Business Politicians:
The Political Economy of Corporate Social Responsibility

Dina KASSAB

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(Work in Progress)

Abstract

This paper studies a game, involving adverse selection, between firms that are heterogenous in their prosocial orientation but also in their political opportunism, on the one hand, and consumers on the other. Demand is solely based on firm's reputation in a perfect Bayesian equilibrium and Corporate Social Responsibility is used as a signalling device. The focus is on one feature that is crucial for understanding many political economy problems in developing countries: the image-spoiling effects of political power that comes along business. Political benefits conferred to businessmen engaging in CSR creates doubt about the true motive for which good deeds are performed, and this effect can induce a partial or even net crowding-out. We also study a case of "elite capture" where business politicians determine the political multiplier in the economy by influencing the provision of public good by the state. I identify a case where the latter may be reduced in order to increase both the marginal utility and visibility of corporate provision of public goods. This paper also sheds light on the role of media and transparency in disciplining the elite. The implications for both the design of agencies within the government and the design of anti-corruption policies are discussed.

JEL classification: D11, D21, D64, P16, P48, L21, H11, M14

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1 Introduction

The traditional view of how society should be organized has rested on two pillars. The invisible hand of the market harnesses consumers’ and corporations’ pursuit of self-interest to the pursuit of efficiency. The state corrects market failures whenever externalities stand in the way of efficiency and redistributes income and wealth, as the income and wealth distribution generated by markets has no reason to fit society’s moral standards. From this perspective, it was only natural to think that the State is the sole provider of public goods as their provision is subject to free-riding problems and hence cannot be left in the hands of individuals.

But recently, government failures have arisen and society’s demands for individual and corporate social responsibility as an alternative response to market and redistributive failures have become more prominent. Government failures can find its origins in the capture by lobbies and other interest groups. Governments under influence may fail to optimally correct externalities, or bend to wealthy agents’ opposition to redistributive policies. Government may also fall due to inefficiency, high transaction costs or poor information. So citizens and corporations empower themselves and substitute for elected government. The movement is gaining momentum and the Private Provision of Public Goods is being revisited. Today, a large fraction of public goods is provided by private agents. The private provision of public goods includes direct contributions or donations by individual agents (Bergstrom et al.(1986), Andreoni (1989 and 1990), Croson and Shang (2005)), not-for-profit organizations (Besley and Ghatak (2005)) and increasingly corporate efforts referred to as Corporate Social Responsibility (Bagnoli and Watts (2003), Kotchen (2006), Besley and Ghatak (2007)).

We focus on the Corporate Provision of public goods, whereby firms provide, alongside the private product they sell, a contribution to the public good. Consider for example the growing market for premium-priced products which are linked to a social cause. This is the case of cause-related marketing (explicitly linking the sale of a company’s product to company contributions to worthy causes) and lumpsum corporate donations to or expenditures on worthy causes or green activities, which implicitly link the contribution to sales of the company’s products. Thus consumers of such products also purchase a joint product -consumption of the private good and investment in the social cause embraced by the firm. In all these examples, the joint product forms an impure public good with private and public characteristics. Firms producing the impure public goods will be referred to as ”socially responsible” firms. Examples are numerous and range from education of underprivileged children to roads construction.

In the context of developing economies, where a relatively small number of industrial tycoons or elite controls a substantial share of economic, but also political, resources, corporate provision of public goods takes a whole different dimension. A striking example is the case of the Egyptian economy prior to the 2011 revolution. The rise to power of prominent businessmen in the ruling National Democratic Party (NDP), in the government, and in the People’s Assembly (Egyptian Parliament) led to waves of anger during the tenure of Prime Minister’s Ahmed Nazif’s government. To the untrained eye,
Egypt’s Parliament list could easily be mistaken for a who’s who of big business. To stay in one of the two clubs, you need to be a member of the other, a clear incestuous relationship between politics and money persisted in Egypt. According to varying estimates, up to a fifth of the People’s Assembly were wealthy businessmen and the role of opposition was limited to that of a "ruling oligarchy" task. What is most interesting about this phenomenon is that those business politicians owned the firms that invested the most in public good provision through CSR.

For instance, the ex secretary general of Hosni Mubarak National Democratic Party (NDP), Ahmed Ezz, the steel magnate, was chairman of the budget committee at the Parliament at the same time. As part of his business CSR efforts, he would grant 30,000 beneficiaries of the "build your house" project (which are mainly low-income youth) with one ton of free steel for each one. Mohamed Mansour, the Chairman of Mansour Group, Egypt’s leading private sector conglomerate (it has distribution, sales and service businesses for autos, retail goods and industrial equipment, distributes audiovisual and household products; it sells office equipment; and distributes marine, mining, and construction equipment) was transport minister under Mubarak’s regime. Following the same trend, "Mansour Foundation for Development” engages in several CSR projects such as eradicating illiteracy, providing 6,000 litres for water relief in Kafr el Sheikh, funding orphanages... etc. Another example is the ex Committee chairman of Industry and Energy in the People’s Assembly, Abou El Enein, who is also chairman of Ceramica Group, one of the largest investment groups in Egypt. In 2001, he established "Abou El Enein Organization for Social Activities and Charity” that undertakes literacy, improving healthcare services, supporting SMEs and female-headed households.

