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Experimental Evidence on the New CSR Rule in India**

**Naman Desai
Viswanath Pingali
Arindam Tripathy**

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**INDIAN INSTITUTE OF MANAGEMENT
AHMEDABAD-380 015
INDIA**

Is 2% the Solution? Experimental Evidence on the New CSR Rule in India

Naman Desai^{*1}
Viswanath Pingali²
Arindam Tripathy³

The Indian government became the first regulator in the world to mandate a minimum CSR spending on certain specified social welfare activities. Prior research in psychology indicates that individuals tend to focus heavily (Anchor) on the initial information or estimate in a decision making context. Therefore, we conduct two experiments to examine the role of the 2% minimum CSR spending limit as an anchor. The first experiment was conducted to establish the effects of anchoring on decisions related to charitable giving. The results of this experiment indicate that participants' charitable contribution was significantly higher in the treatment where no minimum limit was stipulated compared to the treatment where a minimum limit was stipulated. This result suggests that participants did anchor on the minimum stipulated limit while deciding on the amount of charitable contribution. The second experiment was conducted to examine if anchoring specifically affected CSR spending decisions. The results of the experiment indicated that the amount of reported CSR spending was lower when the minimum 2% rule was imposed versus when it was not imposed. Additionally, the results also indicate that when the 2% rule was not imposed the participants appeared to anchor on the overall financial requirement of the CSR activity and decided to spend more or less depending on the financial requirement of the CSR activity.

¹ Finance and Accounting Area, Indian Institute of Management Ahmedabad, Ahmedabad-380015, namand@iimahd.ernet.in. *Corresponding author

² Economics Area, Indian Institute of Management Ahmedabad, Ahmedabad-380015, viswanath@iimahd.ernet.in

³ Milgard School of Business, University of Washington – Tacoma, Tacoma, WA 98402, tripathy@u.washington.edu

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INTRODUCTION

This study examines the potential effect of anchoring on charitable contributions and Corporate Social Responsibility (CSR) spending in the context of the minimum CSR spending limits imposed by the Companies Act (2103) in India.

CSR has been conceptualized broadly as "the managerial obligation to take action to protect and improve both the welfare of society as a whole and the interest of organizations," (Davis and Blomstrom 1975, p. 6). Hill et al. (2007) define CSR as the economic, legal, moral, and philanthropic actions of firms that influence the quality of life of relevant stakeholders. The World Bank Council for Sustainable Development defines CSR as "the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and society at large." The World Bank defines CSR as a tool to improve overall human development and social inclusion. More specifically, the World Bank envisions CSR as an activity that will ensure that corporations will work with government, civil society, and community to improve the lives of the underprivileged people of India by making growth more inclusive (World Bank 2013).

Large corporations around the world have been voluntarily spending a significant amount of money on CSR activities through various charitable foundations funded by them⁴. Prior research has suggested several strategic benefits accruing to companies that invest in CSR activities (Dhaliwal et al. 2011; Dhaliwal et al. 2012, Balakrishnan et al. 2011; Flammer 2013; Lev et al.

⁴ All major US and global companies have charitable foundations that provide money for social causes. E.G. Citi Foundations, Google Foundation, Wal-Mart Foundation, Coca-Cola Foundation etc.

2010; Minor and Morgan 2011; Modi and Mishra 2013). The Indian government became the first regulator in the world to mandate a minimum CSR spending on certain specified social welfare activities. As per Companies Act 2013, all publicly listed companies and private companies whose net worth exceeds INR 5000 million or, whose annual turnover exceeds INR 10000 million or, whose profits exceed INR 50 million⁵, are mandated to annually spend 2% of average net profit of past three years on certain approved CSR activities and also disclose such expenditures in their financial statements and in a separate individual CSR report.⁶ The primary objective of this rule is to ensure that all corporations contribute to the betterment of the society as a whole which in turn would make corporate growth more inclusive.

