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Does Political Instability moderate the relationship between Corporate Social Responsibility (CSR) and Cost of Capital?

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ABSTRACT

Corporate social responsibility (CSR) is a theme of the decade. A few laws concerning corporate social responsibility have been formulated and promulgated the world, particularly in developing countries like Pakistan. The previous studies also illustrated many CSR issues among Pakistani firms. The present study test the association between CSR and cost of capital with moderating role of political instability. The present study contains corporate social responsibility (tax expenses, cost rate, asset liability ratio, dividend per share, interest coverage ratio) and cost of capital . Data were collected from the annual reports throughout 2013-2017 and 21 firms from the cement sector listed in the Pakistan stock exchange, out of which ten firms based on market capitalization rate have been selected. The theoretical framework of the current study is based on stakeholder and agency theories. CSR was measured as second order construct based on six dimensions; tax expenses, cost rate, asset liability ratio, dividend per share, interest coverage ratio. Cost of Capital was used as a proxy as a measure of the cost of capital. Political instability was used as a moderator, and data were gathered from "the World Bank indicators". The current study utilized regression with the fixed and random model to meet the research goals. All the dimensions of CSR indicate a significant association with cost of capital. Political instability shows perfect moderation in the presence of political instability; all dimensions of corporate social responsibility suggest an insignificant relationship with.

JEL Classification: *D24, M14, M19*

Keywords: *: Corporate Social Responsibility Cost of Capital, Political instability.*

INTRODUCTION

The company is a main source under the eye of law. The purpose of managing companies is to achieve the motivational level of stakeholders by maintaining wealth maximization. Under the theme of CSR, most of the companies provide their services towards society in terms of betterment the whole society (Bhandari & Javakhadze, 2017). During the 1980s, the term corporate social responsibility has been introduced under the report of the World Bank. According to previous research, the companies are unable to maintain the standard of resources for the society to the shortage of natural resources that can ultimately affect the whole environment including human beings and their desires as well.

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According to internationalization, the term CSR is the main source to provide the facilities towards society in good manners all over the world (Ishaq & Hussain, 2018). In the business sector, companies play an important role to maintain effective standard to grow the whole society. They spend millions of dollars to, improve their standards as well to maintain the wellbeing of society (Ogborn, Grgic, & Krieger, 2017). The concept of CSR plays an important role all over the world in terms of developed and developing countries. Consequently, the demand of society from the corporate sector is to facilitate their communities. According to recent research, the impact of CSR on the companies is positive and significant. Moreover, companies are interested to spend a huge amount on CSR to meet their standards through market demands (Bhandari & Javakhadze, 2017).

Prior research has established the relationship betweenCSR and firm performance with a discussion of the cost of capital (Suto & Takehara, 2016). The purpose of existing and clear CSR in corporations means that the minimization of cost of capital, less transactional expenses and reduction in informational asymmetry (Matthiesen & Salzmann, 2017). The concept of informational asymmetry is very essential for the maximization of information flow regarding CSR in the whole organization compared with external resources. This comparison creates effective management by using CSR plans, goals, benchmarks, challenges and budget (Barnett, Henriques, Husted, & Layrisse Villamizar, 2019).

Few Multinational Corporations (MNCs) follow CSR plan that are dynamic rather than stable. Generally, most of the companies have CSR plans which are flexible and repay their negatives impact on the society by them. The designs of some proactive companies are very human friendly and not dangerous of the environment. Although, few companies (MNCs) just make their standards according to ethical procedures in order to avoid a negative impact on society. For instance, the company named LUSH COSMETICS are following the CSR plans based on ethical standards that is good for enhancing their company reputation (Yunis, Durrani, & Khan, 2017). According to recent studies, most of the companies in corporate sector suffering from difficult problems and trying to change their standards according to their current targeted population in a very better way. However, in Pakistan, most of the companies usually not familiar about the importance of CSR and they are not capable to pay enough attention to CSR (Yunis et al., 2017).

Problem statement

For the last few decades, the concept of CSR is being commonly discussed in developed and developing countries all over the world. MNCs companies in Pakistan follow the practices of CSR globally. Domestic companies, the practices of CSR are quite difficult due to the shortage of funds/investments that have been suggested on the cost of capital.