If that was the whole story, having business politicians in the economy would have been unarguably a lever for economic growth. The flipside of the phenomenon needs however to be considered. The state became weak and unable to provide the basic public goods, with a set of powerful firms dominating their respective markets, this was the first flame that triggered the revolution. Furthermore, all of the business politicians mentioned above and others faced corruption-related charges after the revolution including profiteering, squandering public funds, illegally allocating pieces of public land to businessmen among other charges.

Some consider the elite to be the engine of economic growth as they are the unique constituency that is both able and willing to step in areas where the state fails to deliver. To others, this elite has weakened the economy by reaping the largest part of resources. In addition, the elite also arguably weakened the democratic institutions by causing tremendous inequality and through their capture of state politics. According to this opinion, it is in the elite’s best interest to keep a weak state so that they can fill this gap and gain even more economic and political powers. As can be seen, CSR is mainly a game of reputation-building or signaling in such context. The key questions are whether reputational concerns underlying CSR are sufficient for reaching optimal levels of public good provision, whether introducing politics into the issue would enforce or counteract market forces, and in case of incompatibilities, what policies would be viable alternatives.

The present paper addresses and formalizes these questions in a market for a final
good, where the price is given and the demand is approximated by firm’s reputation for both prosocial orientation and political opportunism. The basic idea behind the model is that consumers care, not only about the level of CSR efforts the firm undertakes, but also about the motives underlying these activities. Knowing that CSR provides political power to the firm, consumers observe its choice of CSR and parse out its motives. This is the rationale why consumers are usually suspicious towards CSR conducted by business politicians as it can be seen as a form of political green washing. Hence CSR is viewed here as a signaling device when consumers care about firm’s reputation. More formally, we assume a population of firms characterized by their valuations for community development (prosocial behavior) and political-rent seeking. Each tries to create a ”socially-friendly” image for its product. Building on the concept of perfect bayesian equilibrium, we assume that demand is solely determined by consumers’ posterior assessment of firm’s motives upon observing their choice of CSR. Furthermore, we allow for the level of transparency/ media freedom in the economy to vary and assess its impact.

2 Related Literature

According to Bergstrom, Blume and Varian (1386), private provision of public goods is perfectly crowded out by government provision of the public good. The crucial condition driving this result is that private and public provision are perfect substitutes in consumption. The degree of crowding out decreases when this substitutability gets weaker, which for example may be the case in the presence of warm glow utility (Andreoni 1989). However, any form of economic crowding involves at least two parties, one of which will take an action that will affect the probability of action of the other player either positively (crowding in) or negatively (crowding out).

This general view on crowding does not take into account strategic considerations by any of the two parties. However, in the case of one party taking action in order to get a particular reaction from the other, potential crowding effects gain particular importance. Especially when incentives are designed to induce a certain behavior, crowding may explain unexpected and often paradox outcomes. Gneezy and Rustichini (2000) show that day care centers introducing a fine for parents picking up their children late did not achieve the intended outcome of assuring punctual closure, but even had to cope with more parents than before picking up their children late. The authors suggest that the monetary incentive backfired because it helped parents justify their incorrect behavior; they perceived late pick up as a good with a price rather than bad behavior leading to intrinsic disutility (guilt). A similar rationale is illustrated in this paper where the intrinsic motivation is the corporate culture, i.e. its valuation for contributing to the public good and the extrinsic one is the political power that comes along CSR. The implication for economic theory seems to be that extrinsic, mostly material, incentives can be at odds with intrinsic motivations and even may encourage adverse behavior.

Intrinsic utility and emotions motivate action on one hand, and interact with classical extrinsic incentives in ways that can reduce the ultimate, total incentive to take the targeted action (Fehr and Falk, 2002). Intrinsic motivation can take many forms from
fairness and reciprocity to identity, altruism, esteem, pride, or more generally moral motivation and social preferences (see McLeod, 2007). As incentives target motivation underlying behavior, the literature often talks about motivation crowding (Frey and Jegen, 2001, Frey and Stutzer, 2006). If principals and agents are heterogeneous in the level of intrinsic motivation and have preferences to match with similar types, lower than standard monetary incentives signal type and lead to matching at equilibrium (Brekke et al., 2004).

