, traditions, and culture, and on the institutional environment of which the given institution is to be a part. The factors affecting costs and benefits of the institutions change in terms of space and time, resulting in a diversity and evolution of the institutions.<sup>1</sup>

One example of a choice from the “institutional menu” is corporate social responsibility (CSR), which assumes that companies should be guided in their activities not only by conventional commercial and financial indicators but by broader societal interests and the demands of sustainable development,

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environmental protection, adherence to business ethics, protection of social and economic rights, and so on. CSR has become firmly established in the practices of Russian and foreign companies, but despite the ubiquity of this institution, its purpose, foundations, forms of implementation, and achievable results remain a subject of lively debates. The idea of CSR is indeed full of contradictions—it does not fit into the canonical notions of a market economy, where private firms maximize profit, governments provide public goods and regulate the private sector, and philanthropy becomes the domain of altruistic individuals rather than “heartless” legal entities.

Institutional theory provides a clearer concept of the role and place of CSR in the economy and society. In this case, CSR may be viewed as an instrument for reaching a Coasean arrangement between companies and their stakeholders (excluding the owners and management), where the subject of such agreements consists of externalities that arise during the companies’ activities.<sup>2</sup> In this interpretation CSR is a private (not requiring government intervention) institutional alternative to economic regulation—the traditional means of controlling externalities, and the “division of labor” between CSR and government regulation develops on the basis of the relative advantages and disadvantages of these institutions.

This article discusses the effect of a number of factors on which the advantages of CSR over government regulation may depend. This analysis makes it possible to explain and assess the CSR models that turn up in practice, and this opportunity is demonstrated in the case of the Russian model, which is characterized by the government’s active presence as a “client” and “appraiser” of the social responsibility of Russian companies, and in the precrisis version, by abnormally large social investments on the part of Russian companies.

A comparison of the social investments of Russian and Western companies over the past decade provided a basis for citing the social “hyperresponsibility” of Russian business.<sup>3</sup> For example, American corporations donate to charity an average of about 1 percent of before-tax profits, whereas in Russia social investments outside the company reached, according to various estimates, 6–17 percent of profits.<sup>4</sup> Corporate philanthropy in Russia in recent years has been many times greater than donations by private individuals, in contrast to the state of affairs in industrially developed countries.<sup>5</sup> As for the government, it may be viewed with good reason as “one of the chief and vigilant stakeholders” in the socially responsible activities of Russian firms.<sup>6</sup>

The above-mentioned specific features of CSR in Russia can be explained on the basis of the structure of the country’s economy, the way government

authority and finance are organized, the state of society and the established institutional regime. The analysis leads to the conclusion that there is “institutional mutual complementarity” between CSR on the one hand and the protection of property rights in the private sector and the stock of social capital on the other: vulnerable property rights and a weak civil society have a pernicious effect on the social efficacy of CSR.<sup>7</sup>

### **What is corporate social responsibility?**

The concept of CSR is very general, and its interpretations vary within a wide range—from corporate philanthropy to job creation and strict compliance with prescribed laws and regulations. The essence of CSR is perhaps best reflected by the following definition: a socially responsible company takes steps in the interests of its stakeholders that are not dictated by direct commercial needs and market requirements.<sup>8</sup> The necessity of such steps stems from the company’s extra-market influence on stakeholders—in other words, CSR is a means of controlling the *externalities* created by the company.

The conventional solution for the problem of externalities is government regulation, but a socially responsible company not only obeys the government’s compulsory demands but also takes account of stakeholder interests beyond these demands. In this interpretation a fuller definition of CSR emerges: actions by companies that are not motivated by the direct requirements of the market and the law.<sup>9</sup>

Therefore, socially responsible companies constrain themselves and sacrifice commercial objectives out of social, ethical, or environmental considerations.<sup>10</sup> In the process they use two principal instruments of social responsibility: first, companies modify their production and commercial activities (the choice of strategies of development, employment policy, technologies, products, resources, trading partners, etc.) in the interests of stakeholders; second, they make social investments to support various public projects, regional and urban development, philanthropic initiatives, and so on.

The need for socially responsible behavior is often justified on the basis that a company has *multiple stakeholders*, among whom the company’s shareholders constitute only one of the groups.<sup>11</sup> It is argued that a company must realize its responsibility to stakeholders and take their interests into account in its activities. This view, however, contradicts the classical concept of a private company as a tool for creating and multiplying profits for its shareholders. According to this concept, the company’s management is accountable only to the shareholders and must be guided in its activities

solely by their interests—with the understanding that the interests of other stakeholders are taken into account and protected by government-prescribed official requirements, with which the company, of course, must comply in full, but no more than that. Attempts to encumber corporations with additional tasks (beyond maximizing profit) within the framework of current regulations could have an adverse impact on the private sector's efficiency and thereby cause significant damage to society. Hence Milton Friedman's well-known thesis that the social responsibility of business is to increase its profits.<sup>12</sup>

The current interpretation of CSR seeks to combine these seemingly opposing views, based on the premise that socially responsible behavior is ultimately in the company's own interests in their traditional interpretation, because it provides commercial success and sustainable development based on "doing well by doing good." This agreement of interests is possible in several versions, and a certain type of CSR corresponds to each of them.

The first version involves a direct coincidence of wants by the company and society, where actions by the company dictated by production or business necessity (investments in personnel, creation of infrastructure facilities) create a collateral social gain. Such situations, known in the CSR literature as a "free lunch," may be portrayed by the company as a manifestation of social responsibility; but strictly speaking they are not, since society's gain is nothing more than a positive externality resulting from actions taken by the company solely in its own interest.<sup>13</sup>

The second version, known as "cause-related marketing," assumes that a company ties its move into the market for its product to a certain noble initiative—as a rule, by allocating a revenue portion for these purposes. As a result, philanthropy is "sold as a tie-in" with the company's main product, which in a number of cases results in additional profits.<sup>14</sup>

Finally, in the third version, on which most of our attention will be focused, CSR is dictated by strategic considerations: to elicit a favorable response for the company from stakeholders or to prevent a threat from them to business, and ultimately socially responsible behavior produces a financial gain for the company. This motive is not always on the surface: without the anticipated reaction of stakeholders, the *direct* consequences of socially responsible actions may involve costs to the company—hence the appearance of a sacrifice for the sake of the public interest.