The cost-benefit analytical technique is using to examine the additional cost of CSR. As CSR is very important for the good reputation of the company and their goodwill as well so the impact of CSR on company performance is positive and significant. In this situation, CSR is considered an additional responsibility from the side of stakeholders and other businesses stakeholders as well. According to them, CSR is based on funds and donations and is considered as an optional system in any organization (Tak, Shaharuddin, & Fui, 2017). The listed companies in PSX is mandatory to know the association between the Cost of Capital and CSR. The association of CSR and Cost of Capital is negatively related to each other for instance, if the reputation risk of the company is high then CSR will minimize this risk with help of reduction in cost of capital (Kim, Kim, Marshall, & Afzali, 2018). It is very important to know the relationship between cost of capital and CSR to help the managers for making an efficient and effective strategic planning (Ghoul, Guedhami, Mishra, & Kwok, 2011). According to past research, the initial studies follow the accounting–based financial performance for CSR although, some recent studies indicate Capital structure to evaluate the CSR.

While discussing the CSR within industry sector, the cement industry in Pakistan's economy is considered as a unit of analysis for this current study to evaluate their findings. According to CPEC, the cement industry plays an important role in the development of the economy nationally and internationally. However, CPEC is important due to China's huge investment of around 45 million towards this project. Moreover. The cement industry significantly impacts on the development of Pakistan because of its industrial and commercial infrastructure and enhancement in housing societies. However, the disadvantages of the cement industry in Pakistan is very high due to their poor consumption that effect on environment and make the atmosphere dirty. The most prominent issue in the cement industry is crushing the stones that create the large number of poisons in air and affect human lives badly. This is the main issue and reason to select the cement industry of Pakistan in order to make better by using this current study findings (Sarwat et al., 2017).

LITERATURE REVIEW

Underpinning Theory

Stakeholder Theory

The underpinning objective of a corporation is to maximize/ increase/ value added in the shareholders' wealth, along with the interest of shareholders. When preparing policies, managers should understand its impact on shareholder wealth and benefits towards the shareholders and try to minimize the wastage of resources ((Dmytriyev, Freeman, & Hörisch). The underpinning theme of stakeholder theory is to follow and adopt the CSR system voluntarily as it is for stakeholders of the company. If implemented, the hypothesis suggests that a company performs CSR on its program. The stakeholders get a positive or negative continuity impact of economic investors, just like with the firm, and are individuals or groups who are influenced by behavior, policies and organizations. Ali and Abdelfettah (2016) aim to become more diverse than it is now not limited to workers, investors, and consumers to the company-stakeholder relationship. Stakeholder theory maintains that corporations ought to report to their stakeholders to be socially responsible.

Agency Theory

"Mecking and Jensen" emerged in 1976 and developed the principle of agencies. Behind leverage and corporate social responsibility is the philosophy of theory. Specifically listed large corporations usually have an organizational framework in which ownership and power are essentially split among principal and agent. They hire managers or agents on remuneration in the association of individuals (AOP) to negotiate deals in their best financial interest (Hart, 1995). Conflicts of interest arising from the competing interests of shareholder executives are dealt with using the principle of agency theory.

CSR can be described as "the ethical behavior of a company towards society acting responsibly in its relationships with other stakeholders who have a legitimate interest in the business". CSR extends a company's commitment to ethical actions, contributing to an enhancement of the wellbeing of workers and their families, job prosperity, regional society and culture. Im, Oliver, Song and Zhaon (2020) discuss the entire range of CSR operations. For example, companies may concentrate on using environmentally sustainable products or working with society to produce goods. The companies can also want to contribute funds to different organizations, culture, and the community. CSR also refers to a business that acts against workers, communities and the environment which goes beyond or above the regulatory obligations..

Cost of Capital

When investing in businesses, investors weigh many factors that include the risk of the company's prospective cash flows, different alternatives available, and anticipated return on the investment (Cheng, Ioannou & Serafeim, 2014). Such a required rate of return is recognized as the "capital cost" Cost of capital is an instrument used to measure an entity's market value. A company's potential cash flows are calculated at the rate of the capital costs. The cost of equity has a reciprocal relationship to the value of the enterprise, the higher the cost of capital is value of the enterprise.

Risk plays an important part when it comes to investing in stocks on any stock exchange. An expected return has a direct connection with investment risk, the higher the return on investment will be. Moreover, investors have several investment opportunities in the stock market (Utz, 2017) Investor measures the rate of return and their associated risks when making the investments (Reverte, 2012). One of the competitive advantages of the businesses is accessing cheap capital with low yield rates and simple terms. Companies that have access to more low-cost resources perform well and have low risk in their potential cash flows (Harris, Roark, & Li, 2019).

