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Are red or blue companies more likely to go green? Politics and corporate social responsibility ☆

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ABSTRACT

Using the firm-level corporate social responsibility (CSR) ratings of Kinder, Lydenberg, Domini, we find that firms score higher on CSR when they have Democratic rather than Republican founders, CEOs, and directors, and when they are headquartered in Democratic rather than Republican-leaning states. Democratic-leaning firms spend $20 million more on CSR than Republican-leaning firms ($80 million more within the sample of S&P 500 firms), or roughly 10% of net income. We find no evidence that firms recover these expenditures through increased sales. Indeed, increases in firm CSR ratings are associated with negative future stock returns and declines in firm ROA, suggesting that any benefits to stakeholders from social responsibility come at the direct expense of firm value.

1. Introduction

Corporate Social Responsibility (CSR) is becoming an increasingly important part of doing business around the world. Companies are allocating significant portions of their expense budgets to CSR — $28 billion on sustainability[1] and $15 billion on corporate philanthropy[2] spent by large U.S. firms in 2010. Nearly 80% of Global Fortune 250 companies publish detailed CSR reports, up from 50% in 2005,[3] and business school graduates increasingly see "serving the greater good" as an important responsibility of a business manager.[4] CSR is also increasingly important to investors, with $3.07 trillion of professionally managed U.S. assets tied to CSR through socially responsible investing (SRI).[5] Over 965

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[1] See survey by Verdantix on sustainability. http://www.verdantix.com/index.cfm/papers/Press.Details/press_id/42/verdantix-forecasts-us-sustainable-business-spending-will-double-to-60bn-by-2014/.

[2] See Corporate Giving survey on philanthropy. http://www.philanthropyjournal.org/news/top-stories/corporate-giving-grows-median-flat.

[3] See 2008 KPMG International Survey of Corporate Responsibility Reporting. http://www.kpmg.com/global/en/issuesandinsights/articlespublications/pages/sustainability-corporate-responsibility-reporting-2008.aspx.

[4] See "A promise to be ethical in an era of immorality," *New York Times*, May 29 (Wayne, 2009). In addition, Montgomery and Ramus (2007) survey 759 MBA graduates and find that most would be willing to sacrifice financial compensation to work for a socially responsible employer.

[5] See 2010 Report on Socially Responsible Investing Trends in the United States. http://www.socialinvest.org/resources/research/ (Social Investment Forum, 2011).

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institutional investors from around the world, managing over $20 trillion in assets, are signatories to the United Nations-backed Principles for Responsible Investing (UNPRI) initiative.

With the amount of money and attention that companies are giving to CSR, it is important to understand the rationale for CSR. First, spending on CSR may be financially profitable through its branding/reputation effects vis-à-vis customers, employees, investors, etc. (Baron, 2001). However, empirical studies disagree on whether the benefits of CSR outweigh the financial costs (see Margolis, Elfenbein, and Walsh, 2007, for a review). Alternatively, Benabou and Tirole (2010) suggest that CSR may be a form of delegated pro-social behavior, which can provide direct value to firm stakeholders even if it is financially costly. We are the first to test this "direct-value" theory[6] by investigating the relation between CSR and stakeholder preferences for social responsibility, as measured by their political affiliation.

We test the hypothesis that Democratic-leaning firms (i.e., firms with a higher proportion of Democratic stakeholders) are associated with more socially responsible policies than Republican-leaning firms. Our results can be illustrated by a comparison of Starbucks and Wendy's, two large and well-known food and drink retailers. Starbucks started as a coffee beans store in 1971 and began to grow as a popular coffeehouse chain in the late 1980s after entrepreneur Howard Schultz bought it. Schultz, who is the current CEO and Chairman of Starbucks, is a well-known Democrat who donated $130,500 to Democratic federal candidates and only $1,000 to Republicans over his lifetime. In addition, Starbucks was founded and is currently headquartered in Seattle, Washington, a bastion of progressivism and the Democratic Party.