Bénabou and Tirole (2003) go one step further and theoretically derive adverse incentive effects due to intrinsic motivation. The setup chosen in Bénabou and Tirole (2006) is expanding the number of utility groups from two (intrinsic vs. extrinsic) to three (extrinsic, direct intrinsic, indirect intrinsic) by including indirect intrinsic concerns about others’ perception of own action, that is reputation concerns (Johanesson and Ellingson, 2008). It is the mechanism underlying this third subgroup of motivation that allows to build the bridge from the individual utility maximization problem and intrinsic utility to the firm’s profit maximization and strategic benefits. In short, the firm as an organization cannot directly derive intrinsic utility, however, indirect considerations such as reputation are of crucial importance for the strategic firm and the achievement of its main goal which is shareholder value maximization.

The essential links between CSR and firm reputation on the one hand and public image and consumption on the other are well documented by various surveys. Consumers consider CSR as a signal of product quality (if information asymmetries exist or if the product in question is a credence good) and thereby offer firms the opportunity for strategic use of CSR as empirically confirmed by Siegel and Vitaliano (2006). Then if motivation underlying CSR determines not only current levels of public good provision, but also its quality and whether it reaches the groups that need it the most, consumers will be interested in finding out firm type and may take informative signals into account. Due to firms’ strategic considerations regarding reputation and demand, incentives would backfire if they decreased the signaling quality of CSR with respect to firm type.

The paper is organised as follows. Section 3 presents the basic set up where the political multiplier of the economy is given exogenously. Section 4 endogenizes the choice of political benefits by granting the business politician the choice of the level of public good provided by the government and analyzes the impact of that additional signal. Section 5 examines the questions of media freedom and whether transparency plays a disciplinary role in such context. Finally, section 6 concludes and provides policy implications.

3 The Model

3.1 Preferences and Information

We study the behavior of firms that choose the level of the Corporate Social Responsibility (denoted hereby CSR) efforts to undertake. CSR examples include contributing to a public good or worthy cause by engaging in community development projects, re-
fraining from imposing negative externalities through environmental friendly practices, respecting labor rights, etc. We focus our attention on one aspect of CSR, that is the corporate provision of public goods.

Each firm selects a participation level \( s \) from choice set \( S \subset R \) that is continuous; \( s \) can be seen as the amount of money the firm is willing to dedicate to CSR activities or the amount of dollars it invests in the production of public good per unit sold. Choosing \( s \) entails a cost \( C(s) \) and yields a monetary or other material reward \( ks \), where \( k \) is the political network multiplier in the economy. We assume that a firm that contributes to the public good gains some political benefits: if the firm owner is a politician, contributing to the public good allows him to gain more popularity and hence enhances his chances in being elected in the government, and apart from elections, a businessman who engages in CSR activities has access to wider political networks and hence face a more lenient regulation (so CSR can be seen here as a form of lobbying). \( k \) can hence be seen as the rate of return on CSR in terms of political gains. We denote it by multiplier since more political power grants more business gains and a higher business stance allows wider political networks... etc. So \( k \) is a multiplier similar to the keynesian multipliers. Determinants of \( k \) include the existing level of public good, the degree of development/corruption in the economy, the degree of openness of government to capture, the actual system of regulation and the number of business politicians in the economy. \( k \) can also vary with firms’ efforts; we would expect a firm that spends more financial or human resources on lobbying to have a higher political network multiplier. We consider \( k \) to be set by a principal and, for now, firms take it as given.

Types and direct payoffs Denoting by \( v_s \) and \( v_k \) a firm’s intrinsic valuations for contributing to the public good (namely ”corporate culture” discussed further below) and for political gains from CSR, participation at level \( s \) yields a direct benefit

\[
(v_s + v_k k)s - C(s)
\]  

Each firm’s type or ”identity” \( v \equiv (v_s, v_k) \in R^2 \) is drawn independently from a continuous distribution with density \( f(v) \) and mean \( (\bar{v}_s, \bar{v}_k) \). Its realization is private information, known to the firm but not observable by others.

Corporate culture here refers to how integrated CSR is in the firm’s strategy. A higher \( v_s \) reflects the idea that CSR is intimately related to firm’s conduct of business, which is a firm specific variable. Culture is a complex set of beliefs, values and norms that are unobservable by outsiders but determine the behavior of the firm. Schein (1989) defines organizational culture as a multilevel firm attribute that is difficult to grasp even as an insider and even harder to change. In line with this definition, visible attributes (such as mission statements or published CSR reports) of a firm are not necessarily coinciding with the deepest level of culture and hence are no reliable signal to outsiders in predicting firm behavior. In this setting, \( v_s \) refers to the degree to which the provision of the public good is an integrated objective of the corporation. In terms of firm’s payoffs, \( v_s \) enables the firm to reap two mission – related benefits. First, if shareholders have social preferences, \( v_s \) reflects direct utility from providing the public good and acts as
a substitute for monetary gains. Second, if shareholders are classical profit-oriented agents, the firm can have strategic monetary benefits from CSR through its effect on the demand as we will see.