CSR and Cost of Capital

CSR is not a charitable mechanism or small donations. CSR is a display of corporate accountability for contributing to the common good. CSR helps businesses to demonstrate their dedication to following acceptable business procedures and formulating plans in this respect. CSR is a term outside charity; it promotes a balanced partnership for the common good with the stakeholders (Tempels, Blok & Verweij, 2020). Capital cost is characterized as the required rate of return, referred to as the discount rate used by market participants to calculate a company's projected cash flows to measure its present market value. It can also be defined as the threat to whom the firm is related to the interpretation of the market.

Restricting the CSR disclosure advantages to low dividend costs is the possibility that the percentage of the study needs to concentrate mainly on the stock markets (Habib, 2017). On the one hand, ignoring the effect of CSR on debt expenditure limits the power of CSR on other forms of finance. In short, the narrow emphasis differs with the functional and theoretical importance of debt capital. To fully understand the influence of CSR on the capital structure (debt and equity). The findings of the current study will facilitate in understanding the priorities for the funding in CSR. A limited literature has been documented in the domain of CSR in emerging economies particularly Pakistan (Ishaq & Hussain, 2019). The current study intends to investigate the association between cost of capital and CSR with moderating role of political instability.

The relationship between CSR activities and the return on capital as well as its variables, such as the cost of equity and debt costs, is addressed in a restricted literature review (Michaels & Grüning, 2017). There is a small range of data available, but we were inspired by the following factors to research the "CSR and Cost of Capital" relationship (Ishaq & Hussain, 2018) Analyzing the link between CSR and capital cost will help decision-makers in the business understand the impact of Capital employed on the funding cost of the organization, which has important consequences for strategic corporate decisions. Because of the presence of the partnership between capital costs and CSR, capital markets will enable businesses to become more socially conscious (Suto & Takehara, 2016). Due to the presence of the relationship between the cost of capital and CSR, capital markets will enable businesses to become more socially conscious (Suto & Takehara, 2016).

CSR and State of Pakistan

CSR is a sign of legitimacy in an industrialized world where the business world has matured. It is a key aspect of society's trust which ensures the community's long-term survival. The definition of CSR is in the initial stages since the corporate structure of Pakistan is in the evolving stage. But the CSR phenomenon is becoming increasingly common in the region. In Pakistan, a large component of the business field still cannot recognize the real meaning of CSR (Yunis et al., 2017). The CSR is used as a term used interchangeably with philanthropic activities. Many businesses in Pakistan view CSR as only about the rights of employees, compliance with labor laws, and other social programs which are only small gifts or charities. There is a misconception on sides, culture and the business world about CSR. The wider public in Pakistan needs to be aware of the corporate sector's position, duty and objectives. Otherwise, the organization needs to grasp the CSR principle and must discuss the CSR theory (Ehsan & Kaleem, 2012).

A developing nation, which faces many specific social, economic, political which environmental challenges. A failing economy, civil unrest, corruption, political instability, social unrest, rampant corruption, a stagnant economy, insurgency, a climate crisis and an inadequate regulatory system are among the problems facing Pakistan. All these concerns have CSR consequences and obstruct the production and implementation of the definition in Pakistan. Consequently, there has been no study on corporate social responsibility in Pakistan(Ehsan & Kaleem, 2012).

It is a matter of exploring how CSR concepts have been made consistent with Pakistan's market framework so that, amid a difficult business climate with various challenges, CSR can become an integral part of business decisions. In addition to these problems, there is an underdevelopment of research on CSR development in Pakistan's climate, the degree of current CSR adoption and the existence and reach of CSR in Pakistan. In the scope of the above-mentioned evidence, the focus of this section is to gain an understanding of CSR conceptions in the business environment of Pakistan (Ehsan & Kaleem, 2012)

Political Instability

Instability is a time when something is chaotic and things cannot be managed, or Instability is also called unity. "Political instability is characterized as its possibility for administrative change by either legal or constitutional means" Rezgallah, (Özataç & Katircioğlu, 2019). If the state has been unable to guarantee basic needs, food, housing, shelter, and protection for citizens during the political turmoil that may fail to enforce laws and results.

