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ESG: MYTHS and REALITIES

Steven Globerman, Series Editor

ESSAYS BY
Elmira Aliakbari, Terry Anderson, Derek Burney, Douglas Cumming, Pierre Desrocher, Eugene Fama, Steven Globerman, Sofia Johan, Jack Mintz, Marvin Olasky, Bruce Pardy, and Bryce Tingle

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Executive Summary

ESG-related obligations imposed on private sector enterprises cannot be defended on grounds that they will contribute to improvements in private sector efficiency and risk-adjusted profitability. Nor is it appropriate in a democracy to have private sector managers and board directors determine public policy priorities. That responsibility should be assumed by democratically elected legislators.

As Friedman (1970) argued more than five decades ago, the private sector makes its greatest contribution to society's overall standard of living when companies focus on being efficient in pursuit of maximizing their shareholders' wealth, while operating within the boundaries of existing legislation and broad social conventions.

Private sector managers should be willing to openly defend the shareholder governance model. At the same time, if shareholders are willing to sacrifice financial returns to support ESG causes as a matter of conscience, investment managers and managers of operating businesses would not be violating their fiduciary responsibility by implementing unprofitable ESG initiatives. However, they should be obligated to disclose the initiatives to investors along with the anticipated financial consequences, and financially material ESG claims should be subject to conventional securities regulations regarding financial disclosures.

Introduction

The current ESG movement reflects a decades-long evolution of criticisms of shareholder capitalism.[1] Proponents of ESG argue that it is a social responsibility of publicly held companies to put environmental, social, and governance concerns ahead of profit-maximization (and maximizing shareholder wealth). As Mintz and Tingle (2024) put it, many advocates of ESG are demanding that companies do things that benefit some group or purpose (including environmental sustainability) when doing something else would be more profitable for the firm and its shareholders.[2]

This series, *ESG: Myths and Realities*, provides a wide-ranging perspective on the issues surrounding what might be called ESG capitalism, or stakeholder capitalism.[3] The series articles point to serious social costs associated with companies substituting ESG capitalism for shareholder capitalism. Indeed, the goals of ESG advocates might be more satisfactorily promoted if the private sector focused on what it does best, namely, produce and distribute goods and services efficiently which, in turn, is best achieved when management focuses on long-run profitability.

The defence of shareholder wealth maximization does not mean a rejection of legitimate concerns about environmental sustainability, improving the standard of living for all segments of society, and ensuring equal opportunity and treatment under the law, which are major objectives of ESG proponents. Indeed, Friedman's (1970) iconic defence of shareholder capitalism, which arguably inspired an extensive literature critical of it, acknowledged that society has legitimate goals governed by legislation and informal customs, and that business should operate within the social governance structure. However, his main point was that in a democratic society, it should not be the responsibility of business enterprises to do more than operate within the existing "rules." The rules themselves should reflect the outcome of the democratic process as embodied in legislation and social mores.

This brief essay proposes a policy framework whereby companies are best able to contribute to environmental sustainability and other social goals while following the shareholder capitalist corporate governance model.

Setting the rules

Arguably, the overarching principle to guide a post-ESG business environment is that corporate managers and board members should not be expected to make discretionary tradeoffs between ESG initiatives and long-run profitability while serving in those roles. Rather, implementing relevant legislation that imposes ESG-related mandates on the private sector should be the responsibility of democratically elected government representatives. In turn, prominent legislative initiatives should be subjected to cost-benefit analysis before they are implemented in order to increase the likelihood that the initiatives will provide net social benefits.

In this context, the "socially responsible" role of managers and board members is to provide unbiased information to policymakers about how proposed legislation will affect their businesses and, specifically, how their businesses will respond in terms of output, employment, investment, and prices.[4] Similarly, the socially responsible role of investment managers is to inform policymakers and securities regulators about whether and how prominent ESG-focused legislation and regulations will affect capital market activities. While investment managers should be free to market ESG-themed investment products, they should be expected to disclose financially material information related to their products as is required under current securities regulations. Likewise, operating businesses should be expected to disclose financially material information related to their current or future ESG activities which may be mandated by regulations or by shareholder proxy initiatives.[5]

"While investment managers should be free to market ESG-themed investment products, they should be expected to disclose financially material information related to their products as is required under current securities regulations."

Going beyond the rules

A popular argument for corporate and investor ESG initiatives is that the political process is failing to implement ESG-related rules and regulations that would yield net social benefits. Hence, the private sector should step in to correct this government failure by going beyond the existing legal framework in pursuit of ESG goals.

Private sector businesses operating in competitive markets, meaning most businesses, cannot be expected to correct government failures individually if seeking to do so involves sacrificing profits since this would mean eventually going out of business. In the case of companies that are earning above-competitive profits, they might be able to remain in business for an indefinite period by sacrificing some profits in the short term in order to voluntarily and individually implement what management and board members believe are socially worthwhile ESG-related initiatives. However, in doing so, they are effectively making the equivalent of charitable contributions on behalf of their shareholders and possibly their employees. If shareholders are willing to give managers and board members their proxies to make implicit charitable contributions on their behalf, the former would not be violating the shareholder model as long as shareholders are informed about the nature and costs of the relevant ESG initiatives.

