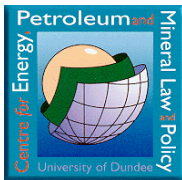


**OPI-NCBS-ESRC seminar series:**  
**Adding public value: the limits of corporate responsibility**  
**Drivers of corporate investment in public sector capabilities**  
**OPI seminars & working papers: ISSN 1748-832X**



THE NATIONAL CENTRE FOR  
BUSINESS & SUSTAINABILITY



### Summary

*The idea that 'good governance' matters for successful business operations, and thus for economic development, has taken centre stage in the development rhetoric since the 1990s. In recent years, a number of academics and policy makers have called for greater efforts on part of the business community to help improve governance. However, as yet there is no clear picture of exactly what the private sector might contribute and what incentives corporations might have to invest in public sector competencies. This workshop discussed the concept of corporate investment in public sector capabilities and its link to other forms of corporate social responsibility. Four factors were identified that appear to be necessary conditions for companies to invest in public sector capabilities. Finally, the workshop investigated the role of NGOs, international organisations and donor agencies, governments and individuals within companies as potential facilitators of such investment.*

### Corporate investment in public sector capabilities

By corporate investment in public sector capabilities, we mean the provision by private enterprises of resources (such as technologies, assets, and skills) to the public sector in the expectation that this will improve its capabilities to provide public services. This kind of investment differs from other forms of corporate investment in that the expected return not only serves the purpose of maximising the company's market value but also contributes to the provision of a 'public good'.<sup>1</sup>

The notion of 'corporate investment in public sector capabilities' has some overlap with the concept of corporate social responsibility (CSR). Although there is no universally accepted definition<sup>2</sup> of CSR, the term usually denotes voluntary corporate activities that aim to minimise any harm resulting from the company's operations and to contribute to the good of the wider communities within which the company exists. The vagueness of the definition allows for a range of practices to be included under the heading of CSR, such as 'good neighbour agreements' with local communities, social and environmental certification and auditing schemes, codes of conduct, the use of technologies which reduce negative social and environmental impacts, as well as the funding of schools, health centres and community organisations.

Corporate investment in public sector capabilities is a voluntary activity by companies which contributes to the public good. It can thus be subsumed under the notion of CSR. However, it is distinct from many other CSR practices in at least two ways:

1. Corporate investment in public sector capabilities is not a philanthropic or charitable activity but an investment which is expected to yield a return for the company.

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<sup>1</sup> A public good is defined to be both 'nonexcludable' and 'nonrival'. A good is nonexcludable if it is not possible to prevent anyone from consuming it. A good is nonrival if one person's consumption does not reduce the quantity available for consumption by someone else. A text book example of a public good is street lighting.

<sup>2</sup> For instance, the World Business Council for Sustainable Development uses the following definition: "Corporate Social Responsibility is 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" (Lord Holme and Richard Watts (2001): Making Good Business Sense). The International Finance Corporation (IFC) defines CSR as "the commitment of businesses to contribute to sustainable economic development by working with employees, their families, the local community and society at large to improve their lives in ways that are good for business and for development" ([www.ifc.org](http://www.ifc.org)).

2. Corporate investment in public sector capabilities seeks to strengthen governments in their capabilities to provide public services, rather than companies providing public services themselves.

Beyond such a tentative differentiation from other forms of CSR, the notion of corporate investment in public sector capabilities remains rather diffuse. Problems exist, for example, in determining what kind of investment we are talking about. The term 'corporate investment in public sector capabilities' can include a range of activities that may actually be quite different from one another. For example, a company collaborating with donor agencies, NGOs and the government in raising funds and establishing the institutional framework for infrastructure development might be considered to be investing in public sector capabilities just as much as a company advising the government on revenue management. Is it analytically sensible to treat both phenomena alike? Furthermore, such investments can take place at the national, sub-national or international levels. What difference does this make? For instance, can we speak of corporate investment in public sector capabilities if it takes place in the international sphere where there is no 'public sector' comparable to that at the national level? More research is required at both the theoretical and empirical levels to achieve more conceptual clarity and to identify the commonalities and differences between these phenomena.