Jong-A-Pin (2009) points out that political instability has a wide range of adverse effects on economic indicators, including, but not limited to, GDP growth, private investment and inflation, and argues that a high degree of political instability leads to lower economic growth. Socio-political turmoil, however, generates an uncertain political-economic climate, growing challenges, and increasing investment. There are many research studies on the local government's effect on Chinese companies. For example, Qian (1994) argues that local government uses firms to serve political and social interests and thus harms firm performance. Local governments, on the other hand, will help businesses obtain scarce resources and develop welcoming neighborhoods, which would have a positive effect on corporate performance. Also, Chang and Wong (2004) explores the local political influence of decision-making by Chinese companies. They indicates that the real degree of influence of local parties is excessive and is adversely associated with firm performance.

RESEARCH METHODOLOGY

Theoretical Framework

This helps businesses cut their Weighted Average Cost (WAC) on resources to save or retain money for a reason. Not only scientifically, but also through numerous experiments and research, it is debatable to conclude that the ties between capital, public CR, and capital are debatable. The coefficient of correlation could have a direct effect on the valuation of the companies in previous studies.

There are 2 indirect and 2 direct relationships has been proposed in theoretical framework presented in figure 1. The research model asserts that owners/managers' perceptions of corporate social responsibility can affect political instability indirectly and negatively, with an indirect and negative effect on capital costs. In Figure 1, the primary relationships inside the model are shown.

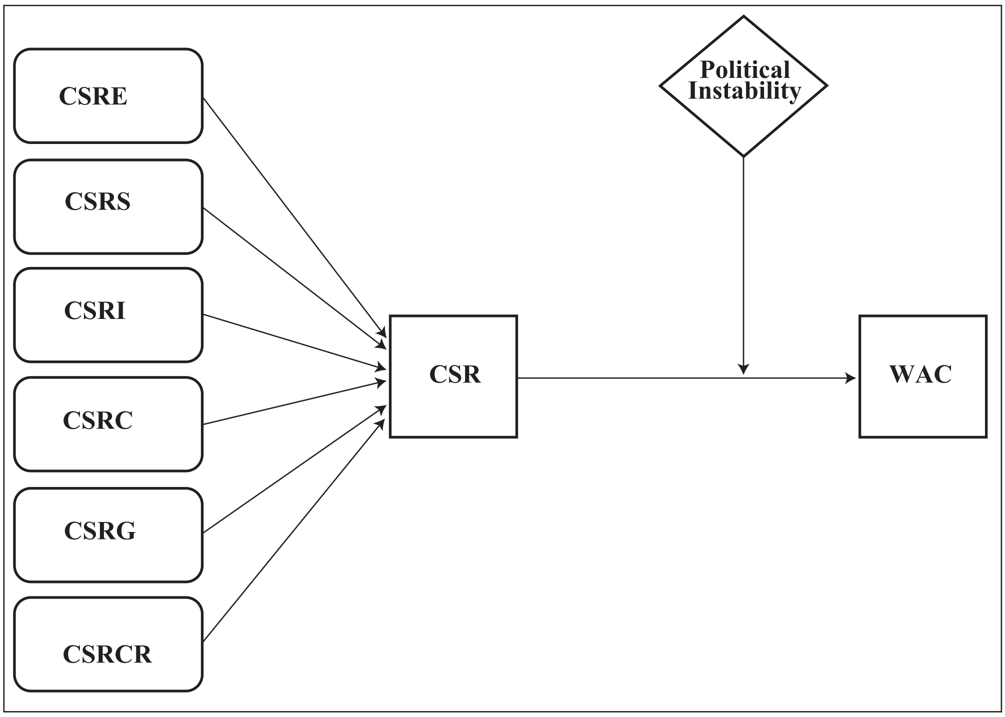

Figure 1. *Theoretical framework of Determinants of Variables*

Research Design

The study overall design aims to provide a suitable framework for an examination. In the research design process, the research method to be chosen is an important decision since it determines the collection of information for reports, but other interrelated decisions are included in the research design process. For checking the hypothesis and drawing out the findings, quantitative analysis is generally used in finance. 21 companies listed on PSX from the financial and non-financial sectors (PSX, 2020).The population consists of full collection of individual events or subjects which have common characteristics of interest to the investigator, referring to the Warren and Fraenkel study. The population sample is determined using the Purposive method of probability sampling. The population of the study is in the cement business. The model size of this study is ten listed companies generated on the highest capitalization of cement production. Measurement of variables are reported in Table 1.