Prior research in psychology indicates that individuals tend to focus heavily (Anchor) on the initial information/number/estimate given to them when making a decision (Tversky and Kahneman 1974). Research also indicates that anchoring effects are pervasive across a wide variety of judgment and decision making contexts (Chapman and Johnson, 1999; Jacowitz and Kahneman, 1995; Mussweiler and Strack, 1999a, 2000a, 2000b; Plous, 1993; Mussweiler and Strack, 1999b), and also that the influence of anchoring is relatively immune to corrective actions (Plous 1993; Wilson et al. 1996). Therefore, a potential problem with the 2% rule is that large companies, who usually spend more than 2% of their profits on CSR related activities, could “anchor” their CSR spending on the minimum stipulated limits which, in turn, could actually reduce their CSR spending. Such a result would be contrary to the objectives of

⁵ 1 crore is equal to 10 million. The Indian Companies Act lists these numbers in crores however to facilitate reading by an international audience we are converting them to millions.

⁶ This rule has come into effect on April 2014. The first CSR reports will come out after the year end March 31st 2015. This rule will be referred to as the 2% rule from here on in this paper.

establishing such a minimum limit. Hence, we examine the impact of anchoring on charitable contributions, and on the CSR spending of companies.

We conduct two experiments to examine our primary research questions. The first experiment was conducted on under-graduate students in their final semester before graduation. In this experiment the participants were made to earn an income by answering a list of 10 questions. They were then asked to voluntarily contribute any percentage of their winnings to charity or, do the same subject to a requirement of contributing a minimum of 5% to charity. This experiment was conducted to establish the effects of anchoring on decisions related to charitable giving. The results of this experiment indicate that participants' charitable contribution was significantly higher in the treatment where no minimum limit was stipulated compared to the treatment where a minimum limit was stipulated. This result suggests that participants did anchor on the minimum stipulated limit while deciding on the amount of charitable contribution.

The second experiment was conducted to examine if anchoring specifically affected CSR spending decisions. This experiment was conducted on mid and upper level company executives. A 2 x 2 between subjects design was employed where we manipulated the presence / absence of minimum CSR spending requirement, and the overall financial requirement (high or low) of the CSR activity in question. The results of the experiment indicated that the amount of reported CSR spending was lower when the minimum 2% rule was imposed versus when it was not imposed. Additionally, the results also indicate that when the 2% rule was not imposed the participants appeared to anchor on the overall financial requirement of the CSR activity and decided to spend more or less depending on the financial requirement of the CSR activity.

These results were further corroborated by an examination of the standard deviations. The results indicate that the increase in standard deviations of reported CSR spending was significantly large when the CSR requirements increase from INR 500 million to INR 2500 million in the treatments where no minimum spending limits were imposed compared to the minimum 2% treatments. This further indicates that where no CSR limits were imposed, and when participants were not anchored on a minimum limit, they focused on the overall CSR needs of a project and were likely to spend significantly more (compared to scenarios where a minimum spending limit is imposed) on CSR projects. This paper has important implications for regulators and standard setters around the world and highlights some of the potential negative effects of setting minimum CSR spending limits on overall corporate CSR spending.

LITERATURE REVIEW

Benefits of CSR

CSR has been defined differently by different organizations and while its definition may vary across organizations, it generally refers to “actions that appear to further some social good, beyond the interests of the firm and that which is required by law” (McWilliams and Siegel, 2001, p. 117). There is a growing body of research that examines the economic impact of a corporation’s CSR activities. For example, research indicates that firms that voluntarily disclose their CSR activities, and have a good CSR spending record enjoy a significantly reduced cost of capital in comparison to similar firms which do not have a good CSR performance record (Dhaliwal et al. 2011; Richardson and Welker 2001). Similarly Ghoul et al. (2012) suggest that firms with better CSR scores also enjoy cheaper equity financing costs. Kim and Li (2014)