More generally, in his work on the economics of corporate culture, Hermalin (2000) suggests two interpretations of Kreps’s (1990) theory of culture. Corporate culture may ensure coordination in games with multiple equilibria by acting as a convention telling players how to coordinate. In addition, culture can be seen as a way of categorizing future contingencies for the purposes of sustaining cooperative play. So in a world where unforeseen contingencies may arise, corporate culture may substitute for infeasible complete contracts. Hence culture is seen as a commitment device between firms and consumers when contracts are incomplete and interaction is repeated over time. Interfirm variation in culture may be aggravated and partly explained by different determinants such as company history, nature of business, preferences of the owner... etc.

**Social Signaling and Demand**

In addition to these direct payoffs, firm’s decisions carry reputational costs and benefits, reflecting the judgements of others, the consumers precisely, that translate into demand. For simplicity, we assume that demand depends linearly on consumers’ posterior expectations of the firm’s type $v$ upon observing its level of CSR $s$ and given the political multiplier in the economy $k$ so that the reputational payoff, or equivalently, the demand from choosing $s$ is

$$D(s, k) \equiv \gamma [\alpha_s E(v_s|s,k) - \alpha_k E(v_k|s,k)]$$

(2)

The signs of $\alpha_s$ and $\alpha_k$ reflect the idea that it is in the firm’s best interest (in terms of increasing the demand) to appear prosocial (a generous contributor to the public good) and disinterested from political benefits so that CSR can be seen as merely a good deed and not lobbying efforts. Note that the reputation coefficients (the $\alpha$’s) are independant of the firm’s type $v$, they are common to all firms and thus public knowledge. The factor $\gamma > 0$ measures the visibility of the firms’ actions; i.e. the probability that consumers will learn precisely the amount invested by firms in CSR activities or number of people who will hear about it or the length of time during which the record will be kept, etc. Factors affecting $\gamma$ vary from transparency in the economy, availability of verifiable CSR reports, quality of auditing, to social factors such as the effectiveness of the word of mouth on firm’s reputation. Furthermore, the firm can invest in enhancing $\gamma$ or at the opposite, it can exploit the fact that it is low as will be discussed further in the paper.

One plausible reason why consumers would care about, not only CSR exerted by firms, but also their underlying motives is that a firm that values its contribution to the public good (high $v_s$) is assumed to provide it to the groups that need it the most and also continue to provide it in the future should any unforeseen contingencies take place. That is, CSR that is compatible with firm culture is more sustainable and more valuable. On the other hand, CSR that aims at obtaining political benefits lacks those two characteristics.

Defining $\beta_s \equiv \gamma \alpha_s$ and $\beta_k \equiv \gamma \alpha_k$, a firm of type $v \equiv (v_s, v_k)$ and reputational concerns $\beta \equiv (\beta_s, \beta_k)$ thus solves

$$\max_{s \in S} \{(v_s + v_k) s - C(s) + p[\beta_s E(v_s|s,k) - \beta_k E(v_k|s,k)]\}$$

(3)
It shall be noted that the crucial choice variable of the firm is \( s \) as it establishes a kind of reputation for the firm which then determines the demand. The focus of the analysis will be on the choice of \( s \). (positionner le modèle dans la littérature)

### 3.2 The Image-Spoiling Effect of Politics

We begin with an intuitive presentation of some key mechanisms. Consider the first-order condition of a firm’s choice of \( s \), assuming a well-behaved decision problem over a continuous choice set. Differentiating equation (3) with respect to \( s \), a firm of type \((v, \beta)\) that faces a political multiplier \( k \) equates

\[
C'(s) = v_s + v_k k + pR(s, k; \beta)
\]  

(4)

where the last term represented by his marginal reputational return from exerting CSR efforts \( s \), which translates into demand, weighted by the price \( p \) the firm is able to charge for its product

\[
R(s, k; \beta) = \beta_s \frac{\partial E(v_s | s, k)}{\partial s} + \beta_k \frac{\partial E(v_k | s, k)}{\partial s}
\]  

(5)

The first-order condition given in equation (4) shows some interesting insights. The firm’s choice of \( s \) reveals three underlying motivations: its culture (which can be seen as an intrinsic motivation), its political benefits from CSR and its reputational returns. Since all three vary across individuals, a signal-extraction problem arises when an observer wants to learn about \( v_s \) or \( v_k \). It is also apparent from equation (4) that a higher political multiplier \( k \) increases the informativeness of firm’s choice about \( v_k \) but reduces it about \( v_s \). Finally, allowing the weights attributed to reputational concerns (the \( \beta \)’s) to vary across firms increases the noise which makes inference about \( v_s \) and \( v_k \) less reliable, and which is amplified the more visible CSR efforts are. That is why we omit this additional source of noise by keeping the \( \beta \)’s fixed for all firms.