Wendy's founder is Dave Thomas, a Republican supporter who donated $47,000 to Republican candidates and $2,000 to Democrats. Furthermore, Wendy's was founded and is currently headquartered in Dublin, Ohio (a Republican-leaning area). Based on these internal and external political differences, our hypothesis suggests that Starbucks should be more socially responsible than Wendy's. Indeed, we find that Starbucks is one of the top CSR performers in our entire data set while Wendy's is a significant CSR underperformer.

In our sample, we find a significant difference in CSR between typical Democratic and Republican firms. A one-standard deviation shock (to the political "left") to the firm's political environment is associated with a 0.1 standard deviation improvement in CSR. This result is robust to controls for firm-level heterogeneity, CEO-level heterogeneity, and a number of tests to rule out alternative explanations. There are several ways to understand the economic significance of our results. First, we find a positive and significant association between CSR and Selling, General, and Administrative (SG&A) expenses, allowing us to convert the estimated effect of political leanings on CSR into direct monetary costs (through higher SG&A) for the firm. Based on this conversion, we estimate that Democratic-leaning firms spend, on average, an extra $18 million per year on CSR relative to Republican-leaning firms (an extra $80 million per year for the subset of firms in the S&P 500), representing approximately 10% of a typical firm's net income.

Second, because CSR performance is also associated with industry, we can use estimated industry effects as a benchmark for the economic significance of the estimated effect of politics. For example, the petroleum and natural gas industry (Fama-French 30) is near the bottom in *environmental* CSR performance while computer software (Fama-French 36) is one of the best in this category. Using those two industries as a measuring stick, we find that the average difference between Democratic-leaning and Republican-leaning firms in terms of environmental corporate social responsibility is about 20% of the difference between typical firms in petroleum and computer software.

Third, we take a broader view of economic significance by examining the implications of changes in CSR policies for the value of the firm, stock holdings by institutional investors, and future operating performance as measured by return on assets (ROA). We find that an expansion of CSR policies is associated with future stock underperformance and a long-run deterioration in ROA. We argue that the first of these effects is a direct market reaction to CSR with a lag resulting from delays in investors' learning about CSR policy changes. The adverse financial effects of CSR on the firm help explain why firms whose stakeholders get "direct value" from CSR are more willing to implement it. After all, if CSR paid for itself or was financially profitable, one would expect all firms, regardless of stakeholder preferences toward social responsibility, to vigorously implement it.

Political affiliation is a natural measure of preferences for social responsibility. The Democratic Party platform places more emphasis on CSR-related issues such as environmental protection, anti-discrimination laws and affirmative action, employee protection, and helping the poor and disadvantaged. A 2007 National Consumers League survey found that 96% of Democrats believe Congress should ensure that companies address social issues, compared to 65% of Republicans.[7] In addition, Hong and Kostovetsky (2012) show a significant difference between Democratic and Republican investment managers in their portfolio holdings of socially responsible companies. Recent papers have also found that political views affect corporate variables such as leverage and investment (Hutton, Jiang, and Kumar, 2011) as well as the decision of individual investors on whether to participate in the stock market (Kaustia and Torstila, 2011).

We measure corporate social responsibility using data from Kinder, Lydenberg, and Domini (KLD). KLD is a leading data provider of social research for institutional investors.[8] In 2006, TIAA-CREF, one of the biggest U.S. retirement funds, sold a large stake in Coca-Cola stock after KLD removed Coca-Cola from its list of socially responsible companies. KLD rates

[6] This is also termed the "delegated philanthropy" theory: "the firm as a channel for the expression of citizen values." (Benabou and Tirole, 2010)

[7] Fleishman-Hillard Inc. and the National Consumers League survey, http://www.marketingcharts.com/?attachment_id=400.

[8] In 2009, KLD was acquired by RiskMetrics, and is now a subsidiary of MSCI, a leading provider of indices and institutional products and services.