To be sure, managers and board members of publicly listed companies will continue to be pressured by activist and other interest groups to sacrifice shareholder interests in favour of spending corporate money on ESG initiatives, while investment and pension fund managers

will be pressured by those same groups to implement ESG-themed investing strategies. The challenge for corporate managers is to articulate the case for shareholder capitalism in a committed and convincing manner. Put simply, the relevant case to make is that shareholder capitalism is consistent with economic efficiency, while economic efficiency contributes to faster economic growth. Since prominent ESG goals, including reducing or even eliminating the use of carbon fuels, require expensive investments in both physical and human capital, faster economic growth implies that more resources will be available to be directed into the necessary government-mandated investments with a smaller sacrifice of other capital investments or of non-capital related expenditures.

Mandating ESG disclosures

Mandatory ESG disclosures imposed on public companies by regulators represent a prominent policy to promote corporate ESG initiatives. The conceptual logic behind mandating broad ESG disclosures is that the information will enable investors, consumers, and other stakeholders who support socially responsible corporate behaviour to identify and reward "green" companies and punish "brown" companies by shifting capital and purchases to the former and away from the latter. Mintz and Tingle (2024) discuss the problem that ESG disclosure is expensive, complex, and quite often misleading.

To the extent that companies implement ESG-focused initiatives and strategies that are financially material, they should be disclosed under existing securities regulations. Likewise, claims in ESG-themed investment products should be governed by the same securities regulations as all other investment products traded on public exchanges. There is no economic argument for mandating disclosure of information that is not materially relevant to shareholders, and much of the growing magnitude and scope of ESG-related information that companies are obliged to report is arguably not financially material.

There might well be a demand for corporate ESG ratings in the future, even if regulators cease to demand corporate disclosures of the type currently required. If nothing else, activist groups might want to use ESG ratings for purposes of lobbying government and pressuring corporate leaders to modify laws and business practices. Similarly, some investment managers will likely continue to market ESG-themed products to investors willing to pay higher management fees so as to align their investments with their consciences. Mintz and Tingle (2024) argue that as investment managers are fiduciaries, they should have a legal obligation not to use such deeply flawed data as ESG ratings. I would stop short of imposing a legal or regulatory restriction on the voluntary use of ESG ratings or similar criteria by investment managers, as long as non-financially material ESG corporate reporting is not mandated, and investment managers disclose how ESG rating-related information is acquired and used. In a free market, investors should not be legally prevented from searching out and using any and all information they think may improve their investment choices, either financially

or ethically. Greenwashing and other misleading advertising is already illegal, and ratings services have competitive incentives to improve the utility of their products for their actual and potential customers.[6]

Concluding comments

The straightforward obligation of private sector managers and board members is to promote their shareholders' welfare. This means focusing on maximizing profits while operating within the existing legal framework. The obligation of investment managers is to maximize investors' risk-adjusted returns. For some investors, a portion of the relevant returns might be non-pecuniary, e.g., indirectly financing environmental sustainability by sacrificing pecuniary returns. Since ESG-related laws and regulations differ across industries and companies, there will likely always be a demand for ESG-themed investing, since the composition of different investment portfolios will offer different combinations of pecuniary and non-pecuniary returns. Hence, the mandate of securities regulators should be to ensure honest disclosure of ESG-themed investment strategies and their historical financial performances.

Endnotes

1 For a discussion of the various schools of thought that have evolved in response to contemporary ESG-related critiques of shareholder capitalism, see Globerman (2022a).
2 Many ESG proponents argue that ESG-themed investing is likely to increase corporate risk-adjusted profitability. However, there is little consistent and statistically significant evidence to support the argument (see Globerman, 2022b).
3 Globerman (2024) summarizes and synthesizes the various studies.
4 See Globerman (2011) for a full development of this argument. Public companies typically disclose the risks their shareholders face including risks related to climate change and other environmental developments.
5 Obviously, proxy initiatives cannot override management's commitment to operating within existing laws and regulations (see Mintz and Tingle, 2024). Privately owned companies are indirectly and adversely affected by costly requirements imposed on public companies to disclose non-material financial information; such requirements make it less profitable for private firms to go public (see Cumming, 2023).
6 On June 20, 2024, the Canadian federal government passed amendments to the *Competition Act* that target companies making untested or unsubstantiated claims about the environmental benefits of their products or business. Some critics argue that the amendments are vague and might actually discourage honest disclosures by companies (see Blakes, 2024).

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The New Capitalism

Steven Globerman

Introduction

The free-market system has long been criticized for a litany of actual or imagined flaws. Indeed, writers as ideologically diverse as Karl Marx and Joseph Schumpeter have questioned capitalism's ability to survive.[1]

More recently, a movement and a supporting literature has emerged that puts forward initiatives to make capitalism both more socially beneficial and more sustainable. The initiatives are meant to reorient the goals and actions of private sector managers and investors—in some cases away from profit or wealth maximization, and in all cases toward the pursuit of larger social objectives. The call for a new set of guiding principles for private sector organizations has taken various identities over time, including socially responsible business behaviour, stakeholder capitalism, sustainable capitalism, socially responsible investing, sustainable investing and, most recently, ESG investing.[2] While there are differences across the varied calls for reforming capitalism, for example whether the main focus is on managers of operating companies or on wealth managers, they all call for a new form of capitalism.

