Promoting Corporate Social Responsibility in Asia: Opportunities and Challenges

Madhu Khanna
University of Illinois, Urbana-Champaign
Outline

• Environmental Challenges in Developing Countries
• Role for Non-Regulatory Approaches to Promoting Corporate Social Responsibility
• Lessons about Effectiveness from Developed Countries and their Applicability to Developing Countries
• Other Market-based Approaches to Environmental Protection: Opportunities and Challenges
• Areas for Future Research
Environmental Challenges in Developing Countries

- Most vulnerable to climate change
  - Could lead to up to 5% loss of GDP
- Highest impact of air pollution, poor water quality, and forest loss
- Large biodiversity losses
- Conflict between GDP and greening
Mechanisms for Promoting Corporate Social Responsibility

- Voluntary programs established by the government: encourage firms to participate in voluntarily reducing pollution


- Mandating CSR: Requiring firms to spend on socially responsible projects

- Unilateral initiatives: Adoption of Environmental Management Systems, ISO certification, eco-labeled products

- Environmental information disclosure programs: empower the public to signal its preferences for environmentally friendly programs
Motivations for Promoting CSR

Motivations in Developed Countries:
- Reduces administrative burden and legislative delays
- Fosters collaborative relationship between industry and government
- Provides a flexible alternative to command and control regulations with a less adverse impact on firm competitiveness than emissions taxes or permits or uniform technology standards

Motivations in Developing Countries
- Limited monitoring and law enforcement capacity
- Low levels of regulatory compliance; influence of industry on regulators
- Substantial financial investments needed for environmental protection and to meet Sustainable Development Goals
Social Responsibility by Firms

• Needs to be in the self-interest of the firm
  • Self-enforcing
  • Cost reduction
  • Product differentiation

• Various regulatory and non-regulatory drivers

• Key challenges:
  • Making value proposition of CSR as being in the self-interest of the firm at the scale needed
  • Adoption of responsible practices does not guarantee improvements in environmental and social performance
Regulatory Pressures

• In Developed Countries
  • Credible regulatory structure; penalties for non-compliance
  • Scrutiny by environmental NGOs to detect non-compliance
  • Incentives for firms to go beyond compliance to improve reputation
  • Incentives for firms to self-regulate to
    • preempt regulatory threats by making good faith efforts
    • shape future regulations
    • reduce stringency of enforcement pressures

• In Developing Countries
  • Significant under-compliance with environmental regulations by domestic firms
  • Regulatory capacity to monitor and enforce regulations is weak
  • Many unregulated small and medium enterprises and firms in the informal sector
  • Civic pressures from NGOs are weak
Voluntary Programs Created by the Government in Developed Countries

- Differ in whether they set numerical targets for environmental improvements or require adoption of better management practices and production technologies
- Provision of public recognition
- Technical assistance
- Require a credible infrastructure for implementation
- Have been found to be effective if
  - Ability of public to track improvements in environmental performance
  - Clear baselines and numerical targets
  - Credible threat of regulation
  - Reputational benefits through participation
  - Public concerns about pollution
India: First country to mandate CSR by large firms

Companies Act, 2013 defines “eligible” firms:
• Meet one of these criteria in any previous three-year period
  • Net profit ≥ Rupees 5 crore
  • Net worth ≥ Rupees 500 crores
  • Turnover ≥ Rupees 1000 crores

• Requires formation of a CSR Committee that specifies a CSR policy and develops CSR activities

• CSR activities that serve societal needs
  • reducing hunger, poverty or disease, child mortality
  • promoting education, gender equality, vocational skills, social business projects
  • disaster relief
  • increasing environmental sustainability

• Go beyond a firm’s efforts to make its own operations environmentally/socially responsible.
CSR Requirement: Mandatory-Voluntary Hybrid

• Large firms to spend 2% of their average profits in past three years on CSR

• Firms cannot simply transfer funds
  • Required to partner with a non-government organization and actively participate in implementation

• No penalties to defaulters
  • Non-compliant firms required to report reasons in their annual report

• Initial effort to establish a social norm for CSR and provide a channel for stakeholder pressure on firms to engage in CSR activities.