A favorable response for the company to "strategic CSR" may reward socially responsible behavior with increased sales and profits and promote market penetration, access to factors of production, and a strengthening of the brand and the loyalty of consumers, employees, business partners, and other stakeholders. The threats that the company seeks to avert may signify

various kinds of sanctions on the part of stakeholders who have suffered from “social irresponsibility”—boycotts, protest campaigns, lawsuits, or appeals to the government to intervene in a conflict.

### **Corporate social responsibility and government regulation from the perspective of the Coase theorem**

Government regulation solves the problem of externalities either by limiting certain types of activities or by imposing taxes (or providing subsidies) in order to make companies factor in more thoroughly the social costs or benefits of their actions. It is well known that such instruments in practice may be imperfect. First, they constitute “incomplete contracts” with significant lacunae; second, they are indiscriminate, ignoring essential details; third, they create opportunities for abuses and may be “taken over” by narrow group interests; fourth, there may be significant costs that exceed the benefit; and finally, fifth, government regulation often fails to keep pace with changes in economic and social needs. These shortcomings could become the basis for turning to alternative tools, including CSR.<sup>15</sup>

Ronald Coase’s famous work opened up a discussion of a private alternative to government regulation.<sup>16</sup> The basis for these debates is the Coase theorem, according to which the involved parties—those who produce externalities and those who experience their effect—may privately negotiate a mutually acceptable (and Pareto-efficient) settlement of the problem. If the transaction costs of reaching and implementing such an arrangement are not too high, government intervention turns out to be superfluous. From this standpoint it is fair to view CSR as a possible implementation of Coase’s idea that works out conflicts between companies as represented by their owners and management, on the one hand, and various stakeholders, on the other.<sup>17</sup>

Negotiations with stakeholders regarding CSR may occur in the form of consultations, roundtable discussions, public hearings, and so on, which are intended to secure a “social license to operate” for the company. Such a license may be obtained on the basis of a tacit response to the company’s self-restraint and/or to appropriate social investments.<sup>18</sup>

According to Coase, the parties to agreements not only coordinate their actions but also arrange, if necessary, a redistribution of the gain obtained through “side payments.” In the case of CSR, such mutual settlements are made in the form of social investments, with which the company compensates stakeholders for infringing on their “natural rights”;<sup>19</sup> it is important that the side payments are possible only in one direction—from the company to stakeholders, and not vice versa.

CSR based on private agreements between the parties in terms of the Coase theorem may be less or more effective than government regulation. It is well known that over time methods of maintaining order in an economy have undergone changes.<sup>20</sup>

In traditional systems, private settlement of conflicts based on mutual consent, concern about one's reputation, social networks, and so forth, has been predominant. During the early Middle Ages, economic practice incorporated judicial settlements of disputes, which created more favorable conditions for economic development.<sup>21</sup> The concentration of economic power during the period of industrialization compromised the effectiveness and impartiality of the judicial system, which led to the proliferation of direct government regulation.<sup>22</sup> The popularity of CSR in today's world represents a "second coming" of private regulation—obviously the traditional mechanism in its current form has a number of advantages over government regulation, which is completely consistent with Coase's views.

As was noted earlier, the advantages and disadvantages of CSR over the institutional versions vary over time and space, depending on the structure of the economy and society, political and cultural traditions, the administrative and judicial system, and the condition of a number of key institutions.

### **Regulation and the government's capabilities**

The effectiveness of government regulation depends on the *complexity and scale* of the tasks that are being implemented and the ability of regulatory authorities to perform their functions effectively. The more complex and numerous the tasks requiring regulation and the greater the doubts regarding the government's ability to accomplish them, the more grounds there are for relying on CSR.

Government regulation, especially in developing countries and nations with transitional economies, successfully deals only with relatively simple matters. Informational asymmetry often complicates the task, when regulators do not have enough data to make the right decisions. In such cases, regulation may be applied where there is no need for it, needlessly suppressing market incentives and signals while ignoring real problems. All other things being equal, informational asymmetry is a strong argument in favor of CSR, since companies and stakeholders directly involved in the problem are better informed than government authorities about the essential details that will be factored into the agreements that have been reached.

Equally important is the government's ability to effectively manage regulatory powers, including selecting regulatory instruments in a timely and

accurate manner and applying them professionally. This requires experience and qualifications, transparency and accountability for decision making by the regulatory authorities, an impartial and effective dispute-resolution system, and so on. It is important that regulatory powers are distributed among the levels of government. The majority of problems requiring regulation are local in nature, and by vesting regional and local authorities with the appropriate functions it is possible to provide the necessary regulatory flexibility and to reduce informational asymmetry, in comparison with centralized authority. This means that overcentralization of regulation also increases the need for CSR to fill in gaps and rectify shortcomings in the application of official instruments.

In Russia the immaturity of the market creates multiple externalities that complicate and widen the range of tasks for economic regulation. Informational asymmetry in the Russian economy is also very high, partly because of the rapid economic and social changes, and partly due to the insufficient transparency of the private and public sectors. At the same time, the practice of government regulation draws significant criticisms and complaints about the misdirected use of regulatory instruments, corruption, and incompetence. Recourse to CSR under these conditions seems logical and natural.

The need for informal mechanisms has grown as a result of the increased centralization of administrative and fiscal authority in Russia. Although regional and local governments are still responsible for economic development and well-being in their jurisdictions, their budgets and official regulatory functions were cut back significantly. What is appealing about the idea of CSR is the possibility of reducing the gap between the authorities and responsibility and obtaining a new source of funds for developing infrastructure, funding social programs, and so on.<sup>23</sup>

## **Market structure**

For a large, town-forming company, the development of local infrastructure and the provision of social services and other local public goods becomes, to a large extent, an “internal affair,” which it has to handle itself, especially if the local authorities cannot cope with these obligations.