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Table 1:
Measurement

Variables	Measurement	References
Dividend per Share	DPS is measured through owner equity dividing the company total dividend paid through common stock.	(Farrukh, Irshad, Khakwani, Ishaque, & Ansari, 2017)
Salaries	Measure by the proportion of the firm's operating profits in the income statement.	(Chaudhry, Sabirb, Rafi, & Kalyarc 2018)
Interest Coverage Ratio	Computed by dividing profit by interest cost paid by the corporation for the year, before taxation expense and interest expense.	(Çıtak & Ersoy, 2015)
Cost Rate	cost rate shall be computed by subtracting net profit by operational cost.	(Bergmo, 2015)
Assets/Liability Ratio	The ratio is computed by dividing the number liabilities of companies by the net assets.	(AL-Shubiri, 2012)
Cost of capital	Measured by WACC	(Habib, 2017)
Tax Expenses	The portion of income tax expense in operating profit.	(Khurshid , Shaheer, Nazir, Waqas, & Kashif 2017)
Political instability	Indicator of world bank governance (terrorism, social disorder, religious and ethnic conflicts to international tensions, protests for autonomy or segregation)	(Krammer, 2016)

FINDINGS

Table 2 shows the descriptive statistics including mean, standard deviation, skewness, kurtosis, and Jarque-Bera values. Table 3 shows outcomes of "fixed effect regression model". Weighted average cost of capital (WAC) is taken as dependent variable, interest coverage ratio, dividend per share, salaries, cost rate, asset liability ratio taken as dimensions of corporate social responsibility. The findings reveal that dividend per share, assets liability ratio, salaries have a significant and negative association with the cost of capital , while interest coverage ratio, cost rate, tax expenses has a positive and significant association with the cost of capital.

Table 2:
Descriptive Statistics

	DPS	ICR	ALR	CR	SALARIES	Tax EXP
Mean	0.857	0.832	33.790	2.697	3.918	0.163
Std. Dev.	0.212	0.472	179.667	1.164	16.864	0.042
Skewness	1.452	0.819	6.825	0.978	6.844	-1.256
Kurtosis	6.123	3.843	47.732	4.714	47.902	11.995
Jarque-Bera	37.909	7.073	4556.964	14.100	4590.871	181.738

Table 3:
Fixed Effect Model

Variables	Coefficient	Std. Error	T-Statistic	Prob.
_1_LOG_DIVIDEND_PER_SHARE	-0.796	0.384	-2.072	0.038
_1_LOG_INTEREST_COVERAGE_RATIO	0.558	0.226	2.469	0.016
_1_LOGASSETS_LIABILITY_RATIO	-6.217	2.100	-2.960	0.001
_1_LOGCOST_RATE	0.406	0.090	4.511	0.000
_1_LOGSALARIES	-0.104	0.020	-5.073	0.000
_1_LOGTAX_EXPENSES	0.537	0.188	2.856	0.001
C	1.093	0.290	3.768	0.000
	Effects Specification			
Cross-section fixed (dummy variables)				
R-squared	0.257	Mean dependent var		1.065
Adjusted R-squared	0.235	S.D. dependent var		0.431
S.E. of regression	0.418	Akaike info criterion		1.350
Sum squared resid	5.958	Schwarz criterion		1.962
Log likelihood	-17.765	Hannan-Quinn criter.		1.583
F-statistic	0.020	Durbin-Watson stat		2.152
Prob(F-statistic)	0.003			

The value of R square is 0.257 at 95 percent level of significance. The lower the difference between R square and adjusted R square the predictive power of the model is higher. The value of F-statistics is also indicating the significance of predictive model.

Table 4 showed outcomes of "Random effect regression model". The findings shown that asset liability ratio and dividend per share have a significant but negative association with the cost of capital. Moreover, cost rate, salaries tax expenses, interest coverage ratio indicate a positive and significant association with the cost of capital. The value of R square is 0.347 while the value of adjusted R square is 0.329 the difference is R square and adjusted R square is higher as compare to fixed effect model. The value of F-statistics also meets the threshold level of significance 0.005. Hence, the findings considered as effective predicting model. To choose the more accurate model for the predictions, Hausman test facilitate in selection of appropriate model between random and fixed effect.