indicate that a company's CSR activities could help in reducing the risk of stock price crash faced by the company. According to prior research, CSR activities can also lead to better financial performance by, improving the firm's reputation with customers which results in increased sales, improvement in the firm's reputation with regulators which helps in receiving more favorable treatment from such regulators, improvement in ability to attract and motivate employees, etc. (Dhaliwal et al 2012; Modi and Mishra 2013; Korschun et al. 2014). This in turn can reduce the level of firm specific idiosyncratic risks faced by any company (Modi and Mishra 2013). Finally, Kim et al. (2012) find that companies that exhibit CSR are less likely to manage earnings through discretionary accruals and real operating activities, and are less likely to be the subject of SEC investigations.

Research in marketing indicates that there is a positive association between a company's CSR activities and consumers' attitudes towards the company and its products (Brown and Dacin 1997; Creyer and Ross 1997; Ellen, Mohr, and Webb 2000). Sen and Bhattacharya (2001) add to this literature and indicate that a company's CSR will have a positive effect on consumers only if the company's CSR activities are in congruence with the consumers' personal beliefs for those CSR activities. Furthermore, the effects of positive CSR on consumer associations and identification with firms can result in higher product evaluations (Berens et al. 2005) and more importantly such, strong brand equity resulting from positive CSR can make consumers less prone to attitude change and reduce the effectiveness of competitors' persuasion attempts (Krasnikov et al. 2009). Additionally Minor and Morgan (2011) indicate that a company's CSR activities can provide some insurance to the company against loss of reputation in the face of

adverse events. There are several other benefits accruing to companies engaging in CSR activities (See Malik (2014) for detailed review).

Effects of Anchoring on Decision Making

Anchoring is a pervasive judgment bias in which decision makers are systematically influenced by random and uninformative starting points (Chapman and Johnson 1999). Anchoring affects human judgment and decision making in a variety of situations. For example, anchoring affects the pricing and rating of simple gambles (Carlson, 1990; Chapman and Johnson, 1994; Johnson and Schkade, 1989; Schkade and Johnson, 1989), the estimation of probabilities (Plous, 1989; Plous 1993; Wright and Anderson, 1989), answers to factual knowledge questions (Jacowitz and Kahneman, 1995; Kahneman and Tversky, 1974), and pricing and valuation decisions ((Northcraft and Neale, 1987; Mussweiler et al. 2000). Moreover, anchoring also affects social judgments of the self and others; specifically, judgments of self-efficacy (Cervone and Peake, 1986), and predictions of future performance (Switzer and Sniezek, 1991).

Although anchoring is pervasive in several contexts, decision makers find it difficult to take the necessary corrective action to mitigate the effects of anchoring (Kahneman and Knetsch 1993; Wilson et al. 1996). For example, Kahneman and Knetsch (1993) suggested a model in which anchoring can occur when the anchor is arbitrary and people are not asked to consider the anchor as a possible answer. The results of Wilson et al. (1996) suggest that basic anchoring occurs if people pay sufficient attention to the anchor value and that knowledge mitigates the effect of anchoring but does not reduce it entirely. Additionally, Wilson et al (1996) infer that anchoring

appears to operate unintentionally and subconsciously because decision makers failed to avoid it even when they were forewarned.

HYPOTHESIS

Despite the several strategic benefits already available to companies investing in CSR activities (Malik 2014), the Indian Government decided to impose minimum CSR spending limits on companies. We infer that this limit was imposed with a view to stimulate corporate spending on social causes and maybe to make the growth experienced by corporations more inclusive of the society as a whole.

This minimum spending limit does have the potential of increasing the number of companies investing in CSR activities. However, certain large companies whose CSR related spending were in excess of 2% of their profits could start anchoring on the minimum 2% limit, and as a result, reduce their investment in social causes. Additionally, once the 2% rule takes effect, it might be difficult for the company's management to explain any CSR spending in excess of 2% to the shareholders. Thus, depriving social causes of the desperately need corporate financial support in a developing country like India. Formally stated:

Hypotheses 1

Individuals and companies subject to minimum spending limits on social causes will anchor on the stipulated minimum limits, and as a result, invest less in such social causes than individuals and companies which are not subject to such minimum spending limits.