If the economy of a town or region is more diversified, the incentives for such corporate initiatives are weaker, because of the opportunity for a “free ride.” Therefore, the higher the concentration of production (the share of one or more major factories in a local economy), the more likely large social investments by town-forming companies are.

It was noted earlier that such investments are often made because of

the direct needs of production, and the social benefit is their side effect. A company's dominant position also creates strategic motivations for social investments. A town-forming company is a key participant in regional development, comparable in influence and importance to the local community and authorities. Naturally, the principal actors enter into a dialogue with one another, and CSR becomes a means for implementing arrangements.

In hundreds of Russian monotowns, town-forming companies until recently took an active part in the funding of health care, education, public transit, housing, and utilities.<sup>24</sup> This practice developed during the Soviet era, and attempts to abandon it at the start of the market reforms demonstrated that it was impossible to support and develop the vital industries of towns without the direct participation of large companies.<sup>25</sup> Socioeconomic realities demanded that the traditions be revived in the more modern form of CSR.<sup>26</sup>

### **The legitimacy and protection of property rights**

Property rights shape the default point of Coasean negotiations, including with respect to CSR. When the property rights of a company's shareholders are not in dispute, CSR is about reconciling these rights with the rights of other stakeholders affected by the company's operations. But shareholders' property rights lack legitimacy and proper legal protection, they too become negotiable in the CSR process. Stakeholders can lay claim to two principal components of property rights—the right to control assets and the right to receive income. In the first instance, the company can be compelled to make “socially responsible” decisions to create redundant jobs, to choose certain business partners, and so forth; in the second instance, the company is pressured to finance certain social projects.<sup>27</sup>

A lack of protection of property rights makes companies more susceptible to outside pressure, which expands the scale of CSR. Unfortunately, quantitative growth is accompanied by a decrease in quality: if CSR is used as an instrument to erode property rights, this has an adverse effect on the social efficacy of that institution. This conclusion is consistent with the Coase theorem, where an effective result from negotiations is contingent on low transaction costs, which in turn requires clear assignment of property rights prior to negotiations.

The problems of protecting property rights in Russia are common knowledge. According to the International Property Rights Index, in 2008 the country ranked ninety-second among 115 nations included in the survey.<sup>28</sup> Takeovers by corporate raiders are common practice, and the judicial system does not offer reliable protection against such encroachments.<sup>29</sup> Threats to property rights

also come from government authorities, which make use of various provisions of tax, civil, and criminal law for this purpose. The “inequality of weapons” gives the government substantial bargaining power in its relationship with business, which can be used to “coerce” private companies into CSR.<sup>30</sup>

One of the reasons for the vulnerability of property rights in Russia is that they lack legitimacy in the eyes of public opinion. The privatization of the 1990s and the subsequent redistribution of property are viewed in society as deeply unjust, and this perception raises questions about the reliability of property rights, even if they are duly validated and recorded *de jure*. The “original sin” of the dubious privatization compels Russian companies to “buy their way out” of adverse public opinion with social investments, in order to reduce the social and political risks of doing business and meet halfway the demands for “sharing.”<sup>31</sup>

### **Social capital**

Society can become a serious partner in a dialogue with large companies only if it is sufficiently consolidated. The prevention of damage from externalities (e.g., the maintenance of clean air) is a public good and therefore collides with the problem of collective action.<sup>33</sup> Individual or small-scale demonstrations will most likely go unnoticed and in any case will be ineffective; only mass support for such activities is capable of balancing the “bargaining power” of large companies.

The difficulties of solving the problem of collective action, including with respect to CSR, often prove to be insurmountable—that is, precisely the government traditionally takes on the task of economic regulation. CSR may successfully compete with government regulation provided that, first, the values embodied by CSR (environmental conservation, sustainable development, adherence to ethical norms, etc.) are rooted in society, and second, people are well enough informed about the relevant aspects of the companies’ activities, and third, citizens are ready and able to take part in social initiatives. The last requirement is especially important, since the motives for voluntary participation in collective actions go beyond the framework of individual rationality (“free rides”) and require a recognition of public interests. The next step must be to coordinate actions in order to obtain the desired result through joint efforts.

The capability of collective action in the common interest is known under the aggregate name of *social capital*, which is formed by the norms and values and by public associations and social networks.<sup>34</sup> Norms and values produce grassroots demand for CSR, while networks and communications promote the collective action necessary to implement this demand.

When social capital is lacking, CSR is not driven by societal needs but by the interests of organized groups, for which it is easier to solve the problem of collective action.<sup>35</sup> There is a fairly common situation where companies seek a “separate” consent from various categories of stakeholders.<sup>36</sup> The agreements reached under this process continue to be mutually beneficial to the parties involved, but there is no longer any *social* effect, since the interests of other stakeholders are not taken into account. A shortage of social capital poses the threat that the institution of CSR may degenerate into a tool for collusion among companies and interest groups at the public’s expense.

Current social capital is in short supply in Russia, which is confirmed by sociological research.<sup>37</sup> Civic initiatives were not cultivated during the Soviet era, and the radical and largely chaotic changes of the post-Soviet period have made preoccupation with one’s own economic welfare the top priority and have had a negative effect on solidarity and trust in society. The weakness of civil society in Russia means that it cannot be expected to play a leading role in CSR processes. The lack of social participation in these processes is highlighted, among other things, by the deep gulf between the public’s notions of desirable priorities for CSR and the actual areas of social investments by Russian companies, and by the widespread doubts about the appropriateness of demanding social responsibility from private companies.<sup>38</sup>

### **Social capital and the social efficacy of corporate social responsibility: A formal analysis**

Using a simple model, we will illustrate how CSR loses its competitive advantages over government regulation when social capital is lacking.

Let a company sell its output to a community of customers, each of whom consumes a unit of output,<sup>39</sup> and as a result receives utility  $u_0$ ; it is assumed that the set of customers makes up a unit continuum, and the output is sold at an exogenously determined price  $p < u_0$ . The company’s production operations create a negative externality of size  $a \geq 0$  and incur production costs  $c(a)$ , which for simplicity are assumed to be independent of output, and where the function  $c(a)$  is monotonically decreasing and concave. The financial estimate of the damage to each customer from the externality is  $\xi a$ , where the parameter  $\xi \geq 0$  characterizes “sensitivity” to the externality and may vary from one community of customers to another.