In fact, an initiative called "The New Capitalism Project" was launched in February 2020 by the US National Civic League with the ambitious goal of changing the future direction of capitalism.[3] The broad objectives of the New Capitalists, a group that includes many business leaders, can be summarized as follows:

> Imagine a future where the economic and financial system serves everyone—a system that is accountable for its effects on people and the planet. Envision a world where financial markets serve all members of society and where finance plays a central role in solving the social and environmental challenges facing the global community such as poverty, inequality and climate change. (Global Impact Investing Network, 2022)

The purpose of this essay is to identify the arguments and recommendations of the various schools of thought that can be grouped under the heading of New Capitalists. Where appropriate, it will also note important points of disagreement. The essay will refrain from evaluating the arguments and recommendations discussed as that is the task of succeeding papers in a series of essays on capitalism and ESG, *ESG: Myths and Realities,* to be published by The Fraser Institute.

Multiple stakeholders

The preceding statement from the Global Impact Investing Network illuminates the key elements of a broad program for reforming capitalism. One element builds on the premise that managers of most private sector organizations focus exclusively on creating benefits for shareholders and ignore the impact of their decisions on other groups in society—including consumers, employees, suppliers, and the local and global communities in which they do business. This premise underlies calls for managers to adopt a *multiple stakeholder* model in which managers of for-profit organizations prioritize the welfare of other groups in addition to the welfare of shareholders.[4]

To be sure, many proponents of a stakeholder approach to managing for-profit enterprises acknowledge that creating wealth for shareholders obliges managers to consider the welfare of others besides shareholders, particularly those who provide inputs to the managers' organization including employees and suppliers as well as the customers who buy the products the organization produces. Simply put, in competitive markets creating wealth for shareholders obliges management to strike agreements with input suppliers that are "fair" to those suppliers. The required collusion among the many organizations bidding for the inputs in question that would result in unfair terms and conditions being imposed on the suppliers of such inputs is legally prohibited and practically unsustainable. Similarly, competition among firms ensures that managers will recognize consumers as important stakeholders and that for-profit enterprises will strive to provide consumers with the competitively priced products that these consumers desire.

A more nuanced argument for stakeholder capitalism acknowledges the competitive imperative for managers to recognize the importance of other groups besides shareholders but criticizes the motives for this recognition. Specifically, it questions the morality of acknowledging the importance of input suppliers, consumers, and others whose activities can influence an organization's profitability solely as means to increase the organization's profitability. This

nuanced argument essentially criticizes a utilitarian approach to caring for stakeholders beyond just shareholders because doing so contributes to the organization's profitability.[5]

In this vein, Burton and Dunn (2005) argue on moral grounds that managers should "care" for the individuals whose lives are affected (or could be affected) by the organization's activities.[6] In doing so, they acknowledge that managers might find themselves in situations that compel them to decide whose needs are most important. In such cases, the manager is obliged to determine whose needs will shape their decisions and then try to explain to other stakeholders why the manager decided in that particular way. However, the authors offer no concrete rules for managers to rank the relative importance of shareholder needs. Nor do they discuss the potential for "caring" organizations to go out of business because they failed to earn risk-adjusted rates of return sufficient to attract and maintain adequate levels of financial capital.

In short, the stakeholder critique of private enterprise rests on a precarious balance. On the one hand, if it is profitable for companies to prioritize the interests of individuals and groups beyond their shareholders, the practical relevance of the critique is moot, since managers will adopt the precepts of the stakeholder model while still focusing on maximizing shareholders' wealth. On the other hand, if this utilitarian approach to managing for-profit organizations is fundamentally immoral, how do managers address the inevitable conflicts between the interests of different stakeholders? Furthermore, how do managers address the tradeoff between prioritizing the needs of non-shareholders and staying in business? Certainly, a bankrupt organization is unable to provide benefits to any stakeholder group.

"How do managers address the tradeoff between prioritizing the needs of non-shareholders and staying in business? "

Sustainability

The statement attributed to the Global Investing Impact Network cited earlier also underscores a crucial feature of most calls for a new capitalism. Namely, companies and investors should ensure that their actions address environmental and social challenges that threaten the continued existence of society and the planet. Concerns about the sustainability of the physical environment encompass the "E" in ESG investing, while concerns about the sustainability of society encompass the "S" in ESG investing.

Rull (2011) characterizes the classical notion of sustainable development as arguing for caring for the natural environment because it is the primary provider of resources to sustain human life. Others have added a social element to this by recognizing that sustainable development involves the simultaneous pursuit of economic prosperity, environmental quality, and social equity.

Schweichart (2010) argues that all economists, whether conservative, liberal, or left leaning, recognize that market transactions can create or involve externalities (costs or benefits)

that are not paid for by the transacting parties and that there is a role for governments to play in rectifying these defects. In this context, while economists debate the appropriate role for government in addressing externalities, there is nothing new about the new capitalism when it comes to recognizing the social costs of environmental externalities.[7] What is arguably new is the admonition that companies and investors should "internalize" the costs of environmental externalities, even when there are no laws, regulations, or other government rules to guide the behaviour of business organizations in this regard. That is to say, companies should recognize environmental externalities as part of their business strategy beyond what may be required by laws and regulations. One of the most well-known proponents of the new capitalism, former US Vice-President Al Gore, makes the somewhat ambiguous assertion that while businesses cannot be asked to do the job of governments, companies and investors ultimately must mobilize the financial, physical, and human capital required to overcome the unprecedented environmental challenges the world faces (see Gore and Blood, 2011).