Just like the minimum spending limits which could act as an anchor for CSR spending, there could be other factors which could act as anchors in the absence of minimum spending limits. One such factor could be the total requirement of a CSR project. If a company decides to finance a CSR activity only partially, then in the absence of a minimum spending limit, it is possible that the total financial requirements of a CSR activity could act as an anchor while deciding on the amount of CSR investment in a particular activity. Since prior research suggests that individuals do not adjust sufficiently from an anchor point (Plous, 1989; Northcraft and Neale, 1987; Mussweiler et al. 2000) such an anchoring could actually increase a company's spending in a CSR activity. Formally stated:

Research Question1

In the absence of a minimum CSR spending limit would the amount of CSR spending be anchored on the total funding requirement of a CSR activity?

METHODOLOGY

We conducted two between-subjects experiments to test our hypotheses. The first experiment was conducted to investigate if anchoring affected decisions related to charitable giving. The experiment was conducted on undergraduate students in their last semester of course work (before graduating). The participants had an average age of 20.34 years. The participants were divided in two treatments and were asked to answer 10 mathematical questions in 15 minutes.⁷ The participants were paid INR 50 for every correct answer and no penalty was imposed for incorrect answers. Participants, who did not answer any question correctly, were paid INR 100

⁷ The questions were selected from various GMAT practice tests.

just for participating in the study. After the pay outs were determined, participants in one treatment (control group) were asked to voluntarily contribute a portion of their winnings to a charity of their choice. The second treatment (treatment group) was similar to the first except that in this treatment a minimum contribution limit of 5% was imposed on all winnings, and then the participants had the option to voluntarily contribute any additional amount to a charity of their choice.⁸

The second experiment was conducted to examine how company executives react to minimum CSR spending limits while deciding on the amount to be spent on a particular social cause. The second experiment was a 2x2 between-subjects experiment where the presence or absence of minimum spending limit and the total requirement of a CSR project (INR 500 million versus 2500 million) were manipulated across treatments. All the participants of this experiment were middle and top level company executives. In this experiment the participants were provided with a brief company description, the abbreviated financial statements of a company and a potential CSR opportunity (improving infrastructure of schools for under privileged children). They were then asked to determine the amount of CSR spending that would be committed on behalf of the company on that particular project. This experiment was conducted to specifically examine if the participants would anchor on the 2% minimum while deciding on their CSR spending. Additionally we also examine if the executives would anchor on the total requirements of the social cause when no minimum spending limits were imposed.

⁸ The minimum 5% of contribution was also given to a charity of the participants' choice.

All the company executives were selected from various executive education programs run by one of Asia's premiere business school. The participants for this experiment reported an average work experience of 18.45 years. The participants were employed by companies involved in a wide range of sectors such as construction, manufacturing, providing data services, pharmaceuticals, telecommunications etc. The participants represented both private and public sector enterprises. All the participants represented companies which regularly undertook CSR activities even before the mandatory spending limits were proposed.

RESULTS

The descriptive statistics in Table 1 indicate that, participants in the first experiment contributed significantly more to a charity of their choice when no minimum contribution limit was imposed, compared to when their earnings were subject to a 5% minimum contribution (38.5% versus 24.9%).⁹ The ANOVA results (Table 2 Panel A) indicate that this observed difference in charitable contribution as a percentage of total winning, was significant between the two treatments. The regression results (Table 2 Panel B) indicate that charitable contributions are negatively correlated with participants fixating/anchoring on the mandatory 5% contribution level that was fixed. The results of a paired sample t-test also indicate that charitable contribution in the 5% mandatory contribution treatment was significantly less than the no mandatory contribution treatment (Mean Difference 1.332; $t = 4.49$; $p < 0.01$). The results of the first

⁹ The contributions were significantly greater than the minimum 5% because of two primary reasons. First, the 5% of total earnings might have appeared to be too less in absolute numbers (For e.g. 5% of INR 200 is only INR 10 which is a very small and insignificant amount in India. Second, the currency denomination is such that participants would have found it difficult to contribute exact percentages and hence they may have rounded up or down to multiples of 10, 20 or 100 which are the most commonly used currency notes in India.

experiment strongly indicate that anchoring affects participants' decision making related to charitable contributions.