The social optimum requires minimization of the total costs of the company and customers  $c(a) + \xi a$  and is achieved when  $a = a^*$ , where  $c'(a^*) = -\xi$ . This optimum depends on  $\xi$ : the higher the sensitivity of customers to the externality, the greater the company costs to mitigate a harmful effect that are justified

from the public perspective. If government regulation is applied to control the externality, a company may be required to maintain the externality at a certain level  $a^0$ . If regulation is overly rigid, where the required level of the externality is the same for all values of  $\xi$ , or because of informational asymmetry, where  $\xi$  is not monitored by regulators, deviations from the social optimum in any direction are inevitable, where regulation either does not prevent serious damage to society from the company's activities (at high values of  $\xi$ ) or, conversely, it needlessly burdens the company with significant costs. In this case, it may be preferable to reach an explicit arrangement with customers in the form of CSR, which, of course, will duly factor in local conditions. The question is, to what degree can the gain in flexibility be implemented given the stock of social capital on hand.

Social capital is reflected in the model by the parameter  $H \geq 0$ , which determines the distribution among customers of the "pain threshold"  $z$ : if the damage from the externality  $\xi a$  exceeds this threshold, the customer in question will refuse to buy the company's product in protest.<sup>40</sup> The assumption is that  $z$  is evenly distributed among customers with a cumulative distribution function  $F_H(z) = \min(1, zh)$ , and if the company has not obtained society's consent by securing a "social license" to produce, then at the externality level  $a$ , a boycott by customers will cause it to lose market share  $\min(1, \xi a H)$ .

The purpose of Coasean bargaining between a company and customers is to maximize joint gain (or to minimize aggregate costs, which is the same thing) and to reach agreement on a mutually acceptable distribution of benefits from cooperation. Aggregate gain is maximized if the customers refrain from boycotting and the company chooses  $a = a^*$ . An important factor in the distribution of the gain between the parties is the default point, which is realized when an agreement is abandoned and thereby determines the parties' initial positions. When the company acts unilaterally at the default point, it maximizes its own gain  $p(1 - \xi a H) - c(a)$  (factoring in the anticipated customer boycott), and the size of the externality  $\tilde{a}$  will be found from the condition  $c'(\tilde{a}) = \xi H$ ; in this instance, the gain of the company and customers will be, respectively,  $\tilde{\pi} \equiv p(1 - \xi \tilde{a} H) - c(\tilde{a})$  and  $(u_0 - p)(1 - \xi \tilde{a} H) - \xi \tilde{a}$ .

Will bargaining result in the socially optimal level of externality  $a = a^*$ ? The answer to this question depends on the parties' ability, if necessary, to redistribute the gain between themselves using side payments so that both parties gain over the default point. If the stock of social capital is large, the threat of a mass boycott compels the company before an agreement, at very high cost, to maintain the externality at an unjustifiably low level; in this case society can agree to increase the externality to the social optimum provided that the additional damage will be substantially covered by a side payment

from the company in the form of social investments (Figure 1a; point *A* denotes the default point; point *B*, the bargaining outcome).

If social capital is in short supply, the company does not view small-scale protests as a serious threat to business, the size of the externality at the default point is very large and clearly exceeds the social optimum. In this case, the company has an interest in a dialogue with customers so as to fully restore demand through a “social license,” but achieving the social optimum would require institutionally unfeasible side payments *from* customers to the company, and such an outcome turns out to be unattainable (Figure 1b). It is not hard to see that the first scenario is realized if  $(u_0 - p) - \xi a^* > \bar{a}$ , while the second one occurs if  $p - c(a^*) \bar{\pi}$ . Consequently, there are threshold values of social capital  $\underline{H} < \bar{H}$  such that when  $H < \bar{H}$  CSR does not provide a socially optimal settlement of the externality, when  $\bar{H} < H$  the social optimum will clearly be achieved, and, in the intermediate scenario  $\underline{H} < H < \bar{H}$ , it may be achieved if the stakeholding customers wield enough bargaining power in their relationship with business.<sup>41</sup>

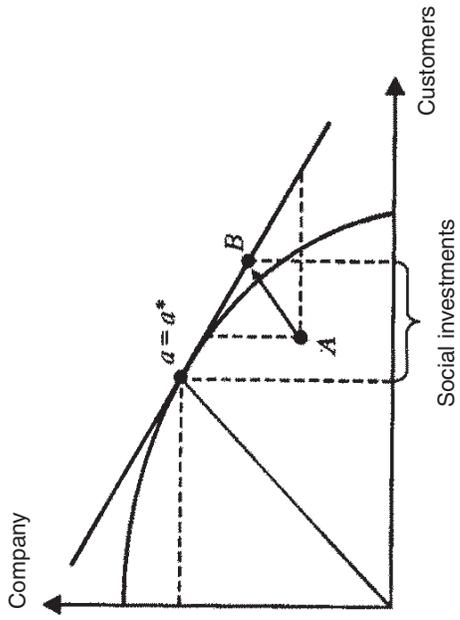
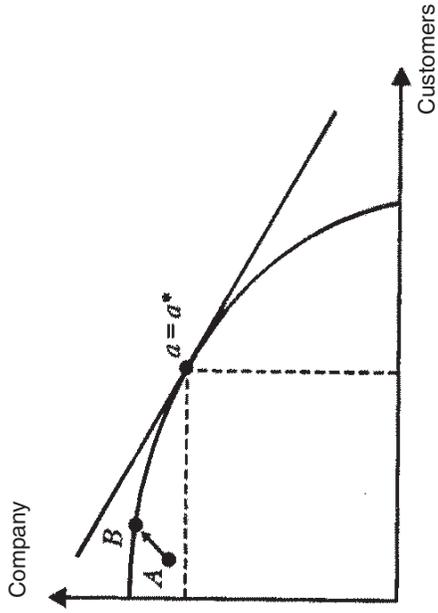
Thus, the analysis of the model confirms the conclusion that the social efficacy of CSR is strongly dependent on the stock of social capital.

