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Corporate social responsibility and capital allocation efficiency

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ABSTRACT

We investigate the relationship between corporate social responsibility (CSR) and firm-level capital allocation efficiency. Using seminal investment-*Q* framework, we provide evidence that CSR distorts investment sensitivity to *Q*. We further determine that this effect of CSR is moderated by the assumed level of agency conflict, stakeholder engagement, as well as financial slack. We also document that CSR negatively affects the sensitivity of external finance to *Q* and aggravates investment sensitivity to cash flow. In addition, we find that the distortion in the firm-level capital allocation efficiency is reflected in firm performance. Our findings are robust to alternative variable measurement as well as tests for endogeneity.

1. Introduction

During the last two decades, a number of studies examining corporate social responsibility (CSR) strategies[1] have gained momentum. Recent research demonstrates that market cares about the socially responsible behavior of firms.[2] Consequently, corporations channel significant resources to improve their relations with key stakeholders. Hong et al. (2012) provide evidence that large U.S. corporations spend hundreds of millions of dollars for CSR initiatives.

Two general views on CSR prevail in the literature. First, a number of influential studies argue that CSR can be consistent with shareholder wealth maximization as well as achieving broader societal goals (e.g., Deng et al., 2013; Edmans, 2011; Flammer, 2013; Servaes and Tamayo, 2013). Alternatively, the opposite view on CSR, beginning with Friedman's (1970) well-known argument that "the only social responsibility of corporations is to make money", argues that CSR is a manifestation of agency problems (e.g., Aupperle et al., 1985; Bénabou and Tirole, 2010; Krüger, 2015; McWilliams et al., 2006) and often is costly for shareholders. Despite the large amount of attention, a fundamental question remains unanswered: does CSR lead to firm-level efficiencies and value creation and, if so, in what ways?

The present paper intends to further our understanding of whether and how CSR affects the firm-level resource allocation efficiency and firm performance. More specifically, we examine the effects of CSR on investment sensitivities to *Q* and to cash flow. As a related question, we examine the moderating role of managerial incentives and the assumed level of agency problem, as well as stakeholder engagement. We also look at the effects of financial slack and the implications of CSR for external financing

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[1] Broadly defined CSR strategies are actions that appear to further some social good (McWilliams and Siegel, 2001).

[2] In 2013 socially responsible funds managed about $6.57 trillion in assets from an overall pool of $36.8 trillion in the US investments (SRI 2014; http://www.ussif.org/sribasics). Similarly, while <100 firms reported sustainability information twenty years ago, by 2013 >6,000 companies around the world are issuing sustainability reports (Ioannou and Serafeim, 2014).

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sensitivity to Q. Finally, we test how the adjustments in the firm-level resource allocation attributable to CSR are reflected in future firm performance.

We propose that CSR reduces the firm-level capital allocation efficiency manifested in investment sensitivity to growth prospects in several ways: first, from the trade-off hypothesis (Preston and O'Bannon, 1997), investing in CSR initiatives is likely to reduce a firm's capital and other critical resources that otherwise could be deployed for identifying and funding growth options thereby distorting investment sensitivity to Q. Further, theoretical studies (e.g., Carroll, 1979) suggest that CSR can potentially be linked to the pursuit of managers' self-interest. From this managerial opportunism view (e.g., Cheng et al., 2013; Tirole, 2001) managers could pursue personal goals and extract private benefits from CSR over-investment that could further reduce a firm's resources and cause inefficiencies in investment policies.

Second, from ethical, political, and integrative theories of CSR (e.g., Garriga and Melé, 2004; Kim et al., 2012), socially responsible firms/managers tend to adhere to a high standard of behavior consistent with their CSR goals. Thus, if firms intend to satisfy all stakeholders including environment activist groups, local community, labor unions, they have to sacrifice certain investment opportunities profitable for shareholders but harmful to various non-shareholder constituencies. Consequently, investments will be less sensitive to Q for these firms.