Examples of corporate investment in public sector capabilities are still relatively hard to find. This may be explained by a combination of two factors. First, they are rare. Second, they have hardly been studied and thus publicised. However, this situation is changing. There have been an increasing number of scholarly attempts to distinguish and re-interpret the variety of arrangements treated collectively as Corporate Social Responsibility or Public-Private Partnerships.<sup>3</sup> On both the national and international level, there are an increasing number of cases where private business has provided resources to enhance governments' capabilities.

Some of the best known examples have been implemented at the international level and have involved extractive industries. They include the Extractive Industries Transparency Initiative (EITI), the Kimberley Process, and the Chad-Cameroon Pipeline Development Project. At the national level, companies have assisted governments in modernising mining legislation and have collaborated with the government, donor agencies and NGOs to raise funds and to establish an institutional framework for infrastructure development.<sup>4</sup>

### **Drivers of corporate investment in public sector capabilities**

The idea that private business should assist governments in strengthening their capabilities may appear to run counter to neo-liberal demands for a smaller state, which have dominated much of the political and academic debate since the 1970s. Moreover, corporate investment in public governance sits uneasily with many social science theories, which assign governance responsibility to the public sector. Successful public governance has often been defined as a government's ability to create an enabling environment for private economic activity. The opposite idea, that the private sector should assist the state to strengthen its capabilities, remains anomalous for many academics and practitioners.

However, even on the basis of existing social science theories one can make an argument for corporate investment in public sector capabilities. Recognising that institutions have at least as much influence on the economy as individual's choices, in the 1990s many academics and policy makers have emphasised 'good governance' as indispensable for

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<sup>3</sup> For example, R. Hall & T. Biersteker (2002): *The Emergence of Private Authority in Global Governance*, Cambridge; V. Haufler (2001): *A Public Role for the Private Sector: Industry Self-Regulation in a Global Economy*, Carnegie Endowment for International Peace.

<sup>4</sup> For further examples, see other workshop notes in this series.

economic growth. The problem is that many governments do not have the capabilities to provide public services and to design and enforce policies conducive to sustainable economic growth. Donor agencies may not deliver the amount of aid required, and much of their current assistance is used ineffectively.

In this situation, some might argue that, especially, foreign companies, have both some comparative advantage and interest in assisting developing countries' governments to improve their governance capabilities. The transfer of skills and resources from the private to the public sector could help improve governance effectiveness and efficiency and thus contribute to both social development and economic growth. Higher levels of economic growth, health and education would, in turn, benefit individual companies and represent the reward for corporate investment in public sector capabilities. Indeed, on that basis, it could be argued that companies making long term investments in a country have a vested interest in seeing the public sector improve its capabilities to manage the economy and to improve the quality of public services.

From the perspective of an individual company, there are a number of problems with this argument. First, the value of such investment is very hard to assess because its potential return is uncertain and can only be reaped at a distant point in time. Moreover, it is extremely hard to calculate when (and, indeed, whether) corporate investment in public sector capabilities will lead to economic growth, which sectors of the economy will benefit from it and how this will impact on the revenues of the individual company. The second problem is that both improved public sector capabilities and economic growth are public goods. Their consumption not only benefits those companies that have invested in their production but also any other economic actor present, including current and future competitors. This 'free rider problem' may weaken the incentives for individual companies to make such investments. Finally, it could be argued that investors in extractive industries serving export markets have little interest in the host country's economic growth, as distinct from its stability, as their prime interests are in security of tenure and their long term international competitiveness.

#### *Why do companies invest in public goods?*

A preliminary analysis of cases where companies have invested in public sector capabilities suggests that the prospect of more rapid long-term economic growth has played only a minor role in the investment decisions, if that. Rather, companies have responded to poor public sector performance where it had impacted specifically on the company's operations and where investments in improvements would yield identifiable, near-term benefits for the company, which were higher than the costs of investment. From the perspective of public goods theory, companies that invest in public sector capabilities because the anticipated individual benefit is higher than their investment costs are conceptualised as a 'privileged group'. A privileged group has an incentive to produce a public good despite potential free riding because its members derive greater benefits than the costs of their investment. Beyond investments in local public goods, physical and social infrastructure, education and training required to maintain and develop the primary investment, corporate investment in public sector capabilities has occurred most frequently in order to:

- protect current or planned investment;
- protect the company's reputation.