### Corporate social responsibility and government

Since the social responsibility of business is realized within the realm of the government’s powers, the role of government authorities in regulating CSR is of great importance. In accordance with the notion of CSR as a private alternative to government regulation, worldwide practice proceeds from a “division of labor” between government and CSR: the former prescribes a minimal set of mandatory rules, while companies, responding to market signals, that is, if there is mutual benefit for themselves and stakeholders, may “overfulfill” these requirements. In the process, cognizant of the social value of CSR, the government may provide support for this institution in the form of recommendations, certification and evaluation procedures, requirements for the disclosure of information, participation in drawing up codes of behavior, in consultations, roundtable discussions, and so forth. The thrust and purpose of such efforts is to create a favorable environment for companies to implement their social responsibility.<sup>42</sup>

In the Russian CSR model, government authorities play a much more active role as one of the principal “clients” (if not the most important or only one) of social responsibility.<sup>43</sup> This state of affairs, of course, is largely attributable to the weakness of civil society and its inability to act as a real partner with business on issues of social responsibility, so the government fills in this gap.<sup>44</sup>

Figure 1. [Company's Gain Versus Customer's Gain]



(a)

(b)

The practice of active government participation in CSR is viewed by many in Russia as the norm and receives fairly wide support in public opinion and the business community.<sup>45</sup> Yet this situation is, to a certain extent, paradoxical and clearly contradicts the generally accepted interpretation of CSR as a *nongovernmental* institution in its intent. It is well known that adapting institutions to the specific conditions of various countries sometimes requires nonconventional solutions, and this could *explain* the Russian metamorphosis of CSR.<sup>46</sup> A separate task is to conduct an *assessment* of the Russian model of social responsibility, which should answer the question of whether this model is a “second-order optimum,” that is, a rational choice, from the public perspective, among realistically available options.

By acting as a “client” and partner with business on issues of social responsibility, the government effectively supplements the traditional instruments of economic policy—officially mandated taxes and rules—with information regulation and taxation on an ad hoc basis. The advantages and risks of this practice have been thoroughly examined in the analysis of the “rules vs. discretion” dilemma. Rules make government policies more predictable and transparent, but at the same time take away its flexibility and ability to respond swiftly to changing circumstances. The vesting of discretionary powers in the regulatory authorities engenders uncertainty regarding decisions that are made, gives rise to doubts about the reliability of the government’s declared intentions, and creates an opportunity for abuses. The above disadvantages and risks of an ad hoc approach are partially overcome if decision-making officials value their professional and personal reputation and the decisions themselves undergo an *ex post* review.<sup>47</sup>

The inadequate accountability and transparency of the civil service in Russia makes it impossible to rely on reputational mechanisms, and CSR projects initiated by the government are not monitored or audited because such projects are nominally implemented outside the public sector, and therefore do not fall under budgetary control. The companies themselves by no means always disclose sufficient information about their social investments.<sup>48</sup>

The interaction between government authorities and companies on issues of social responsibility takes two basic forms.<sup>49</sup> In the first case, CSR is “voluntary-coercive,” when companies come under pressure from the government, and social investments become *de facto supplemental business taxes*. As was already noted, such revenues partly offset the insufficient official sources of revenue for regional and local budgets. In the 1990s, Russian regions had the ability to establish their own taxes, but lost it with the implementation of the Tax Code and found an alternative in informal taxation under the guise of CSR. This practice, however, is a highly flawed surrogate for a full-fledged system of government finance, since it violates two key principles of how

such a system should be organized—budget integrality (the ability to control revenues in their entirety when choosing expenditure items and the amounts of itemized funding) and the accountability of budgetary planning and execution. Another serious defect is the lack of transparency and the unpredictability of surrogate taxation, which make the business climate worse and have a negative impact on the competitiveness of business.

The second form of government participation in CSR can be called “contractual”—in this case, the parties wield comparable influence and resources and enter into a relationship with each other to mutual benefit. This practice, as was noted earlier, prevails in the relationships of large, primarily town-forming companies with regional and local authorities; here social investments and other forms of participation by a company in the development of a town or region are exchanged for the financial and especially “organizational” support of government authorities, as well as advantages in government purchases.<sup>50</sup> This model is consistent with the concept of CSR as Coasean agreements between companies and stakeholders, with the important caveat that the latter are represented solely by bureaucrats. Participation in these agreements by only one category of stakeholders—government authorities—raises questions about the benefit to society of such arrangements (see above). The interests of officials and politicians by no means always match the public interest, especially when democratic accountability is lacking; as a result, arrangements between bureaucrats and business may not meet the needs of society.<sup>51</sup> CSR, however, has a convenient and legitimate format for such “transactions,” reducing their costs. Traditional corruption in the form of bribes and kickbacks is not a necessary condition for implementing such mutually beneficial agreements, but there has been testimony that it also results from corporate social investments.<sup>52</sup>

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The specific structural features of the Russian economy, the diversity and complexity of the country’s socioeconomic problems, and the limited capabilities of government regulation and the public sector create a significant “demand” for CSR, which under favorable conditions may prove more efficient than the traditional instruments of government economic policy or fill in the niches where these instruments do not work for various reasons. A combination of a number of factors that give CSR relative advantages over economic regulation can explain the massive proliferation of this institution in Russia. In many cases, the socially responsible behavior of Russian companies unquestionably benefits society by mitigating market failures and providing more favorable business conditions.<sup>53</sup>

At the same time, the lack of protection of property rights and the weakness

of civil society reduce the efficacy of CSR. The unreliability of property rights makes business too vulnerable to outside pressure, and because of the lack of social capital the principal source of such pressure is the government. As a result, CSR ceases to be a private alternative to government regulation of the economy and becomes another tool of government influence on the private sector—this time an informal one that is assigned to an “institutional offshore account” without official rules and procedures.