In a similar manner, there is nothing new about concerns surrounding inequalities in the distributions of income and wealth. Again, what might be new is the call for private sector organizations to help remediate economic and social inequities. In 2017, the International Business Council (IBC) of the World Economic Forum sponsored *The Compact for Responsive and Responsible Leadership*. Among the Compact's long-term objectives is to end poverty and hunger, in all their forms and dimensions, and ensure that all human beings can fulfill their potential in dignity and equality (see World Economic Forum, 2020). The IBC, along with many other proponents of a new capitalist system, argue that aligning corporate goals to the long-term goals of society—including addressing economic and social inequities—will prove profitable for those businesses that do so. If doing good for society equates to doing well financially, then championing environmental and social goals for capitalists is equivalent to advocating that businesses pursue efficiency and profit-maximization. If addressing economic and social goals is desirable but not necessarily profitable, the challenge for new capitalism is how businesses can be self-sustaining if they are expected to prioritize and direct scarce resources toward unprofitable initiatives.

Governance

The "G" in ESG stands for governance, which broadly represents the organizational and operational features of organizations. In the model of new capitalism, aligning governance with the broad objectives of remediating environmental and social problems is a way to pursue those objectives while also being profitable. Indeed, the implicit notion behind the

importance of a new form of corporate governance is that it will assist managers and investors to identify profitable opportunities that are consistent with responsible stewardship of the physical and social environments—or, at least, that it will help managers and investors mitigate risks that will inevitably arise from unresolved environmental and social problems. In this view of the world, it is not that socially responsible corporate behaviour is unprofitable. Rather, it is that meaningful changes in the governance of corporations are prerequisites to harmonizing profitability and socially responsible behaviour.

There are two major elements to improving the governance of operating companies and wealth managers who, in today's economy, are charged with allocating much of the collective savings of private investors. One is to improve the diversity of corporate board members as well as of senior executives. While social justice (part of the "S" in ESG) typically is the initial impetus behind the case for inclusion and diversity, companies are increasingly being advised to treat inclusion and diversity as a source of competitive advantage. In this context, diversity is defined as having a greater proportion of women in the workforce and in the ranks of top management as well as having a more mixed ethnic and cultural composition of the workforce—and especially of the leadership of large corporations. Proponents of this school of thought see more diverse companies as better able to attract top talent and improve their customer orientation, employee satisfaction, and decision-making (Hunt, Yee, Prince and Dixon-Fyle, 2018).

A second broad element to improving governance is to incorporate ESG reporting into the planning and execution of the business strategies of operating and wealth management companies. "Better" ESG reporting would supposedly assist managers to identify and leverage profitable opportunities consistent with the goals of sustainability. It would also help companies identify their commitment to solving environmental and social problems which, among other things, will assist in attracting investors who are themselves committed to socially responsible investing. This, in turn, will result in lower debt and equity capital costs for companies, thereby acting as another source of competitive advantage.

Standardizing ESG disclosures

Many investment managers of ESG-themed funds argue that the financial benefits of ESG investing would increase if there was more consistency in the reporting of ESG metrics.[8] In this regard, ESG ratings and indices prepared by rating agencies such as Sustainalytics have been widely criticized for being of inconsistent quality and often conflicting. This perspective, in turn, has led to calls for mandating disclosure of standardized ESG information

> "Many investment managers of ESG-themed funds argue that the financial benefits of ESG investing would increase if there was more consistency in the reporting of ESG metrics."

(Steffen, 2021). For example, the CEOs of eight major public pension funds in Canada recently teamed up to demand that companies adhere to the recommendations made by the Sustainability and Accounting Standards Board and the task force on climate-related financial disclosures framework when reporting ESG disclosures. Perhaps the most prominent call for standardization comes from the World Economic Forum's International Business Council, which has proposed a set of common ESG metrics with the goal of driving a convergence of global reporting standards—ostensibly to provide asset managers and investors with better data for investment decision-making (Gagnon, 2021).

Whether standardized ESG reporting would pass a social benefit-cost test given the diverse technologies companies use, the different markets they serve, and the differentiated output those companies produce, is highly questionable. For some companies, specific metrics related to, say, water usage might be financially material, whereas this likely would not be the case for many other companies. Nevertheless, regulators are continuing to move in the direction of mandating increased disclosure of specific ESG metrics.

The European Union (EU) has had ESG disclosure mandates for publicly-listed companies since 2018 that are explicitly tied to the EU's policy embrace of the UN's Sustainable Development Goals. In the United States, the Securities and Exchange Commission (SEC) has indicated that ESG disclosure regulation will be a central focus of its attention in future. In May 2022, the SEC voted to advance a proposed rule requiring public companies to make public disclosures of risks to physical assets from climate change, as well as from governments' climate policies. Companies will also have to report greenhouse gas emissions generated directly from their operations and from their energy consumption. They will also have to report what are called Scope-3 emissions from their supply chains and customers if the emissions are material (Editorial Board, *Wall Street Journal,* 2022). These are emissions from suppliers providing inputs to companies, as well as consumers using the companies' products.