The safety of current and planned investment can be compromised by poor public sector performance in several ways, including corruption, lack of government control over security, and lack of infrastructure. A company's reputation can be damaged if it is associated with governance failures, such as human rights violations, corruption and failed states.

The extent of corporate damage caused by poor public sector performance may differ between companies operating in the same political environment. For example, reputation protection is most critical for companies that are in direct contact with their final consumers, if there are many substitute goods for their products, or if their products have a strong emotional value, such as diamonds. In addition, the incentive to invest in order to protect markets and investments may depend on the scale of sunk costs and the value placed on a specific market by the company.

### *A preliminary hypothesis*

Poor public sector performance affects many businesses, but only a few companies seek to assist governments in improving the situation. The hypothesis derived from the case studies to explain the differences in corporate behaviour can be stated as follows. A company will invest in public sector capabilities only if all of the following conditions are met:

- if it can identify a clear link between a specific kind of public sector failure and negative impacts on the company's operations;
- if it can identify what kind of investment is likely to improve the situation;
- if it has the means to make this investment;
- if the expected benefits from the investment are higher than the investment costs.

However, although these conditions are necessary, they may not be sufficient. Other factors often play a key role in facilitating corporate investment in public sector capabilities.

### *Facilitating factors*

Five groups have been identified that can facilitate corporate investment in public sector capabilities.

- NGOs
- donor agencies and international organisations
- governments
- institutional investors
- individuals within the company

Facilitation seems to operate in three main ways:

- lowering the company's investment costs or raising the costs of non-investing;
- strengthening legitimacy;
- providing leadership.

Lowering the company's investment costs or raising the costs of not investing The costs for an individual company to invest in public sector capabilities can be lowered by collaboration with other groups. For example, NGOs can lower a company's investments costs by providing expertise to improve public sector governance. On the other hand, NGOs can raise the costs of not investing by discrediting a company's reputation, for instance by associating individual companies or industry sectors with certain kinds of governance failure such as corruption and human rights violations. NGOs such as Publish What You Pay, Friends of the Earth, Fair Trade and the Tax Justice Network, by emphasising disclosure, attempt to improve market efficiency by increasing market information and, at the same time, leveraging companies' 'cravings for legitimacy.' They are effective to the extent that companies are sensitive to reputational costs and to the extent that NGOs can confer legitimacy.

Donor agencies can lower the investment costs for individual companies by providing additional funds for public sector development. Additionally, donor agencies and international organisations can lower transactions costs for companies by providing a platform for co-ordination and negotiation with other stakeholders.

Finally, institutional investors can raise the costs of capital for companies which do not invest in improved governance by incorporating Extra-Financial Factors (EFFs) into their investment risk analysis.

However, despite an increasing interest<sup>5</sup> in EFFs, there remain significant challenges for institutional investors to play a significant role in promoting corporate engagement in

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<sup>5</sup> Socially Responsible Investing (SRI) now makes up about 11 percent of professionally managed assets. Furthermore, an increasing number of institutional investors actively promote the integration of Extra-Financial Factors (EFF) in the institutional investment process and corporate management strategies, and some governments actively promote responsible investment through legislative changes, such as the UK Pensions Act 2000.

improved governance. Fund managers, analysts, and brokers lack knowledge and competence about how to integrate EFFs into a company's performance assessment. This creates a 'spiral of neglect' where fund managers do not ask and, indeed, do not pay for brokers to take EFFs into account. The sell-side, in turn, do not demand information about EFFs from corporate management and so do not provide an incentive for managers to pay more attention to EFFs in either investment decisions or corporate reporting.

Fundamental technical problems lie behind this 'spiral of neglect.' More rigorous analytical tools are required to measure EFFs and to integrate them into the models used to inform investment decisions. In addition, more research is required into how investment in public sector capabilities adds value and improves competitive advantage for individual companies before institutional investors will pay more attention to EFFs, demand the relevant information from companies, and thus present a driving force for corporate investment in public value.