Given this kind of inappropriate use as a surrogate instrument of economic policy, the institution of CSR loses a significant portion of its competitive advantages.<sup>54</sup> Such surrogates reduce the effectiveness of reforms in the public sector by opening up circuitous ways to preserve the old practices.<sup>55</sup> For example, the informal and arbitrary taxation of companies in the form of social responsibility emasculates the basic idea of tax reform (to reduce the tax burden on business and make the burden more predictable), and the opportunity for arrangements between government authorities and companies is in obvious conflict with attempts to limit corruption by means of direct-effect laws, which preclude an ad hoc approach.

The massive appeal to business for assistance in government’s performance of its functions blocks fulfillment of the potential of the reforms already carried out and crushes incentives for further reform and modernization of public governance, the economy, and the social sector. This is graphically demonstrated by the economic crisis that began in 2008.

The main social task during the crisis is now to maintain employment and living standards at a time of significant recession and downturn in the revenue of the private and public sectors. The instruments of government economic policy that can be used to accomplish this task include: targeted supported of viable companies (on condition, if necessary, that they are restructured), measures to develop the labor and small-business markets, to provide advanced occupational training and increase the mobility of the population, improve social protection, and so forth. As an alternative, it is possible to assign to business as a “social responsibility the preservation of jobs in spite of the crisis, by offering financial support in exchange<sup>56</sup> and deferring to the future the solution of structural problems and institutional reforms.

The second scenario has become very common in the system of anticrisis measures, continuing the entrenched tradition in Russia of incorporating CSR into the set of government economic instruments. It also reflects the practices and interpretation of CSR, which have changed during the crisis. The need for rigorous savings is forcing companies on a massive scale to abandon noncore projects, while social responsibility has begun to be viewed in public opinion

and government circles primarily as maintaining employment. The threat of a downturn in income, unemployment, and shutdowns of plants has led to the growth of civic activity. In contrast to the precrisis period, demands for social responsibility on the part of business are cropping up with increasing frequency today at the grassroots, while the government, in the interests of social and political stability, supports these demands. But the transformation of companies into de facto suppliers of social protection carries excessive costs and depletes corporate and government finances while preserving an inefficient economic and employment structure.

The foregoing analysis confirms that the choice between institutional alternatives depends on the socio-economic, political, and general institutional context. Moreover, the institutions themselves sometimes undergo radical changes under the influence of this context, and as a result an expansion of the “institutional menu” by adding potentially beneficial institutions to it does not necessarily enhance social efficacy. In order to fully realize the potential of CSR, the preponderantly nongovernmental nature of that institution should be preserved, and it should not be viewed as an alternative to the development of markets, to modernization of the social sector, to improvement of fiscal policy and government regulation, and other key reforms.

## Notes

1. D. North, *Institutions, Institutional Change, and Economic Performance* (Cambridge: Cambridge University Press, 1990) (for Russian translation, see D. Nort, *Instituty, institutsional'nye izmeneniia i funktsionirovanie ekonomiki* [Moscow: Nachala, 1997]).

2. R. Coase, “The Problem of Social Cost,” *Journal of Law and Economics*, 1960, vol. 3, pp. 1–44 (for Russian translation, see R. Kouz, “Problema sotsial'nykh izderzhkek,” in R. Kouz, *Firma, rynek i pravo* [Moscow: Novoe, 2007]).

3. The term comes from Ia. Pappe. See S.V. Shishkin, ed., *Biznes kak sub'ekt sotsial'noi politiki: dolzhnik, blagodetel', partner?* (Moscow: GU-VShE, 2005), p. 6.

4. L. Polishchuk, “Biznesmeny i filantropy,” *Pro et contra*, 2006, vol. 10, pp. 59–73; Iu. E. Blagov et al., “Doklad o sotsial'nykh investitsiakh v Rossii—2008” (Moscow: Assotsiatsiia menedzherov, 2008). See also A. Yakovlev, “The Russian Corporation and Regional Authorities: Models of Interrelations and Their Evolution,” Higher School of Economics WP 13/14, 2007.

5. U.S. corporations play a relatively modest role in American philanthropy: in 2004 they accounted for 5 percent (\$12 billion) of all donations, while private individuals accounted for 75 percent, or almost \$190 billion (The Annual Report on Philanthropy for the Year 2004. Giving USA Foundation, 2005). In Britain, corporate donations in the 2003/2004 fiscal year amounted to £900 million (0.4 percent of the gross profits of British companies), while charities had total revenues of £35 billion

(Charity Aid Foundation, 2005). In Russia, according to available estimates (CAF News Centre, July 8, 2004), charitable contributions by Russian companies in 2003 exceeded \$1.5 billion, while private individuals allocated \$100 million for charitable purposes. Thus, the proportions between corporate and private philanthropy in Russia proved to be virtually the opposite of those in the West.

6. S.E. Litovchenko et al., "Doklad o sotsial'nykh investitsiakh v Rossii—2004" (Moscow: Assotsiatsiia menedzherov, 2004).

7. M. Aoki, *Toward a Comparative Institutional Analysis* (Cambridge: MIT Press, 2001).

8. D. Baron, "Private Politics, Corporate Social Responsibility and Integrated Strategy," *Journal of Economics and Management Strategy*, 2001, vol. 10, no. 1, pp. 7–45.

9. A. McWilliams and D. Siegel, "Corporate Social Responsibility: A Theory of the Firm Perspective," *Academy of Management Review*, 2001, vol. 26, no. 1, pp. 117–27.

10. This expansion of the domain of the company's responsibility is reflected by the metaphor "triple bottom line," when the system of priorities includes (in addition to the pursuit of profit) concern with society's needs and the condition of the environment.

11. T. Donaldson and L. Preston, "The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications," *Academy of Management Review*, 1995, vol. 20, no. 1, pp. 65–91.

12. M. Friedman, "The Social Responsibility of Business Is to Increase Its Profits," *New York Times Magazine*, 1970, September 13, pp. 122–26.

13. See, for example, F. Reinhardt, "Market Failure and the Environmental Policies of Firms. Economic Rationales for 'Beyond Compliance' Behaviour," *Journal of Industrial Ecology*, 1999, vol. 3, no. 1, pp. 9–21.