We now turn to a simple presentation of the basic mechanisms in the model. The group of ”responsible firms”, that contribute at least \( s \) to the public good, comprises all firms with

\[ v_s + v_k k \geq C'(s) - R(s, k) \]

so its boundary is a straight line corresponding to (4), along which firms are indifferent between participating and abstaining and they choose exactly \( s \) if they participate.

Figure 1 shows the different effects of the political multiplier on the pool of firms that engage in CSR, and how it attracts some firms and repels others. We consider three different scenarios here. First, the vertical line represents the case where CSR is not linked to any political benefits \((k = 0)\) and has no reputational impacts \((R(s, k) = 0)\). This is perhaps the case of a government that is not prone to capture, so the level of \( s \) is merely a good deed and is perfectly informative about firm’s culture and its true valuation for the public good.

Now consider the bold line which represents a simple rotation to the left. This is the effect of introducing political gains into the model \((k \neq 0)\). The slope then becomes \( -\frac{1}{k} \) and the intercept remains the same. The set of ”responsible firms” expands as the types
in A+B are drawn in. Evidently, now firms engage in CSR not only for their prosocial orientation, but also for the political network that comes along. So even firms who do not have CSR quite embedded in their culture (with a \( v_a < C'(a) \)) find it profitable to contribute.

The dotted line on the graph represents the case where the reputational aspect is taken into account, which is simply a shift to the right of the bold line. Since this shift occurs at every level of \( s \), the overall contribution clearly increases. However, some firms who would contribute before reputational concerns were introduced now don’t. Precisely, those are the firms in the area C. Comparing the vertical line and the dotted one, we find that introducing the political multiplier into the model with the reputational signals that come along induces two effects at equilibrium.

First, the new members of the elite club are less socially oriented (have a lower \( v_s \)). These new members drag down the elite club’s reputation for prosocial orientation \( E(v_s | s, k) \). Furthermore, the reputation of the low contributors (those who still choose to contribute below \( s \)) also declines. Intuitively, an observer who sees a firm contributing a small \( s \) even though there are political benefits must have an initially low valuation for the public good so that even the political benefits are not sufficient to induce it to contribute. In other words, granting political privileges to firms spoils the image of both the elite club and the low contributors. The effect on the marginal return from contributing \( \frac{\partial E(v_s | s, k)}{\partial s} \) is thus a priori ambiguous.

Second, the new members that join the elite club have a higher political orientation \( v_k \). However, those who still contribute below \( s \) signal that they care less about political
benefits. This unambiguously reduces the reputational incentive. So linking CSR to politics not only makes firms appear less socially oriented, but it also makes them appear "greedy" in the sense that they engage in CSR in order to have wider political networks.

Now when these two effects add up, the total effect on inferences can be either positive or negative. In the latter case, \( R(s, k) < R(s, 0) \) political benefits attracts some new firms with a relatively high political orientation and low prosocial one (those in the area B) but repels some existing ones who are more prosocially oriented (those in the area C). The impact on the overall amount of contributions depends however on the weights assigned to those two groups, which is defined by the distribution \( f(v) \).

### 3.3 (Reputation-) Separating Equilibrium

We assume here that a firm chooses \( s \) over a continuous choice set \( S \), with cost \( C(s) = as^2/2 \). Firms’ types \( v \) are distributed in the economy as normal random variables with respective means \( \bar{v}_s \) and \( \bar{v}_k \) and with variance-covariance matrix given by:

\[
\sigma = \begin{bmatrix}
\sigma_s^2 & \sigma_{sk} \\
\sigma_{sk} & \sigma_k^2
\end{bmatrix}
\]

We now present a more formal analysis for the intuitive insights given in the previous section. Assuming fixed reputational weights (fixed \( \beta \)'s), the reputational returns from choosing a level \( s \) of CSR is

\[
R(s, k) \equiv \beta_s \frac{\partial E(v_s|s, k)}{\partial s} + \beta_k \frac{\partial E(v_k|s, k)}{\partial s}
\]

Since firm’s type \( v \) is private information, a consumer would like to infer its prosocial and political orientations from the amount \( s \) it invests in CSR which is observable. We use here the concept of conditional expectations for normal random variables (see appendix):

\[
E(v_s|s, k) = \bar{v}_s + \rho(k). (as - \bar{v}_s - \bar{v}_k k - R(s, k))
\]

and

\[
E(v_k|s, k) = \bar{v}_k + \xi(k). (as - \bar{v}_s - \bar{v}_k k - R(s, k))
\]

Intuitively, the posterior assessment of a firm’s valuation for public good is a weighted average of the prior, which is the mean of firms’ valuations in the economy \( \bar{v}_s \) and of the marginal cost of its contribution net of the constant reputational returns and average politics related motivation. Similarly, inference made on the firm’s valuation for political networks upon observing its contribution \( s \) is a weighted average of the prior, which is the mean of political orientation \( (\bar{v}_k) \), and of the marginal cost of \( s \) net of reputational returns and average valuation for public good. The weight \( \rho \) attributed to social orientation and its counterpart \( \xi \) for political orientation are defined as

\[
\rho(k) = \frac{\sigma_s^2 + k\sigma_{sk}}{\sigma_s^2 + 2k\sigma_{sk} + k^2\sigma_k^2}
\]
Note that both are determined by the specific distribution of $v$ and the political multiplier in the economy. That is why $\rho$ and $\xi$ are specific to each economy and so is the signalling power of CSR. This point will be discussed further in the analysis.