Table 4:
Random Effect Model

Variables	Coefficient	Std. Error	T-Statistic	Prob.
_1_LOGASSETS_LIABILITY_RATIO	-0.030	0.070	-2.750	0.012
_1_LOGCOST_RATE	1.014	0.363	2.793	0.010
_1_LOGSALARIES	1.432	0.525	2.727	0.013
_1_LOGTAX_EXPENSES	1.981	0.953	2.078	0.042
_1_LOG_INTEREST_COVERAGE_RATIO	1.739	0.823	2.113	0.037
_1_LOG_DIVIDEND_PER_SHARE	-0.868	0.317	-2.73	0.014
C	1.243	0.528	2.354	0.023
		Effects Specification		
			S.D.	Rho
Cross-section random			0.000	0.000
Idiosyncratic random			0.418	1.000
		Weighted Statistics		
R-squared	0.347	Mean dependent var		1.065
Adjusted R-squared	0.329	S.D. dependent var		0.431
S.E. of regression	0.434	Sum squared resid		8.122
F-statistic	0.005	Durbin-Watson stat		1.892
Prob(F-statistic)	0.000			
		Unweighted Statistics		
R-squared	0.353	Mean dependent var		1.065
Sum squared resid	8.122	Durbin-Watson stat		1.992

The cutoff value for the selection of fixed effect and random effect model is p-value 0.05. if the p-value is higher than cutoff value than random effect and if the value is lower than cutoff value than fixed effect model is appropriate. The findings of Hausman test reported in table 5 (indicate the p-value is 0.006 which is quite low hence, we select the fixed effect model.

Table 5:
Hausman Test Model

Test Summary	Chi-Sq Statistics	Chi-Sq. Fd	Prob.
Cross-section random	11.822	6	0.006

Table 6 report the outcome of final model. The moderating role of political instability has been tested between the association of corporate social responsibility and weighted average cost of capital. The findings showed that corporate social responsibility have a positive and significant association with the cost of capital. Political instability indicates a positive and significant association with cost of capital. However, the moderating role of political instability indicates a negative and significant influence of the cost of capital. The value of R square is 0.269 and the value of F-statistics affirm that the predictive power of model is significant. Other parameters like Durbin-Watson is also in the acceptable range.

Table 6:
Regression with Moderating Effect

Variables	Coefficient	Std. Error	T-Statistic	Prob.
CSR	0.142	0.054	2.629	0.027
POLITICAL_INSTABLIBILITY	2.544	1.182	2.152	0.046
C	1.203	0.192	6.265	0.000
CSR*POLITICAL_INSTABLIBILITY	-0.411	0.205	-2.004	0.047

R-squared	0.269	Mean dependent var	1.065
Adjusted R-squared	0.219	S.D. dependent var	0.431
S.E. of regression	0.452	Akaike info criterion	1.471
Sum squared resid	7.578	Schwarz criterion	1.968
Log likelihood	-23.777	Hannan-Quinn criter.	1.660
F-statistic	0.007	Durbin-Watson stat	1.981
Prob(F-statistic)	0.000		

DISCUSSION AND CONCLUSION

The underpinning objective of the current study is to test the association between cost of capital and corporate social responsibility. The corporate social responsibility was taken as a multidimensional second-order construct. Six dimensions including dividend per share, interest coverage ratio, tax expenses, salaries, cost rate, and assets liability ratio. The current study also considers political instability as moderating factor.

To achieve the research objective of the current study, the dataset was obtained from the annual reports of non-financial listed companies on PSX. The top ten firms were selected on the highest market capitalization. All the preliminary test was applied on the data to test the conditions were met before moving to the testing of hypothesis. Hausman test was carried out to evaluate the suitable model for the dataset between "Random effect" and "fixed effect". Based on the findings fixed effect model was applied in the first and second order for the testing of hypotheses.

The findings showed that asset liability ratio, cost rate, salaries, interest coverage ratio, dividend per share, and tax expenses significantly influence the cost of capital. Moreover, the findings reveal that corporate social responsibility positively and significantly linked with cost of capital in the case of non-financial firms listed on the Pakistan Stock Exchange. Moreover, political instability also indicates a positive and significant association with the cost of capital. However, the role of political instability as a moderating variable indicates a negative and significant association with cost of capital. The findings of the current study significantly contribute to the body of literature and theory by empirically testing the moderating role of political instability. The current study will facilitate the top management of listed companies, investors, shareholders, and policymakers in understanding the role of CSR towards the cost of capital and will facilitate in understanding how political instability influences the cost of capital. Future studies need to consider the findings of the current study and this model needs to be further tested on a larger sample for better understanding. Future studies also need to consider the financial sector as well as a unit of analysis, because the dynamics of financial and non-financial companies are different.

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