14. L. Polishchuk and E. Firsov, "Doing Well by Doing Good: An Industrial Organization Perspective of Corporate Philanthropy," Higher School of Economics Working Paper 13/15, SU-HSE, Moscow, 2007.

15. K. Webb, ed., *Voluntary Codes: Private Governance, the Public Interest, and Innovation* (Ottawa: Carleton Research Unit for Innovation, Science and Environment, 2004); B. Husted and J. de Jesus Salazar, "Taking Friedman Seriously: Maximizing Profits and Social Performance," *Journal of Management Studies*, 2006, vol. 43, no. 1, pp. 75–91.

16. Coase, "The Problem of Social Cost."

17. The fact that CSR and government regulation are substitutes for each other is indirectly evidenced by the opposition to CSR of advocates of a free market with a minimal governmental presence and the support for this idea by those who agree with the need for government regulation of market activities. See J. Ludischer, A. McWilliams, and D. Siegel, "The Economic View of Corporate Citizenship," in *Handbook of Research on Global Corporate Citizenship*, ed. A. Scherer and G. Palazzo (Cheltenham, UK: Edward Elgar, 2008), pp. 315–42.

18. M. Porter and M. Kramer, "Strategy and Society. The Link Between Competitive Advantage and Corporate Social Responsibility," *Harvard Business Review*, 2006, vol. 84, no. 12, pp. 78–92; Ludischer, McWilliams, and Siegel, "The Economic View of Corporate Citizenship."

19. Economic legal theory distinguishes between two principles of protection of property rights (see G. Calabresi and A. Melamed, "Property Rules, Liability Rules

and Inalienability: One View of the Cathedral,” *Harvard Law Review*, 1972, vol. 85, no. 6, pp. 1089–128). According to the first principle (a property rule), property rights may be infringed only with the prior consent of their holder, if he is satisfied by compensation offered ex ante. In the second case (a liability rule) compensation is designated by a court ex post—after the infringement of rights has become a fait accompli. Since CSR does not assume any judicial sanction (although one of the motivations for social responsibility could be to avert a lawsuit), it is more consistent with the first regime.

20. S. Djankov, E. Glaeser, R. La Porta, F. Lopez-de-Silanes, and A. Shleifer, “The New Comparative Economics,” *Journal of Comparative Economics*, 2003, vol. 31, no. 4, pp. 595–619.

21. A. Greif, “Cultural Beliefs and the Organization of Society: A Theoretical Reflection on Collectivist and Individualist Society,” *Journal of Political Economy*, 1994, vol. 102, no. 5, pp. 912–50.

22. E. Glaeser and A. Shleifer, “The Rise of the Regulatory State,” *Journal of Economic Literature*, 2003, vol. 41, no. 2, pp. 401–25.

23. See Shishkin, *Biznes kak sub’ekt sotsial’noi politiki*. Unlike a number of officially established taxes, which either come in to the federal budget or are shared with the region in a certain proportion, social investments by companies, as a rule, are spent on the spot, and therefore could prove to be more attractive to regional and local authorities than traditional tax collections. Government authorities in the regions sometimes tolerate tax evasion by companies in exchange for financial support of projects and programs (P. Haaparanta and T. Juurikkala, “Bribes and Local Fiscal Autonomy in Russia, BOFIT Discussion Papers 12.2007; Yakovlev, “The Russian Corporation and Regional Authorities”).

24. Institut regional’noi politiki, *Monogoroda Rossii: Kak perezhit’ krizis?* (Moscow, 2008).

25. P. Haaparanta et al., “Firms and Public Service Provision in Russia,” BOFIT Discussion Papers 16.2003.

26. Shishkin, *Biznes kak sub’ekt sotsial’noi politiki*.

27. “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 the rights and privileges given the company—L.P.], then it may demand additional contributions [from the company—L. P.]” (J. Ludischer, A. McWilliams, D. Siegel, “The Economic View of Corporate Citizenship,” p. 335).

28. *International Property Rights Index Report*, 2008.

29. A. Radygin and Iu. Simachev, “Institut bankrotstva v Rossii: osobennosti evoliutsii, problem i perspektivy,” *Rossiiskii zhurnal menedzhmenta*, 2005, vol. 3, no. 2, pp. 43–70.

30. Polishchuk, “Biznesmeny i filantropy.”

31. In a survey conducted in 2004 by the Institute for Sociopolitical Studies, Russian Academy of Sciences, 77 percent of the respondents felt that the majority of large corporate owners in Russia did not rightfully own their assets (V.N. Ivanov, “Privatizatsiia glazami rossiian,” *Rossiiia v global’noi politike*, 2006, no. 6); other surveys yield similar results.

32. T. Frye, “Original Sin, Good Works, and Property Rights in Russia,” *World Politics*, 2006, vol. 5, no. 4, pp. 479–504.

33. M. Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (Cambridge: Harvard University Press, 1965 (for Russian translation, see M.

Olson, *Logika kollektivnykh deistvii: Obshchestvennye blaga i teoriia grupp* [Moscow: Fond ekonomicheskoi initsiativy, 1995]).

34. D. Halpern, *Social Capital* (Cambridge, UK: Polity, 2005).

35. Olson, *The Logic of Collective Action*.

36. This practice is in line with the pragmatic interpretation of CSR as “a stakeholder management tool). See M. Clarkson, “A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance,” *Academy of Management Review*, 1995, vol. 20, no. 1, pp. 92–117.

37. R. Rose, “Uses of Social Capital in Russia: Modern, Pre-Modern, and Anti-Modern,” *Post-Soviet Affairs*, 2000, vol. 16, no. 2, pp. 33–57; I. V. Mersianova and L. I. Iakobson, *Obshchestvennaia aktivnost' naseleniia i vospriiatie grazhdanami uslovii razvitiia grazhdanskogo obshchestva* (Moscow: GU-VShE, 2007).