In order to estimate the reputational returns from CSR, we differentiate (7) and (8) with respect to $s$. We hence get the first order linear differential equations:

$$\frac{\partial E(v_s|s,k)}{\partial s} = \rho(k)[a - R_s(s,k)]$$

and

$$\frac{\partial E(v_k|s,k)}{\partial s} = \xi(k)[a - R_s(s,k)]$$

We hence get the first order linear differential equation:

$$R(s,k) = [\beta_s\rho(k) - \beta_k\xi(k)][a - R'(s,k)] \tag{11}$$

that we solve to find the equilibrium.

**Proposition 3.1** At equilibrium, each firm, as part of its Corporate Social Responsibility efforts, contributes to the public good with

$$s^*(v_s,v_k) = \frac{v_s + v_k}{k} + p[\beta_s\rho(k) - \beta_k\xi(k)] \tag{12}$$

A marginal increase in firm’s CSR efforts raises its reputation for prosocial orientation by $\delta\rho(k)$ and that for political greediness by $\delta\xi(k)$ regardless of its initial level of CSR.

At equilibrium, $\rho = \frac{\partial E(v_s|s^*,k)/\partial s}{\delta}$, that is, the marginal reputational return for prosocial orientation to the marginal cost of an additional unit of CSR, and $\xi = \frac{\partial E(v_k|s^*,k)/\partial s}{\delta}$ is its counterpart for political greediness. It is important to note that both $\rho$ and $\xi$ are independent of $s$, they solely depend on the political multiplier in the economy $k$. In other words, all firms in the economy, exerting different levels of CSR efforts get, at equilibrium, the same reputational return-to-cost ratio at the margin.

The question that arises now is: what is the impact of $k$, the political multiplier, on inferences and behavior? Attributing political benefits to firms engaging in CSR clearly increases firms’ direct payoffs. For instance, a firm that builds a school to help educate the poor as part of its community development CSR projects gains, not only the intrinsic value of the project (that is the alignment of the project with the corporate culture) but also a wider political network that can facilitate its business. This additional benefit however comes at a cost, that is, it spoils the firm’s image along both dimensions: it reduces firm’s reputation for prosocial behavior and increases its reputation for political-rent seeking.
Lemma 3.2 Even when firm culture and political-rent seeking are not correlated, a higher (exogenous) political multiplier $k$ reduces the signaling value of firm’s CSR efforts along both dimensions.

Consider the benchmark case where the prosocial and political orientations of a firm are not correlated ($\sigma_{sk} = 0$). This means that, in the economy, firms that are the most public-spirited may or may not be seeking political rents, observing one valuation tells nothing about the other. Let $\psi$ denote the noise-to-signal ratio ($\frac{\sigma_k}{\sigma_\sigma}$), we have

$$\rho = \frac{1}{1+k^2\psi^2}$$

and

$$\xi = \frac{k\psi^2}{1+k^2\psi^2}$$

Differentiating the above equations with respect to $k$, we find that $\rho'(k) < 0$, meaning observers attribute less of a role to prosocial orientation the higher the political multiplier in the economy and more of a role to political opportunism $\xi'(k) > 0$ so long as $k$ is sufficiently low ($k \leq \frac{1}{\psi}$). This is exactly the effect evoked earlier on the graph. Introducing politics into the CSR domain drags down all firms’ reputations. This can be seen as some sort of negative externality that the politically-oriented firms impose on the more public-spirited ones, in the sense that business politicians who use CSR to gain political benefits create an environment of distrust that impacts other prosocial firms that merely aim at providing the public good. The most interesting aspect of this effect is that it takes place even in the absence of any correlation between prosocial and political valuations, furthermore, it takes place even when none of the firms has any control over the value of the political multiplier (it is assumed to be exogenous up to this part of the analysis).

Now we can allow for both CSR orientations to be correlated ($\sigma_{sk} \neq 0$). A positive correlation tends to amplify the image-spoiling effect of $k$. Intuitively, when firms that are more prosocial are the ones that seek political rents the most, CSR represents no good news about firm’s culture, this effect is stronger the higher the value of $k$. A negative correlation, on the other hand, tends to reduce this negative effect, in a way, observer can distinguish between the good from the bad apples.

