Foreign Institutional Investors' Preference for Innovation and Corporate Social Responsibility

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INTRODUCTION

Foreign capital is an important driver of economic growth in emerging markets (Prasad et al., 2007). A significant fraction of foreign capital in the emerging market is injected through foreign institutional investors (FIO). How FIOs affect the outcomes of firms and, through them, the emerging market economies has long been debated (Frenkel & Menkhoff, 2004). This has been an important concern for regulators as they periodically review capital control measures (Pandey et al., 2020).

In our research, we focus on one specific channel through which FIOs can affect economic growth in emerging markets - corporate innovation. It is well established that innovation is central to future economic growth and development. However, it is not straightforward to draw strong conclusions about FIOs and the R&D activities of their portfolio of emerging market firms because these investors can voluntarily invest in the more innovative companies (Luong et al., 2017). Hence, to understand whether FIOs drive corporate innovation, it is important to examine the allocation of resources for innovation in the presence of increased competition for resources or when the returns to innovation unexpectedly increase.

The main innovation in our paper is that we focus on how companies with high foreign investment allocate resources to Research and Development (R&D) when they face increased tradeoffs. Our lens on the tradeoff is the Indian CSR regulation of 2013. This law, or Section 135 of the Companies Act, made it mandatory for Indian firms above certain profit thresholds, turnover, and net worth to spend 2% of their pre-tax profits from the three preceding fiscal years on CSR projects. Complying with this law will reduce the net profits and reserves of eligible companies, making resources available for R&D scarce. It has been well established that the CSR policy has caused affected firms to reallocate their resources (Gangopadhyay & Homroy, 2023).

How do foreign investors react to this tradeoff? The answer to this question is salient for economic policy. On the one hand, FIOs can foster deep engagement with the CSR law and promote socially responsible business practices. On the other hand, they can increase R&D investments that reduce pre-tax profits to below the qualification threshold of the CSR law. Therefore, our results shed light on the channels through which FIOs can potentially affect emerging market economies.

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DATA AND SAMPLE CONSTRUCTION

We use the information on all listed Indian firms from Prowess, which provides data on the financial indicators of Indian firms. We start with all 8,431 firms listed on the two main Indian stock exchanges – the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) for 2010-2019.[1] The sample firms' mean pre-tax profits, net worth, and sales turnover are ₹6,546 million, ₹13,918 million, and ₹23,674 million, respectively. The mean (median) R&D expenses of firms in our sample are ₹360 million (₹23 million), and approximately 21% of firms have zero R&D expenses.[2]

We obtain data on equity ownership of these companies from Prowess, Capital IQ and Orbis. From these sources, we obtain information about the fraction of equity shares of different ownership categories: Promoters (business group families) and foreign and domestic institutions. On average, promoters own 32% of shares of listed Indian firms. Institutional investors own 18%, of which 3% are foreign. We create a dummy, *High FIO,* if the fraction of FIO in a company is greater than p75 of the sample distribution (4.1%).

From these sources, we also identify the country of origin of the foreign institutional investors. Institutions from 31 countries own the equity of the sample firms. We use the Banerjee et al. (2022) criteria to classify these countries as High CSR (the US, EU, Australia and Canada) and low CSR countries (China, UAE, Saudi Arabia, Russia, South Africa, Brazil etc.).

MAIN RESULTS

We have two main results. First, we show that firms with FIOs are more likely to increase their R&D expenses to avoid qualifying for the CSR regulation. Second, this increase in R&D expenses leads to better innovation outputs in terms of new product development and patent applications.

We also highlight a mechanism through which FIOs influence the strategic avoidance of CSR regulation in favour of higher R&D expenditure. We show that firms closer to the threshold of CSR law qualification and with high FIOs have fewer shareholder proposals on Socially Responsible Issues. Additionally, such proposals receive fewer votes in favour. Since institutional shareholders are typically sponsoring shareholder proposals, their preferences likely impinge upon these proposals.

CONCLUSION

What do these results say about the effect of FIOs on emerging market firms? Faced with a resource constraint for discretionary expenses, firms with high FIOs choose to increase innovation expenses. To the extent that innovation drives economic growth, we highlight the channel through which foreign investment can facilitate the growth of emerging economies. It is important to emphasise that our results are in the context of the Indian CSR regulation. Companies affected by the law face two prospects that are both sub-optimal from their pre-law resource allocation - either spend more in CSR or spend in

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[1] Prowess covers over 50,000 Indian companies, but our focus is on the subset of companies that have been listed on the two main stock exchanges: "All Companies listed on BSE & NSE Superset' is a set of companies that are or were listed on the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) at least once even if it merged with another company or ceased to exist at some point in time." This choice ensures that our results are comparable with most published results on corporate innovation (Helmers et al., 2017)

[2] All variables are expressed in nominal terms as we use threshold values expressed in nominal terms.

something else that brings them below the threshold of the CSR law. Our results highlight that high foreign institutional investment is associated with the later choice where firms invest in innovation.

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