Table 1: Descriptive Statistics for Experiment 1 Indicating Charitable Contributions as a Percentage of Total Earnings

| <u>Treatment</u> | <u>N</u> | <u>Mean</u> | <u>Std. Dev.</u> | <u>Minimum</u> | <u>Maximum</u> |
|------------------|----------|-------------|------------------|----------------|----------------|
| 1 | 42 | 0.385 | 0.176 | 0.04 | 0.80 |
| 2 | 41 | 0.249 | 0.145 | 0.05 | 0.53 |
| Total | 83 | 0.318 | 0.174 | 0.04 | 0.80 |

Treatment 1 = no mandatory contribution

Treatment 2 = 5% mandatory contribution

Table 2: ANOVA and Regression Analysis for Experiment 1

| <u>Panel A: ANOVA Analysis of Charitable Contributions as a Percentage of Total Earnings</u> | | | | |
|---|-----------|--------------------|----------------|----------------|
| | <u>df</u> | <u>Mean Square</u> | <u>F</u> | <u>p-value</u> |
| Between Groups | 1 | 0.384 | 14.76 | <0.001 |
| Within Groups | 81 | 0.373 | | |
| Total | 82 | | | |
| <u>Panel B: Regression Analysis of Charitable Contributions as a Percentage of Total Earnings</u> | | | | |
| | <u>B</u> | <u>t</u> | <u>p-value</u> | |
| Mandatory Contribution | -0.393 | -3.842 | <0.001 | |

The second experiment was conducted to examine if the anchoring effects observed in the context of charitable contributions actually extend to individuals making CSR spending decisions. The descriptive statistics in Table 3 indicate that the CSR spending was higher when no minimum was stipulated compared to conditions where a 2% minimum spending limit was imposed. This result holds true irrespective of the overall requirement of the social project (321.2 versus 254.2 and 284.9). Additionally the CSR spending is the highest (509.0) for the condition where fund requirement is relatively high (INR 2500 million versus INR 500 million) and where no minimum CSR spending limits are imposed.

Table 3: Descriptive Statistics for Experiment 2 Indicating Amount of CSR Spending

| | Mean (Std. Dev) | Mean (Std. Dev) |
|-------------------|----------------------------|-----------------------------|
| | Project Requirement 500 m. | Project Requirement 2500 m. |
| <u>Minimum 2%</u> | 254.2 (24.4) | 284.9 (80.0) |
| <u>No Minimum</u> | 321.2 (106.7) | 509.0 (388.8) |

Table 4: 2 x 2 ANOVA Examining the Effect of CSR Spending Limit and Overall CSR Requirement on Participants CSR Spending

| Source | df | Mean Square | F | Sig. |
|--------------------------------|----|-------------|--------|--------|
| CSR Rule | 1 | 5147.652 | 17.750 | 0.001* |
| Project Requirement | 1 | 3085.160 | 7.641 | 0.007* |
| CSR Rule x Project Requirement | 1 | 1747.067 | 4.327 | 0.041* |
| Error | 76 | 198.269 | | |
| Total | 80 | | | |
| Corrected Total | 79 | | | |

*Significant at $p < 0.05$

The results of the 2 x 2 ANOVA¹⁰ (Table 4) indicate that both the mandatory 2% CSR limit and the overall requirement of the social project have an effect on CSR spending. These results along with the means reported in Table 3 indicate that CSR spending was significantly lower when the 2% minimum spending limit was imposed than in cases where the limit was not imposed. The significant effect of overall project needs on CSR spending (INR 500 million versus INR 2500 million) also indicates that when the 2% limit was not imposed participants appear to be fixating on the overall requirement of the CSR project. When the overall project requirement was increased from 500 million to 2500 million, the CSR spending (in the 2% mandatory condition) increased from 254.2 million to only 284.9 million.¹¹