• Voluntary compliance could preempt threat of mandatory compliance
Motivations for Participation in CSR by firms in India

- Voluntary CSR prior to Companies Act in self-interest

- CSR by eligible firms likely to increase after the Act to avoid negative public perception

- More profitable firms likely to undertake more CSR expenditures as required by the Act
  - have the human resources and the financial resources
  - face greater risk of negative publicity, increased government regulation, greater incentive for maintaining a socially responsible public image
  - At greater risk if 2% CSR requirement becomes a tax

- But also potential for crowding out of expenditures on CSR
  - Donations that are not recognized by Companies Act
  - Motivated previously by peer pressure

Bansal et al., 2021
Firms Reporting CSR

Percentage of Firms

Year


% of Non-Eligible Firms Doing CSR % of Eligible Firms Doing CSR
Average CSR and Charitable Donations by Eligibility and Year

Average Expenditures (Rs. Million)

- Eligible CSR
- Non-Eligible CSR
- Eligible Donations
- Non-Eligible Donations

Observed CSR Expenditures

2014

2016
Regression Discontinuity Approach: Shows Threshold Effect of CSR Act on Eligible Firms
Key Findings on Effectiveness of Mandating CSR

- Eligible firms more likely to report CSR expenditure as compared to non-eligible firms.
  - Difference in probability of reporting CSR expenditure by eligible firms is 28% higher than for non-eligible firms in 2015 and 43% higher in 2016
  - As their profits increase

- Eligible firms are also likely to spend more on CSR after the Act
  - Expenditures are higher in 2016 than in 2015 and increase with profits
  - Expenditures due to the Act are about 1% of profits on average

- Firms at the threshold of eligibility were spending about 0.7% of profits on CSR

- No evidence that the Act led to a reduction in other charitable donations

- Requirement making CSR spending proportional to profits diminishes the role of peer pressure as a driver of CSR
Opportunities and Challenges with CSR Act

• Potential to raise a significant amount of resources
• Inculcate a culture of volunteerism among employees
• No mechanisms to target CSR activities to areas of societal need vs those in the firm’s interest
• Ensuring compliance requires the same regulatory structure that is needed for enforcing environmental regulations and is weak to begin with
• Lack of coordination of efforts by different firms
• Difficulty finding suitable projects to spend on
Market-Based Pressures in Developing Countries

• Green supply chains
• Final consumer demand for green products
• Financial markets: investors and banks
• Eco-tourism
Green Supply Chains

• Many MNCs are developing their own global environmental standards and not adopting national standards
  • Seeking suppliers that have environmental certifications, adopting responsible environmental management systems
  • Demonstrating green practices in developing countries: can potentially raise standards for other firms

• Green supply chains: Linking upstream firms to downstream buyers that seek to be environmentally responsible
  • Particularly effective when downstream firms are MNCs or global firms
  • Pressure from social media, consumers, investors and NGOs on MNCs to be responsible

• Asia is central to the global supply chain as a major supplier of raw materials, intermediate products, and final products to businesses and consumers located in the US and Europe

• Many Asian countries rely heavily on export markets for their economic growth

• Adoption of ISO 14001 in the region has been stimulated by demand from MNCs, particularly those that are larger, more visible and vulnerable to negative publicity for their environmental performance
Effectiveness of Green Supply Chains

- Supply chain pressures are more effective if supplemented by other policy drivers to green supply chains
  - national environmental standards
  - existence of or aspiration to free trade agreements with the EU and the US
  - effectively enforced international environmental agreements

- Global economic activity with major environmental impacts affected by the green supply chain is small
  - products largely consumed domestically or exported to other developing countries with weak environmental standards

- Share of MNCs in production in most developing countries is small
  - focus is often on the few products made in developing countries and exported to developed countries

- Consumer concerns in developed countries tend to be selective and focused on developing country practices that are often more symbolic, like wildlife protection, than critical, such as urban air quality.
Challenges to Greening Supply Chains

• Changes to the supply chain can be expensive and risky
• Requires support from senior management and finding suppliers with resources to adopt environmental management systems and comply with the requirements of certification programs.
• Obtaining ISO certification can incur significant implementation costs; limited to larger firms
• Need to ensure quality of the certification and independence of auditors
• Government role in ensuring that third-party auditors are operating independently
• Governments can also develop approaches to induce and verify compliance with the standards by offering regulatory relief, faster access to permits, or other benefits
Barriers to Greening SMEs

• High costs of implementation, lack of resources and trained staff
• Low environmental awareness within the organization, including top management
• Lack of consumer demand for green products
• Firms operate with very low margins and in hyper-competitive industries
  • focused on surviving in the near term rather than building customers and demand in the future
• Regulatory vacuum, legislation outlining best practices essentially absent
• Many Asian SMEs have shown limited response to green supply chain pressures
• MNCs differ in their approaches to green supply chain management, the lack of harmonization makes it difficult for best practices to spread across the entire supply chain
Market-Based Motivations: Consumers

- Consumer and public preferences for goods produced by environmentally responsible firms are vital to create demand. Firms are motivated to be green to
  - Increase market share by differentiating products
  - Meet demands from downstream supply chain for environmentally responsible products
  - Increase revenue through price premiums from environmentally conscious consumers
  - Avoid negative publicity and boycotts