Next, in the spirit of Jensen and Murphy (1990), the alignment of shareholders' wealth interests with those of the executive team could incentivize management to minimize overinvestment into CSR initiatives and instead use corporate resources for identifying and funding profitable growth opportunities. On the other hand, actively engaged stakeholders could press management to over-invest in certain CSR initiatives or neglect specific positive NPV projects that directly contribute to shareholder wealth but are damaging to the interests of these stakeholders. Consequently, the distortionary effect of CSR on investment sensitivity to Q depends on the shareholder-manager incentive alignment as well as on the extent of stakeholder engagement.

Further, if firms do not have sufficient internal resources to finance growth yet choose investing in CSR activities, they have to trade-off between funding profitable investment projects and CSR initiatives as external financing might be limited. We argue that CSR reduces external financing sensitivity to Q because financiers could realize distortions in investment efficiency attributable to CSR and restrict access to external financing. In addition, managers in high CSR firms could try to shield themselves from the disciplinary forces of external capital markets and intentionally minimize use of external finance.

We test these predictions using MSCI ESG KLD Stats Data widely used in the financial economics literature to measure CSR. To preview the results, we find that CSR activities constrain the sensitivity of current growth opportunities to future investment. That is, CSR distorts the firm-level capital allocation efficiency. We further show that the shareholder-manager incentive alignment, stakeholder engagement, as well as availability of slack resources significantly moderate the effects of CSR. We also document that CSR inversely affects the external finance sensitivity to Q and investment is more dependent on internally generated cash for firms with higher CSR activities. Finally, our results are consistent with the prediction that CSR has important implications for future firm performance. These results are robust to alternative model specifications as well as variable measurement. To address the endogeneity concerns in our baseline regressions we apply the instrumental variable estimation and still find convincing support of our main conjectures.

This article contributes to the emerging literature investigating the relation between CSR and firm growth in several ways. First, our paper complements contemporaneous research by Benlemlih and Bitar (2016). In one of the models the authors apply McLean et al. (2012) framework and provide evidence of the positive association between CSR engagements and investments. Their analysis is somewhat consistent with the evidence provided in the present paper (we also document CSR increases investments as measured by McLean et al., 2012) but differs in an important respect: we argue that moderating effect of CSR on the sensitivity of investment to Q is the effective measure of capital allocation efficiency since it reflects how firms' current growth opportunities (Q) affect future investments. Consequently, to disentangle implications of CSR on investment efficiency it is imperative to include interaction term of CSR and growth opportunities in the investments regressions.

Second, this study is the first to our knowledge to examine how managerial compensation incentives moderate the effect of CSR on investment efficiency. In addition, we also provide novel analysis of the moderating role of another previously unexamined factor – stakeholder engagement. Alignment of interests between management and shareholders via explicit compensation incentives motivates managers to minimize distortions in investment efficiency attributable to CSR. On the other hand, these managers might attempt to earn a good reputation vital for their personal human capital by catering to the demand for CSR initiatives from powerful stakeholders at the expense of shareholders' wealth. Our empirical design allows us to examine how this overlooked multidimensional agency problem where managers have to optimize along several dimensions could alter the effect of CSR on investment efficiency.

Third, our study also adds new understanding to the moderating role of yet another previously ignored factor – financial slack – for the implications of CSR on investment efficiency. In addition, we also provide the first evidence that CSR reduces the sensitivity of external financing to Q. Further, our paper casts doubt on the generality of recent study by Cheng et al. (2014). The authors argue that internationally firms with better CSR performance face significantly lower capital constraints as measured by KZ Index. However, consistent with Fazzari et al. (2000, 1988), we argue that investment sensitivity to cash flow reflects financial constraints. Using sound, theoretically well-grounded econometric model, and firm fixed effects framework we provide some evidence that CSR positively affects investment sensitivity to cash flow for the US firms implying that CSR aggravates financial constraints to some extent.

Fourth, this study also contributes to the literature on the implications of CRS for firm performance (e.g., Ameer and Othman, 2012; Di Giuli and Kostovetsky, 2014; Jain et al., 2016; Margolis et al., 2007). The extant literature is inconclusive regarding the effects of CSR on future firm performance. Contrary to the vast majority of recent and prior studies, Lys et al. (2015) posit that CSR