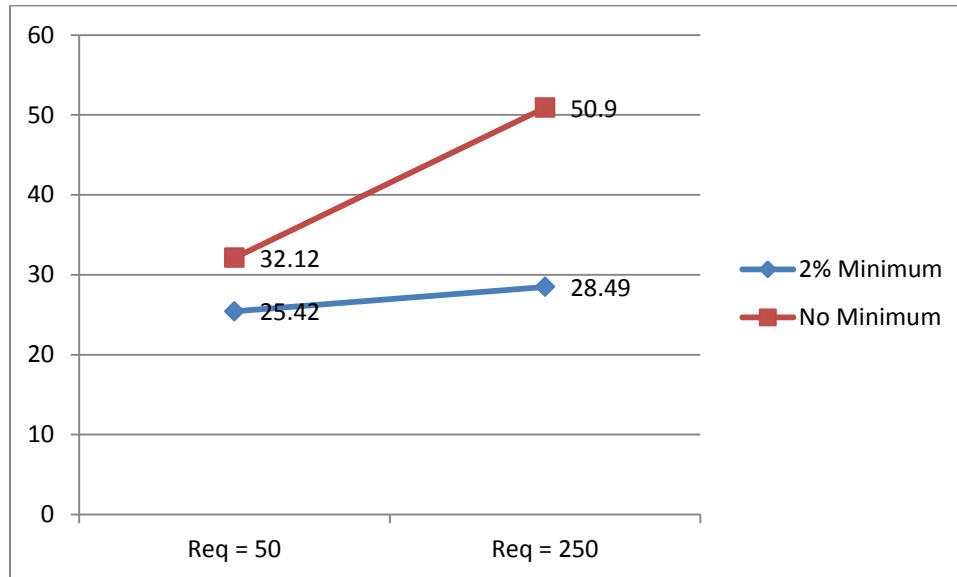
¹⁰ In this analysis CSR rule is a dummy variable which is 0 for conditions with the 2% minimum limit and 1 for the conditions where no limit is stipulated. Project Requirement is a dummy variable which is 0 when the requirement is 500 million and 1 when it is 2500 million.

¹¹ As per the given company results in each treatment 2% of the company's profit was 234 million.

Additionally, an examination of the standard deviations indicate that when the CSR requirements increase from INR 500 million to INR 2500 million in the minimum 2% treatments, the deviation in average CSR spending increased from 24.4 to 80.0. However, for similar treatments where no minimum CSR spending was stipulated, the standard deviation increased from 106.7 to 388.8 (Table 3). The relatively small increase in standard deviations (24.4 versus 80.0) when the 2% minimum is imposed also provides strong support of the fact that individuals anchor on the stipulated minimum limits when asked to determine CSR spending. The relatively large increase in standard deviations (106.7 versus 388.8) in the treatments where no limits were imposed, could be indicative of the fact that when participants are not anchored on a minimum limit, they tend to focus on the overall CSR needs of a project and are likely to spend significantly more (compared to scenarios where a minimum spending limit is imposed) on such CSR projects.

Based on these results it can be clearly inferred that the 2% minimum stipulation was acting as an anchor for the proposed CSR spending. However, in the conditions where no minimum spending limit was stipulated, the CSR spending increased from 321.2 million to 509.0 million (Figure 1). This result again indicates that the total project requirement is having some effect on CSR spending when minimum spending limits are not stipulated. The significant interaction between the CSR rule and project requirement (Table 4, Figure 1) provides statistical evidence to answer Q1. The overall results of this study provide strong evidence in support of H1.