In Canada, Bill C-97, which received Royal Assent in 2019, introduced amendments to the Canada Business Corporations Act that will require corporate boards to disclose certain social information to shareholders, including information relating to diversity on boards and in senior management roles, as well as the well-being of employees, retirees, and pensioners. At the time of writing, these amendments had not yet come into force. Legislation mandating ESG-related disclosures has also been implemented in some Canadian provinces. For example, a 2017 update to the Ontario Pension Act of 1990 requires pension funds in that province to disclose whether ESG factors are incorporated in their statement of investment policies and procedures.[9] In 2020, British Columbia passed legislation enabling enterprises to register as "benefit companies." This was done via amendments to the province's Business Corporations Act. A benefit company is a for-profit, taxable structure that commits to conducting its business in a responsible and sustainable manner that promotes one or

more "public benefits." This is another example—besides mandating increased corporate disclosure of pertinent information—of how governments are encouraging enterprises to embrace ESG principles.

Private and social benefits of mandating more ESG disclosures

The rationale of new capitalists for broadening the scope of mandated ESG reporting and for standardizing the reporting metrics can be questioned on the grounds that corporate managers and board members better understand the determinants of their organization's past successes and future risk-adjusted net cash flows than do legislators, regulators, or social and environmental activists. Furthermore, managers and board members typically have strong incentives to disclose information about ESG-related initiatives that promise to increase their organization's risk-adjusted net worth in the absence of regulatory mandates. As well, institutional and large retail investors with interests in ESG-themed investing can be expected to inquire of companies about their ESG policies and practices in carrying out their fiduciary due diligence. This latter observation further mitigates the likelihood that potentially profitable ESG policies and practices will be unreported by companies in the absence of more stringent disclosure regulations mandated by governments and regulators.[10]

Whether expanding standardized regulatory mandates will lead to an improved financial performance of the private sector (or segments of the private sector, such as publicly listed companies) is ultimately an empirical question. While it is beyond the scope of this essay to review the relevant literature in any detail, that literature can be fairly interpreted as offering no consistent support for a positive relationship between the sustainability rankings that companies receive from ESG rating agencies and the stock market performance of those companies. That is, there is no consistent evidence of shareholder benefits associated with a company gaining a reputation as an ESG-conscious organization.

> "...there is no consistent evidence of shareholder benefits associated with a company gaining a reputation as an ESG-conscious organization.

This is not to say that there are no external benefits to society from enhanced ESG activities and disclosures on the part of organizations. For example, improvements to the environment may be enjoyed by large portions of society. But if organizations undertaking environmental initiatives are not directly rewarded by the beneficiaries of the environmental improvements, other stakeholders may suffer. For example, employees may be required to accept less compensation if they want to keep their jobs, and consumers may be obliged to pay higher prices if the "do-gooding" organizations from which they purchase goods and services are to remain financially viable. There is no free lunch when it comes to environmental or other societal benefits and imposing social obligations on privately owned organizations makes owners and managers responsible for adjudicating the tradeoffs between helping some groups in society while potentially harming others. It is far from clear that owners and managers of publicly-listed corporations are competent to be given responsibility for adjudicating those

tradeoffs.[11] Major economic and social tradeoffs would seemingly be more appropriately left to elected officials and other public sector bodies that are accountable to legislators and governments chosen through the democratic process.

Conclusion

Some elements of the new capitalist model are hardly new. For example, calls for replacing the fiduciary responsibility of managers to shareholders with a responsibility to a broader set of stakeholders is not a recent phenomenon. Nor are calls for private sector organizations to act sustainably, which encompasses ensuring that there is no net depletion of natural resources over time and that the physical environment suffers no degradation owing to the actions of businesses.

What is relatively new is the growing constituency in the private sector for ESG-themed investing and ESG-consistent business practices, combined with claims that ESG-driven investors and operating companies will perform better financially than other firms while also benefitting the broad society. Relatively new, as well, are calls for more regulation designed to broaden the reporting responsibilities of listed companies surrounding their environmental practices, their hiring and outreach to minority groups, and related matters. In this regard, there is a growing constituency among wealth managers and regulators to impose standardization of ESG reporting. While the ostensible objective is to enhance the "information content" of ESG reporting, it is plausible that the end goal of standardized ESG reporting is an expansion and standardization of regulations of the practices covered by the reported metrics. In this context, there is a risk that the new capitalism is potentially a new road to government as Leviathan.

Endnotes

1 Marx (1867/2019) sets out how communism will displace capitalism as the dominant economic system in developed countries, whereas Schumpeter (1942) discusses how the material success of the capitalist system leads to the emergence and growth of economic and social forces that threaten the continued existence of free market capitalism.
2 The acronym ESG stands for environmental, social and governance imperatives in investment and management activities. The pillars of ESG imperatives will be discussed later in this essay.
3 See Muoio, Bouri and Jurgens (2021) for a description of this project.
4 For seminal discussions of the stakeholder capitalism model, see Freeman (1984) and Donaldson and Preston (1995).
5 The utilitarian approach to treating stakeholders views any explicit or implicit transaction as being worth doing only if it increases the expected risk-adjusted profitability of the organization.
6 A survey of moral arguments for stakeholder capitalism is provided in Burton and Dunn's study.