4 Endogenous Political Multiplier

4.1 Public Good and the Political Multiplier

Up to this point of the analysis, we have assumed the political multiplier $k$ to be determined exogenously. For the remainder of the paper, we assume $k$ to be determined by the existing level of public good in the economy $G$, such that:

$$k = \theta G$$

(14)
( Explain the link between provision of public good and state capture - the sign of $\theta$ will depend on the nature of the relation between the public good and that provided through CSR project - in wut follows we focus on the case where less pub good means more pol power (higher $k$) )

4.2 CSR and the Public good

Now we turn to the analysis of the impact of varying the political multiplier (and hence the existing level of public good $G$) on the corporate provision of public goods $s$. Summing (12) over firms yields the aggregate supply of public good through CSR

$$\int_{v_k^-}^{v_k^+} \int_{v_s^-}^{v_s^+} s(v_k, v_s; k) \, dk$$

whose slope is simply

$$\bar{s}'(k) = \frac{\bar{v}_k}{\delta} + p[\beta_s \rho'(k) - \beta_k \xi'(k)]$$

Equation (15) reflects both the effect of $k$ in increasing the direct payoff and its impact on the supply of CSR via the reputational channel. The details of the above equation can be found in the appendix. We focus however on the no-correlation case and the case where $k$ is initially equal to zero.

**Proposition 4.1** Assuming $\sigma_{sk} = 0$, an increase in the political multiplier (resulting from reducing the existing level of public good) decreases the aggregate (per capita) CSR investments by firms over a certain range $[k_1, k_2] \subset \mathbb{R}^+$ and increases it everywhere else on $\mathbb{R}$ for a sufficiently low exogenous market price ($p < \frac{v_k}{\beta_s \delta \psi^2}$). This range widens as the noise-to-signal ratio $\psi$ increases.

Basically, two variables play a crucial role in determining whether political benefits attached to CSR might backfire or not: the firm’s valuation for political rents $v_k$ and its reputational returns that translate into demand that ultimately matter to the firm in as much the price is high. A firm for which political network is crucial is less likely to reduce its production of $s$ as a reaction to an increase in $k$ because the firm is able to reap large direct political benefits giving less importance to the reputational effects that underlie the adverse effect of the political multiplier.

On the other hand, a high exogenous market price of the public good increases the probability of an adverse effect on the supply of CSR. This is because, in our model, demand solely depends on firm’s reputation and thus the price reflects the weight the firm assigns to its reputation. A higher price makes the reputational channel increasingly important.

Now we discuss the second part of the proposition that suggests that the range of political multipliers that would lead to adverse effect on CSR increases in the noise-to-signal ratio $\psi$. Intuitively, a higher $\psi$ decreases consumer’s ability to interpret the signal in favor of the firm (lower weight on underlying social motivation $\rho'(\psi) < 0$ and a higher weight on
political one). This in turn reduces the firm’s reliance on $s$ as a signal and amplifies the adverse effect of $k$.

Another interesting result is that related to initially ”clean” economies. Starting from a null political multiplier, a marginal increase in $k$ causes a sharp decline in CSR supplied by firms. That is,

$$\lim_{k \to 0} s'(k) = -\infty$$

so long as $\psi$ is very large (tends to $+\infty$). This signal-reversal around zero is a well known phenomenon in incentives theory. It takes place at this specific point because it is where CSR turns from being a ”good deed” to a politically beneficial activity and thus comes to be interpreted as a signal of opportunism rather than benevolence. In other words, the political rents are small relative to reputational loss. As the political multiplier increases, political returns will eventually outweigh the reputational effects and again act as an incentive to increase CSR.

This result is consistent with what is frequently observed in developed versus developing countries. In the latter, political rents that come along CSR are quite important (in some cases it reaches the point of enabling the businessman to occupy positions in the government), resulting in an excessively large political multiplier. Reputational loss is hence important (businessmen are known for their political opportunism). However, the political gains exceed the reputational losses and I argue that this is the reason CSR tends to fall in the sphere of politics rather than that of business in such societies. Whereas in developed countries, the political multiplier is bound to remain relatively low due to transparency, governance and regulatory issues. In this case, a small increase in $k$ backfires; it reduces CSR investments by firms in fear of appearing greedy. Reputational loss thus outweighs the political benefits from CSR. That is why CSR is a signal for prosocial orientation in this case.

(figure 2 goes here)

4.3 Business Politicians

In this section, we endogenize the choice of public good in the economy. In a first step, we consider the case where a firm with strong political power determines the level of public good in the economy. This is the scenario encountered in economies ruled by an elite that cumulates both economic and political powers or the case of Russian business oligarch that control the decision-making in the political sphere or the ruling Indian panchayati.