Figure 1: Increase in CSR Spending across Treatments when the Overall Project Need Increases from 50 to 250 crores¹²



The results of this study have important implications for policy makers and regulators. While the setting of a minimum CSR spending potentially increases the number of companies investing in CSR activities, the minimum spending limit could actually act as an anchor and potentially reduce the amount of CSR spending of certain large companies which usually spend more than 2% of their profits on such activities. Additionally the overall results also indicate that the total requirement of the CSR project tends to drive CSR spending when no minimum limit is imposed.

CONCLUSION

This study investigates the impact of anchoring on charitable contributions and CSR spending. Recently India became the first country to impose a minimum spending limit for certain approved CSR activities (2% of average net profits of past three years). This minimum limit was imposed to increase much needed corporate spending on important social causes. Prior literature

¹² 1 crore is equal to 10 million.

suggests that CSR spending results in strategic benefits (Malik 2014). As a result, it can be inferred that CSR spending is actually aligned with the overall success of company. Thus, the strategic benefits enjoyed through CSR spending, should act as sufficient motivation to stimulate corporate CSR spending. Despite these findings, the Indian regulators imposed a minimum CSR spending limit to ensure that all companies contributed to social causes which are deemed to be of national importance. One potential adverse impact of imposing such a minimum spending limit is that companies which in the past spent more than 2% of their profits on CSR activities¹³ could anchor on the 2 % minimum spending limit and as a result the regulations could result in reduction of CSR spending of such companies.

The overall results of this study indicate that individual's charitable contributions and reported CSR spending are anchored on the imposed mandatory limits. Therefore before stipulating any minimum limits regulators should clearly understand the implications of such limits and also conduct a detailed analysis before deciding on the magnitude of any minimum spending limit. Additionally, the results of our study suggest that organizations and individuals could ignore the impact of strategic benefits gained through CSR spending and anchor solely on the minimum stipulated spending limit. This result is consistent with the research on anchoring which indicates that individuals frequently anchor their decisions on readily available numerical values. The impact of such anchoring behaviour on the overall CSR spending of all corporations should be investigated before imposing any minimum CSR spending limits.

¹³ In the absence of formal CSR reporting in India a significant portion of CSR spending was not being explicitly reported. However, there are several large companies that invest more than 2% of their profits on social causes.

More interestingly our results also indicate that in the absence of minimum CSR spending limits, the CSR spending appeared to be driven by the total requirement of the CSR project (Figure 1). If such an anchoring leads to greater CSR spending than regulators should try and increase awareness about the requirements of various CSR activities rather than imposing minimum spending limits on corporations.

From a policy perspective, the minimum 2% CSR rule is already implemented in India, thereby establishing a benchmark for CSR spending. Repealing the law at this stage, may not lead to attenuating of the anchor of 2% that is currently established. In this context, the lessons we derive from in this paper, become pertinent to any other country that is contemplating on regulating their CSR activities. Along with anchoring on the 2% minimum spending limit, it is also worth noting the other repercussions of this law. First, the results indicate that the 2% minimum would serve as a significant anchor when compared to the overall requirements for the projects identified. Second, given the restriction on the kind of activities the companies can spend their CSR budgets on, there could be a lot of cross-over effect, wherein, current spending is readjusted at the cost of existing spending. Third, the CSR limit can be looked at as tax, and the companies might indulge in misreporting their profits/revenues in order to reduce CSR spends. Finally, till date companies were motivated to spend on CSR activities to enjoy some of the strategic benefits accruing from such spending (Malik 2014). However, since the new law forces all companies to spend on CSR, these strategic benefits might reduce, thereby making CSR spending less attractive. Whether all these implications mentioned here would materialize or not, becomes a part of the future research agenda.

Finally, another pertinent question in this context is what could be the alternative models of improving CSR spending by the companies. While the answer remains speculative currently, one way is to anchor firms locally on the total volume of funds required on welfare activities in any particular area. Again, the nature of appropriate policy decisions remains the topic of future research.

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