7 Many economists, for example, argue that stronger private property rights, enforced by laws and the court system, can address many environmental problems conservationists identify.
8 See, for example, BNP Paribas (2021).
9 See Scanlon (2021) for a discussion of ESG disclosure rules in Canada.
10 Many public companies already include some level of sustainability-related disclosures in periodic financial reports and proxy statements filed with regulators.
11 This caveat about ceding such decision-making to private sector managers was convincingly addressed by Friedman (1970), who argued that managers have no particular expertise in making such social judgments. Others, including Mehrotra and Morck (2017) argue that shareholder value maximization represents a bright line decision rule, whereas societal (or stakeholder) value maximization is an ill-defined charge to assign corporate boards who would then be in a better position to act in a self-interested manner with respect to shareholders.

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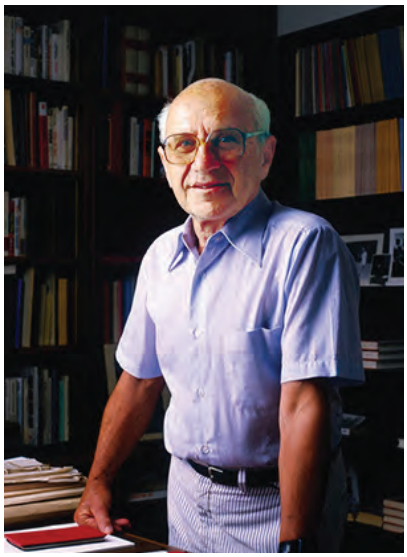
Friedman and His ESG Critics

Steven Globerman

Introduction



Milton Friedman was a Nobel Laureate and one of the most consequential economists of the 20th century. Notwithstanding his major academic contributions, most notably in monetary policy, the article of his that arguably spawned the largest follow-up literature was his 1970 commentary in the *New York Times* entitled: "A Friedman Doctrine—The Social Responsibility of Business Is to Increase Its Profits." This short piece generated decades of academic and other studies both criticizing and (less frequently) supporting the main arguments Friedman advanced in the article.

The purpose of this essay is to identify the main criticisms of Friedman's iconic commentary and to offer brief assessments of those criticisms.[1] The critical literature that Friedman's article effectively spawned is broadly associated with the ESG[2] movement, although other labels have been attached to his critics' schools of thought including stakeholder capitalism, socially responsible business, sustainable capitalism, and The New Capitalism.

The next section of this essay sets out Friedman's description and defense of shareholder capitalism. It pays particular attention to several nuances of his description and defense that directly or indirectly underlie the more problematic criticisms of his essay.

Friedman's case for shareholder capitalism

In his 1970 commentary Friedman begins by noting that individuals—and not businesses—have responsibilities against which their actions should be measured. He focuses his attention on corporate executives rather than individual proprietors on the grounds that large corporations are the focus of critics of shareholder capitalism. While this was undoubtedly the case when Friedman wrote the piece, and is still largely the case, the emergence of companies

such as Facebook in which the original entrepreneurs remain as CEOs, and often as owners with controlling shareholder voting rights, has raised some new concerns about corporate governance, which will be discussed later in this essay.

> "The corporate executive's role is to make as much money as possible while conforming to the basic rules of the society..."

Friedman asserted that in a free enterprise, private property system, a corporate executive is an employee of the owners of the business in question, and the executive's responsibility is to manage the business in accordance with the desires of the owners. Friedman suggests that owners typically want the companies they own to make as much money as possible, which leads to his summary statement about the social responsibility of managers that has been the lightning rod for his critics. Specifically, as an employee of the shareholders, the corporate executive's role is to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom.

It is relevant to note that Friedman acknowledged that some owners may have objectives other than maximizing wealth, such as supporting particular charitable causes, and he did not explicitly object to the existence of what is today known as Public Benefit Corporations (PBCs)—legal entities with a legal affirmative duty to be "good corporate citizens."[3] However, he cautioned that the more complex the criterion of performance, the more difficult it is for owners to monitor the performance of their managers. In this circumstance, it is easier for managers to suborn the interests of owners, whatever those interests are, in favour of the managers' own interests. As a consequence, owners will need to monitor managers more, which will impose additional transactions costs on the economy, or they will undertake specific activities as individual proprietors when those activities would be more efficiently done by organizations that employ specialized managers. While Friedman acknowledged that it is not necessarily easy for owners of public corporations to monitor the performance of their managerial agents, it is easier to do so when their criterion of performance is corporate profitability.[4]

Friedman dispensed with the notion that being "socially responsible" in their capacity as executives can be consistent with acting in the interests of shareholders who invest in order to maximize their personal wealth. He stated quite clearly that if the claim that corporate executives have a social responsibility to fill in their role as executives is not pure bluster, it must mean that they must act in some way that is not in the interests of shareholders. In making this statement, Friedman undercut a growing line of argument by managers of leading investment companies such as Blackrock that socially responsible actions by companies is in the interest of those companies' shareholders.[5] Put simply, Friedman made the reasonable assumption that if, say, hiring minority employees increases the profitability of companies, executives acting in their role as agents for shareholders will voluntary hire any and all minority employees whose contribution to corporate profitability exceeds their compensation. In such cases, there is no practical difference between acting socially responsibly and focusing on shareholders' financial interests.

A critical extension of Friedman's point that differentiating between socially responsible business behaviour and profit maximization is meaningless when those objectives involve the same managerial actions is his insight that if firms are performing efficiently, which is a prerequisite to maximizing profits, no managerial action is possible that makes one or more groups better off without making one or more groups worse off. For example, if executives donate company funds to an environmental activist group, it might reduce the profits available to shareholders, or it might mean that consumers will be charged higher prices, or that workers will be offered less compensation. These stakeholders could make their own donations to the environmental group if they wished to do so.