- Key constraint to green goods is that they are “credence goods”
  - Critical to have trustworthy eco-labels
  - Role for governments in developing standards, transparent and credible
  - Demand for eco-labeled products has been growing in Asia

- Export oriented firms have greater incentives to demonstrate environmental responsibility

- Challenge for Small and Medium Enterprises to conduct environmental impact assessment and life-cycle assessments
  - Lack of expertise, financial and organizational capacity
  - Can make eco-labels an exclusionary and anti-competitive strategy for greening small firms

- Technical assistance and financial support for getting products eco-labeled to assist SMEs
**Voluntary Initiatives by Firms in India**

- Participation in a broad number of voluntary initiatives by a sample of firms in India
- Key drivers were firm size, profitability, riskiness of the firm export orientation

Kumar and Shetty, 2018
Role for Capital Markets in Greening Businesses

• Financing to establish and grow green businesses is often difficult to acquire

• Initial high costs of production and uncertain market returns

• Long-term financing is needed to establish green businesses that are often infant industries with market benefits that may take many years to materialize

• But these firms will pose lower environmental risks and thus economic risks in the future

• Capital markets can lead to greening of businesses through
  • Rewarding green businesses that rely on traditional methods of financing their operations by lowering their cost of capital because these businesses are likely to be less risky
  • Provide new financial instruments to establish green businesses by enabling innovation and investment in green technologies
Rewarding Green Businesses through Lower Cost of Capital and Higher Returns on Investment

• Green business may have lower risks of liabilities, penalties, and high compliance costs in the future and are less likely to receive negative publicity

• Investors that value environmental performance can adjust the cost of capital to account for underpriced environmental risks and support greening of business

• Capital markets can respond negatively to disclosures about poor environmental performance
  • Reward firms that are environmentally friendly

• Voluntary disclosure vs mandatory disclosure: Needs to be credible, transparent and verifiable
  • Green Ratings programs
  • Carbon Disclosure program
  • Toxic Release Inventory in US
Public Disclosure Programs in Developing Countries

- At small scale, pilot programs to rate firms in an industry based on environmental performance
- Focused on improving compliance with existing regulations and not at beyond compliance efforts
- Shows that firms care about public reputation
- Provide static evidence and lack long term information

<table>
<thead>
<tr>
<th>Country/year</th>
<th>%Non-compliant</th>
<th>%Compliant</th>
<th>Change in % compliant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia (PROPER)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>63</td>
<td>37</td>
<td>+24</td>
</tr>
<tr>
<td>1997</td>
<td>39</td>
<td>61</td>
<td></td>
</tr>
<tr>
<td>Philippines (ECOWATCH)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td>92</td>
<td>8</td>
<td>+50</td>
</tr>
<tr>
<td>1998</td>
<td>42</td>
<td>58</td>
<td></td>
</tr>
<tr>
<td>Hanoi, Vietnam</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td>90</td>
<td>10</td>
<td>+14</td>
</tr>
<tr>
<td>2002</td>
<td>76</td>
<td>24</td>
<td></td>
</tr>
<tr>
<td>Zhenjiang, China (GreenWatch)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1999</td>
<td>25</td>
<td>75</td>
<td>+10</td>
</tr>
<tr>
<td>2000</td>
<td>15</td>
<td>85</td>
<td></td>
</tr>
<tr>
<td>Hohhot, China (GreenWatch)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1999</td>
<td>77</td>
<td>23</td>
<td>+39</td>
</tr>
<tr>
<td>2000</td>
<td>38</td>
<td>62</td>
<td></td>
</tr>
</tbody>
</table>
Information Disclosure Program in China: Green Watch Rating

Effective in inducing firms with foreign owners, private ownership, export oriented, higher profitability to have higher rating

Green Rating Program in India

- Firms in 3 sectors rated for their environmental impact by Center for Science and Environment in Delhi
  - Paper and pulp plants in 1999
  - Automobile manufacturers in 2001
  - Chlor alkali firms in 2002
- 19% reduction in stock market returns over 10-day period following announcement for paper and pulp firms

Gupta and Golder, 2005
Mandatory Environmental Disclosure

• Mandatory disclosure over long period of time allows tracking of quantifiable performance of all firms relative to themselves and others
  • Example: Toxic Release Inventory in the US provides detailed information on releases at facility-specific, chemical specific, media specific level and on pollution prevention, recycling and disposal actions by firms

• Has adverse reputational effects for large polluters

• Evidence of negative impacts on stock market returns and on firm behavior, including inducing participation in voluntary initiatives to reduce releases
Can Information Disclosure Programs Play a Bigger Role in Corporate Environmental Sustainability?