38. Based on data from the Russian Center for Public Opinion Research (VTsIOM), 65 percent of respondents in a survey conducted in 2004 considered job creation to be the main social task of big business, but only 24 percent of the respondents noted real efforts in that direction. The second-ranked form of social responsibility was the granting of an additional social package to employees (33 and 8 percent, respectively). Regarding other expenditure items, the demand for CSR lagged far behind the supply: cultural and sports events, 3 and 19 percent, respectively; restoration and construction of religious structures, 2 and 12 percent, respectively (VTsIOM press release, 2004, no. 95). According to later VTsIOM surveys, almost 50 percent of Russians believe that business must be competitive and pay taxes, leaving the solution of problems to the government. Almost the same number think that business must participate in social programs even at the price of a decrease in cost effectiveness (E. Pakhomova, “Uchastie rossiiskogo biznesa natsional'nykh sotsial'nykh programm: otsenki i ozhidaniia rossiian,” *Natsional'nye proekty*, 2006, no. 5).

39. It is assumed that the product being sold has no substitutes and the company has no competition. We should note that the effect of market power on CSR is ambiguous. On the one hand, there is a view that competition precludes corporate altruism by not leaving any surplus for “wasteful spending” (W. Baumol, “(Almost) Perfect Competition (Contestability) and Business Ethics,” in *Perfect Markets and Easy Virtue: Business Ethics and the Invisible Hand*, ed. W. Baumol and S. Blackman (Cambridge, MA: Blackwell, 1991, pp. 1–23). On the other hand, if CSR has strategic motivations, the situation is the opposite: companies with significant market power do not have to fight for customers, so they can painlessly ignore the damage that they cause society by their activities (the cost savings required to prevent such damage becomes one of the sources of monopoly rent). A monopoly can be disciplined only by government regulation or a consolidated position of civil society. Conversely, if there is competition CSR becomes one of the strategies of fighting for customers (D. Vogel, *The Market for Virtue. The Potential and Limits for Corporate Social Responsibility* [Washington, DC: Brookings Institution Press, 2005]; Polishchuk and Firsov, “Doing Well by Doing Good”).

40. Such a protest is “individually irrational” in the sense that the protester loses the customer gain in the amount  $u_0 - p$ , while his step does not have any noticeable effect on the company's profits, and makes sense only as part of a fairly massive demonstration. This, then, is the problem of collective action, which requires social capital to solve.

41. For a more detailed discussion, see L. Polishchuk, "Corporate Social Responsibility vs. Government Regulation: Institutional Analysis with Application to Russia," Higher School of Economics Working Paper WP10/01, 2009.

42. H. Ward, *Public Sector Roles in Strengthening Corporate Social Responsibility: Taking Stock* (Washington, DC: World Bank, 2004).

43. For a more detailed discussion of the role of government authorities, especially at the regional and local levels, in the Russian model of CSR, see M. Liborakina, ed., *Gorod i biznes: formirovanie sotsial'noi otvetstvennosti rossiiskikh kompanii* (Moscow: Fond Institut ekonomiki goroda, 2003); Shishkin, *Biznes kak sub"ekt sotsial'noi politiki*; and Polishchuk, "Biznesmeny i filantropy."

44. Under conditions of "poorly expressed public demand for social activity by the private sector, [when] societal claims have not been formulated, public notions of fairness have been distorted, the range of stakeholders boils down mainly to the government and corporate owners, the mechanisms for providing public information and public recognition of the social activity of companies . . . the government was forced to replace public demand for social activity with government pressure on, and coercion of, business" (Litovchenko et al., "Doklad o sotsial'nykh investitsiakh v Rossii—2004," p. 13).

45. About half the respondents in a survey conducted by VTsIOM believe that the government has the right, if necessary to recruit business to solve social problems, and about two-thirds think that the government should reward socially responsible behavior by business (Pakhomova, "Uchastie rossiiskogo biznesa natsional'nykh sotsial'nykh program"); 94 percent of company managers said that the government should reward CSR financially (Blagov et al., "Doklad o sotsial'nykh investitsiakh v Rossii—2008").

46. See, for example, D. Rodrik, "Institutions for High-Quality Growth: What They Are and How to Acquire Them?" *Studies in Comparative International Development*, 2000, vol. 35, no. 3, pp. 3–31.

47. N. Stokey, "'Rules vs. Discretion' After Twenty-Five Years," in *NBER Macroeconomic Annual*, ed. M. Gertler, and K. Rogoff (Cambridge, MA: MIT Press, 2003), pp. 9–62; M. Seidenfeld, "Bending the Rules: Flexible Regulation and Constraints on Agency Discretion," *Administrative Law Review*, 1999, vol. 51, no. 2, pp. 430–95.

48. Litovchenko, "Doklad o sotsial'nykh investitsiakh v Rossii—2004."

49. Polishchuk, "Biznesmeny i filantropy"; Yakovlev, "The Russian Corporation and Regional Authorities."

50. Financial assistance to business most often turns out to be in the form of the already-mentioned tax benefits, while organizational assistance denotes support for investment projects, land allotment, access to engineering infrastructure and assistance in contacts with federal agencies. Furthermore, it is typical for large, dynamically developing companies with a government share in the joint-stock ownership to receive support from the authorities and simultaneously provide assistance to them, which indicates that the interchange is based on an agreement (Yakovlev, "The Russian Corporation and Regional Authorities").

51. A. Shleifer and R. Vishny, "Politicians and Firms," *Quarterly Journal of Economics*, 1994, vol. 109, no. 4, pp. 995–1025.

52. Polishchuk, "Biznesmeny i filantropy"; Shishkin, *Biznes kak sub"ekt sotsial'noi politiki*.

53. For a survey of best CSR practices in Russia, see, for example, Blagov et al., "Doklad o sotsial'nykh investitsiakh v Rossii—2008."

54. For a more detailed discussion, see L. Polishchuk, "Netselevoe ispol'zovanie institutov: prichiny i sledstviia," *Voprosy ekonomiki*, 2008, no. 4, pp. 28–44.

55. This obstacle to reform is known as the "see-saw effect." See D. Acemoglu, S. Johnson, P. Querubin, and J. Robinson, "When Does Policy Reform Work? The Case of Central Bank Independence," *Brookings Papers on Economic Activity*, 2008, vol. 1, pp. 351–418.

56. An analysis of such exchanges between companies and the government is presented in Shleifer and Vishny, "Politicians and Firms."

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