That there is no "free lunch" when it comes to socially responsible behaviour leads to what is perhaps Friedman's strongest defense of shareholder capitalism. Namely, an executive who engages in extracting corporate wealth to support social causes is effectively imposing a tax on one group and providing a transfer payment to some other group. Friedman argues that on the level of political principle, the imposition of taxes and the expenditure of the tax proceeds are governmental functions. When corporate executives impose taxes and spend the proceeds for social purposes, they become, in effect, public employees, even though they remain in name employees of private enterprises. If executives are to impose taxes and make expenditures to promote social objectives, the assessment of taxes and the objectives to be served from the tax revenue raised should be determined by a political process.[6]

The doctrine of social responsibility would therefore extend the scope of government regulation to the everyday activities of privately owned enterprises, as Friedman noted. In this respect, the doctrine of social responsibility does not differ from a collectivist or socialist doctrine. Hence, executives that extol their commitments to socially virtuous behaviour in the hope of gaining some type of short-run financial advantage undermine the foundation of the free enterprise system.

It might be argued that Friedman did not go on to develop the important caveat to his assertion that the responsibility of executives is to make as much money as possible for shareholders, i.e., that in doing so they conform to the basic rules of the society. Laws and regulations are formal rules. Social customs and conventions are informal rules. Even formal rules can be ambiguous or non-transparent, which obliges executives (and their lawyers) to be sufficiently knowledgeable to obey the rules. Conforming to informal rules that can vary by the geographical locations of a company's business activities as well as over time is even more challenging than conforming to formal rules. Friedman's position is therefore

potentially open to the challenge that it is as difficult for executives to identify and conform to the basic rules of society as it is for them to understand the linkages between their decisions as managers and the social consequences of their decisions. Indeed, in many cases, the same knowledge is required.

As we shall discuss in a later section, the arguably more economically sophisticated challenges to Friedman's basic argument in defense of shareholder capitalism directly or indirectly rely on the notion that executives cannot be expected to conform to the basic rules of society for one or another reason unless they are directed to do so by changes in corporate law or by regulations that oblige companies to report whether or not they are meeting ESG-related regulations promulgated by securities regulators and government agencies. We turn next to the arguments of Friedman's critics.

Stakeholder capitalism

One of the early academic schools of thought to criticize the shareholder capitalist model is represented by those advocating a stakeholder model of capitalism. In broad terms, this school of thought maintains that corporate executives should consider the interests of a wide range of individuals and groups who are directly or indirectly affected by their decisions including, but not necessarily restricted to, consumers, employees, suppliers, and the communities in which the relevant companies do business.

> "(Stakeholder capitalism) maintains that corporate executives should consider the interests of a wide range of individuals and groups who are directly or indirectly affected by their decisions... "

The stakeholder model is defended by its proponents on both positive and normative grounds. The positive argument is that profit maximization requires corporate managers to treat each of these sets of stakeholders "fairly" and, therefore, an exclusive focus on shareholders will contribute to reduced profitability.[7] Obviously, firms in competitive markets must offer consumers and suppliers of inputs "fair" terms of exchange if they are to stay in business, and it hardly took Friedman to make that point. Still, he addresses the positive argument for stakeholder capitalism in his observation that arguments for alternatives to shareholder capitalism based on claims that specific alternatives would profit the adopting organizations are purely rhetorical.

The normative argument for stakeholder capitalism is that managers have an ethical obligation to stakeholders beyond just the shareholders. Those making this argument point to various ethical theories that have been applied to management, and it is beyond the scope of this essay to discuss these theories. The point that might be made here is that to the extent that ethical norms are embedded in social norms, Friedman addresses this argument by acknowledging that executive actions are bounded by the formal and informal rules of society. To be sure, there will inevitably be instances when clear social rules do not exist or are,

at least, matters for interpretation.[8] In such cases, however, one would be hard pressed to argue that executives flaunted social norms.

A more specific ethical challenge to shareholder capitalism is posed by the claim advanced by some ethicists that it is immoral to treat stakeholders as means to an end, i.e., increased profits, even if executives break no laws or social norms in doing so.[9] Burton and Dunn (2005) argue that on moral grounds, managers should "care" for all individuals whose lives are affected (or could be affected) by their organizations' activities. In cases of conflicting needs, managers should give preference to those stakeholders whose needs are most important on ethical grounds rather than on the direct or indirect contributions individual stakeholders make to the organizations in question.

It is tempting to dismiss Burton and Dunn's normative argument as being an impractical principle upon which to base the management of a company. However, it is unnecessary to do so. Whatever the ethical criterion, welfare tradeoffs across individuals inevitably will arise which will oblige managers to impose the equivalent of taxes on some in order to benefit others. Burton and Dunn's normative critique of shareholder capitalism is therefore rebutted by Friedman's argument that unelected private sector managers have no legal standing to redistribute income based on whatever "moral model" they choose to invoke.