• Significant requirements for collecting information
• Information must be trustworthy and credible
• Expansion to a larger number of firms must go beyond ratings
  • need mandatory disclosure of environmental information
  • mechanisms for public provision of that information in a transparent way
• Requires government intervention – inspections, monitoring, verification for accuracy, enforcement actions for violations
• Information disclosure will affect capital markets only if investors believe it will hurt the future profitability of firms
  • requires regulatory and market-based consequences for poor environmental performance
Provision of Green Finance

• Can encourage investments in projects that both provide investable returns and protect the environment
• Expand green investments by including environmental considerations in existing infrastructure projects or catalyzing investments in key environmental sectors
• Green finance small source of financing in Asia but growing particularly in Japan
• Public-private partnerships can meet financing deficit by providing concessional financing
• Green bonds: investments in low carbon and climate resilient infrastructure
• Banking sector: potential for green lending to grow
  • Requires developing guidelines and environmental criteria to be incorporated
Challenges to Green Financing

• Insufficient disclosure requirements on environmental and long terms systemic risk factors
• Gaps in enforcement of environmental regulations and pricing of emissions
• Fossil fuel subsidies limit profitability of green investments
• Lack of awareness of threats posed by environmental degradation and climate change on financial sustainability of industry
• Lack of trained staff to assess environmental and climate risk at financial institutions and a shortage of bankable projects constrain green investment.
Increasing Green Lending

- Rating and labeling green bonds can open demand for green bonds
- Establishing uniform labeling standards and indices for rating green bonds would make these bonds benchmark-eligible securities for institutional investors
- Enhancing transparency through comprehensive and verifiable ESG disclosure requirements will build investor and lender trust
- Fundamental cultural change needed in financial markets to include sustainability considerations in all financing and investment decisions.
  - developing a new approach to these decisions and including all relevant stakeholders in the decision-making process.
Challenges of Relying on Capital Markets to Promote CSR

• Role of capital markets may be limited to larger polluters, consumer-oriented, and investor-owned firms

• Enabling capital market support requires infrastructure for data gathering, monitoring and verification, inspection and penalties for non-reporting or falsification of data
  • This regulatory infrastructure is often missing in the developing Asian countries or is subject to regulatory capture. A vast majority of small enterprises or state-owned enterprises means concerns about negative publicity and cost of capital are likely to be weak

• Capital markets in developing countries prioritizing growth can be expected to care more for news about economic performance than environmental
Markets for Environmental Services: EcoTourism

• Potential to benefit local communities and conserve the environment
  • bring jobs, business opportunities and diversified source of income and can be profitable

• But impact of environment ecotourism is mixed
  • failed to fulfill its promise to local communities for various reasons, including a lack of mechanisms to fairly distribute the economic benefits of ecotourism, compulsory displacement, and land insecurity
  • can disturb wildlife behaviors such as nesting or breeding, cause damage to habitats and ecosystems, and spread disease among wildlife
  • employment opportunities tend to be concentrated in the hands of a few people, and most jobs are given to skilled people drawn from urban areas. Local people with resource and skill constraints are often denied access to revenue opportunities generated by tourists
Increasing Effectiveness of EcoTourism

- Restrict the scope of recreational use based on carrying capacity, introduce codes of conduct for tourists, and involve the local community in the implementation of conservation and tourism policies.
- Guiding principles need to be mainstreamed into the development and implementation of policies governing ecotourism and sustainable tourism more generally.
- Importance of improving the use of environmental resources for tourism development, while respecting the sociocultural authenticity of host communities and ensuring long-term economic viability and socioeconomic benefits for all stakeholders.
- Avoid incidents of “greenwashing” or providing misleading information about a tourist site’s environmental impact or sustainability.
- Regulatory frameworks and enforcement must also be strengthened to ensure proper implementation of sustainable tourism policies.
- Empowering local communities through education and participation in decision-making and management of tourism destinations to ensure the environmental and socioeconomic gains.
In Summary

- Key question: Can voluntary corporate efforts achieve sustainable development goals, improve domestic environmental quality and keep us on track to achieve the carbon mitigation needed to keep temperature rise below 1.5 degrees C?

- There is growing interest among large firms in Asia in becoming more socially responsible; setting net zero carbon targets and pledging large investments to meet sustainability goals
  - but lack of accountability, monitoring and transparency in actual efforts

- Efforts to promote green businesses require a robust regulatory framework, proactive engagement of domestic civil society, and pressure from markets for consumer goods, capital and ecosystem services to impose regulatory and non-regulatory pressures on businesses to be more environmentally responsible

- Much of the civic and green supply chain pressure for greening of businesses in Asia is currently emanating from environmental regimes and consumers in the Western world rather than domestically

- This external pressure is focusing attention on some environmental issues in developing countries, it is less effective in targeting attention toward environmental problems caused by SMEs serving domestic markets

- Regulatory pressures and green finance are needed to encourage technological innovation and commercial scale deployment and facilitate green supply chains