Strengthening legitimacy Any kind of corporate engagement in public sector competencies is likely to raise questions about their democratic legitimacy. There is evidence to suggest that companies have sought collaboration with NGOs and international organisations before engaging in governance problems in order to avoid criticism of undue corporate influence on public policy. While the involvement of NGOs and international organisations may indeed help appease some critics, it does not resolve the problem of democratic legitimacy since neither NGOs nor international organizations can confer it. However, more research is needed into how important these considerations really are for corporate decision making and how this varies between different companies, industry sectors and countries.

While the importance of legitimacy may vary between companies and circumstances, the question of utmost importance to every company considering such investments is whether they are considered to be legitimate by the host-country's government. If state authorities interpret such activities as an intrusion into their competencies, companies may endanger their relations with the government and expose their operations to considerable risk.

The role of the government in facilitating corporate investment in public sector capabilities is another key issue that requires more research. Questions to be addressed include:

- Why do governments encourage such investment – or not?
- How much and what kind of public sector capability is necessary for corporate investment in public value to be effective?
- Which types of corporate investment are most likely to elicit government support and cooperation: macroeconomic management, legal reform, improved financial management?
- How do problems of legitimacy play out in such investment projects?

Leadership is a key factor in facilitating corporate investment in public sector capabilities where there are few structures and institutions exist to guide action. Leadership can be provided by both individuals and organizations. NGOs, international organisations and governments can provide leadership by placing certain issues on their agenda and suggesting how companies might contribute to their resolution. Companies can themselves act as leaders by demonstrating how corporations can help improve government capabilities and promoting 'best practices'.

Moreover, the leadership role of individuals has been crucial and is often neglected in the academic debate of corporate investments in public value, partly because their influence is hard to grasp at a theoretical level. The support of senior company managers is particularly important since this can help ensure the commitment of other employees. But also individuals at the operational level who take the initiative on certain projects can be crucial in determining whether such investments will be made or not. Individual leadership appears to be one of the most important factors facilitating corporate investment in public sector capabilities. However, there is some evidence to suggest that the influence of individual

leadership diminishes the more experience a company gains and the more management structures are required to sustain engagement with public sector organisations.

### Conclusions

The hypothesis advanced here is that companies may be willing to invest in the production of the public good, 'public sector capabilities,' provided that:

- they can identify a clear link between a specific kind of public sector failure and its negative impacts on the company's operations;
- they can identify what kind of investment is likely to improve the situation;
- they have the means to make this investment;
- the expected benefits from the investment are greater than its costs.

Such investment can be facilitated by other actors, such as NGOs, donor agencies and international organisations, governments, institutional investors, and individuals within the company. Facilitation can occur in several way, including

- by lowering the company's investment costs or raising the costs of non-investing;
- by bolstering legitimacy;
- by providing leadership.

However, the existence of a 'privileged group' of companies that are willing to invest in public sector capabilities because they benefit to a disproportionate extent is not a complete solution to the free rider problem. Companies that are particularly exposed to certain risks resulting from weak governance will only invest in improving public sector competencies in these areas, resulting in the underproduction of the public good 'public sector capabilities' in other areas of governance.

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**June 2006**

**Citation:** Roemer-Mahler, Anne (ed) (2006) Drivers of corporate investment in public sector capabilities *Adding public value: the limits of corporate responsibility: OPI-NCBS-ESRC workshop series* OPI, Oxford

**Acknowledgements:** This note is based on the proceedings of a workshop held on 9 May 2006 at CEPR. OPI is grateful to the following who gave presentations: Malcolm McPherson, Kennedy School of Government; Nicolas Di Boscio, Rio Tinto; Andrew Bone, De Beers; Barry Newton, former MD Booker Tate Ltd; Raj Thamotheram, Senior Advisor, Responsible Investment, Universities Superannuation Scheme; Richard Murphy, Director, Tax Research LLP .

### Further reading & useful websites

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