We extend the model to allow a player called the elite to choose, not only the amount to invest in CSR, but also the amount of public good provided by the government $g$ over a continuous choice set $G \subset \mathbb{R}$, which then defines the political multiplier in the economy through the production technology given in (14). The timing of the game is as follows. The elite (denoted E hereby) moves first by choosing both $g$ and $s$ simultaneously. Consumers observe both choices but not the underlying motivations ($v_s$ and $v_k$) and decide on the demand which is simply the weighted sum of their expectations of the elite’s prosocial and political orientations upon observing $s$ and $g$. We solve the problem for a
perfect bayesian equilibrium in the sense that player E takes into account the consumers’ beliefs and best responses when making his choices. Production of the public good entails a cost $C(g) = cg$ whereas that of CSR follows the cost function $C(s) = \delta s^2/2$. The Elite aims to maximize:

$$\max_{s,g} \left\{ (v_s + v_k \theta g)s - C(s) - C(g) + p[\beta_s E(v_s|s,g) - \beta_k E(v_k|s,g)] \right\}$$  \hspace{1cm} (16)

In this setup, each choice generates a different marginal reputational return. The first-order conditions thus become

$$C'(s) = v_s + v_k \theta g + pR(s|g)$$

and

$$C'(g) = v_k \theta + pR(g|s)$$

$R(s|g)$ and $R(g|s)$ are the respective solutions for the two first-order differential equations:

$$R(s|g) = \beta[\delta - R_s(s|g)]$$

and

$$R(g|s) = \frac{\beta}{1 + \theta \beta'\frac{\theta \beta'\psi}{\beta} - R_g(g|s)}$$

with $\beta$ denoting the difference in the change in the weights attributed to prosocial orientation and political-rent seeking respectively, weighted by the importance of each to the consumers $\beta = \beta_s \rho(g) - \beta_k \xi(g)$ ($\rho$ and $\xi$ are the same as in (12), except that $k$ is now replaced with $(\theta g)$, and $\beta'$ also reflecting the reallocation of weights attributed to each but due to a marginal increase in the public good $g$, such that $\beta' = \beta_s \rho'(g) - \beta_k \xi'(g)$.

**Lemma 4.2** If $\theta < 0$, the elite faces a trade-off between the level of public good provided and CSR investment in order to maximize its returns. The only case where the elite chooses to increase the provision of public good through both channels is when it has a negative valuation for political rents ($v_k < 0$).

Substituting the marginal reputation returns into the first-order conditions, we obtain two relations that are crucial for the equilibrium analysis:

$$s^*(g) = \frac{v_s + v_k \theta g^*}{\delta} + \beta$$  \hspace{1cm} (17)

and

$$g^*(s) = \frac{s^* \theta v_k - c(1 - H) + \bar{v}_s}{\bar{v}_k \theta}$$  \hspace{1cm} (18)

Differentiating (17) with respect to $g$ yields the result presented in lemma 4.1. What is important to note here is the nature of dependance of CSR investments on the chosen level of public good. CSR investments will follow the public good provision in one direction or the other, according to the production technology of the political multiplier, that is, $s^*(g) = \frac{c}{\delta} \theta$; meaning that the level of CSR will depend on the value but also
the sign of $\theta$. In economies where providing a low level of public good increases the political multiplier ($\theta < 0$), CSR will be negatively correlated with the existing level of public good. Intuitively, a decrease in $g$ conveys more political power to the elite and encourages it to increase its investment in CSR to further exploit those political benefits.

Note that a higher value of $\theta$ in absolute terms reflects the idea that a marginal increase in the public good induces a sharp increase (or decrease) in the political multiplier. This is perhaps the case of an economy with an initially low level of public good so that a marginal increase will have a high impact. One would expect $\theta$ to be quite high in developing economies where the basic public goods and services are underprovided so that a businessman who fills this gap through CSR activities gains considerable political power. Whereas in developed economies, where the public good is sufficiently provided by the state, $\theta$ is not as large since a marginal increase in the public good does not have much influence on the overall level, at extreme, it may go unnoticed $\theta = 0$.

**Lemma 4.3** Regardless of the sign or value of $\theta$, $g^*(s) = e$ where $e$ is the relative political opportunism of the elite ($e = v_k/\bar{v}_k$)

Solving the FOCs simultaneously yields the equilibrium CSR investments $s^*$ and level of public good $g^*$:

$$s^*(e) = \frac{(v_s/\delta + \beta) - e[\bar{v}_s + (1 - H)c]}{1 - e\theta v_k}$$

(19)

and

$$g^*(e) = es^*(e) + \frac{\bar{v}_a - (1 - H)c}{\theta \bar{v}_k}$$

(20)

5 Media and Transparency Issues (forthcoming)

In this last section, we allow the elite to control $x$, that is interpreted as degree of transparency or media freedom in the economy (recall that $\beta_s = x\alpha_s$ and $\beta_k = x\alpha_k$ where $x$ is a measure of the visibility of firms’ actions or choices.
6 Appendix

References