Ruggie, Rees, and Davis (2020) do not challenge the stakeholder model on ethical grounds. Rather, they offer a normative interpretation of ethical behaviour that they claim "harmonizes" the interests of various stakeholders. Specifically, they advocate embedding human rights due diligence processes into corporate decision-making and oversight systems in order to identify and mitigate adverse human rights impacts connected to corporate operations and business relationships. The authors do not make the case that corporate boards and managers can avoid making welfare tradeoffs in pursuit of human rights. Moreover, they argue in favour of regulations to ensure that human rights are not violated by corporate activities. As such, their stakeholder capitalism paradigm does not rebut Friedman but, rather, implicitly acknowledges the primacy of laws and regulatory rules when it comes to addressing broad public policy issues such as human rights.

ESG

Contemporary proponents of ESG reforms to shareholder capitalism can be viewed as putting forth a more expansive version of the stakeholder capitalism model. Specifically, they include the natural environment as a key stakeholder. This position is also associated with

the model of sustainable capitalism which Rull (2011) characterizes as one that prioritizes caring for the natural environment because it is the primary provider of resources to sustain human life. Others have added a social element to this position by arguing that sustainable development involves the simultaneous pursuit of economic prosperity, environmental quality, and social equity.

While Friedman understandably does not explicitly address the specific contentions of ESG proponents in his 1970 commentary, he clearly acknowledges the obligation of executives to follow laws and regulations meant to address environmental externalities. In this regard, a potentially important source of intellectual conflict between Friedman's model of shareholder capitalism and proponents of ESG-oriented management is whether companies should go beyond existing laws and regulations in their efforts to practice "sustainability." For example, former US Vice-President Al Gore, a prominent advocate of environmentalist causes, asserts that while businesses cannot be asked to do the job of government, companies and investors ultimately must mobilize the financial, physical, and human capital required to overcome the unprecedented environmental challenges the world faces (see Gore and Blood, 2011).

As in the case made for stakeholder capitalism, many ESG proponents argue that private sector companies would be more profitable or pose less risk to their shareholders if they adopted ESG "best practices" more intensively, i.e., beyond what is required by laws and regulations. For example, the International Business Council (IBC) of the World Economic Forum posits that aligning corporate goals to the long-term goals of addressing environmental sustainability as well as economic and social inequities will prove profitable for those businesses that do so (see World Economic Forum, 2020).

The doing-well-by-doing-good argument embedded in much of the ESG literature is nuanced by claims that inefficiencies in product, factor, and capital markets may contribute to a disconnect between the ESG best practices and risk-adjusted returns to owners of companies. Specifically, managers may be inadequately informed about how implementing ESG best practices will improve their organizations' financial performance, while investors are insufficiently informed about what specific companies are doing with respect to ESG practices such that shareholders of high performing companies by ESG standards are not rewarded with higher risk-adjusted equity values for being owners of those companies.

The argument that inefficient product, factor, and capital markets might lead to executives "underinvesting" in ESG disclosures and initiatives is a contentious one with which Friedman would probably have disagreed. At the least, he would likely have argued that social

activists and government officials are less likely than corporate executives to identify the profit-maximizing amount of ESG activity for individual companies, and he would also likely have argued that mandating expansive and standardized ESG disclosures from private sector participants amounts to activists seeking to attain by undemocratic procedures what they cannot attain by democratic procedures including acquiring sufficient ownership shares in companies to vote in board members who support the activists' goals.[10]

Whether capital markets are inefficient in rewarding shareholders of companies that implement practices that ESG activists favour, including going beyond existing laws and regulations to reduce their carbon footprints, appoint members of minority groups to board and senior executive positions, and so forth, is ultimately an empirical issue. In this regard, it is suggestive that empirical studies of the relationship between ESG rankings of companies that specialized rating agencies perform and shareholder returns provide no consistent support for the claim that the returns to shareholders of highly ranked ESG companies exceed the returns to shareholders of less highly ranked companies.[11] However, if a substantial number of investors are willing to accept below-market returns in exchange for financially supporting companies that are sufficiently ESG-compliant in their opinion, companies taking the lead in ESG initiatives will have strong incentives to disclose their ESG practices, since doing so should reduce their costs of capital.

"If a substantial number of investors are willing to accept below-market returns in exchange for financially supporting companies that are sufficiently ESG-compliant in their opinion, companies taking the lead in ESG initiatives will have strong incentives to disclose their ESG practices..."

This benign view of the principal- agent relationship in large companies has unsurprisingly been challenged by what might be identified as the latest school of thought to challenge the shareholder capitalist model. This school maintains, among other things, that managers of large companies can operate free of direction from shareholders as well as from social norms more generally. The essay now turns to this set of Friedman's critics.

Market power and the political influence of large companies

Recent criticisms of stakeholder capitalism centre around the assumption that executives of large companies enjoying dominant market positions are essentially responsible to no one but themselves. Moreover, executives of such companies have sufficient political and economic influence to shape formal laws and informal social customs to the advantage of their shareholders and to themselves personally, as well as to charge above-competitive prices and pay below-competitive wages.

Posner (2019) provides one illustration of this line of argument. For example, he asserts that established businesses will make the greatest profit by eliminating competition and not,

presumably, by trying to be as efficient as possible. Simple models from industrial organization economics show that a single seller of a product (a monopolist) will maximize profit by restricting output and charging a price above the competitive level. Other things constant, this imposes welfare losses on consumers that exceed the increased profits to shareholders. In simple terms, monopoly pricing is not in the social interest.

It would unduly expand the size of this essay to discuss the relevance of the monopoly model to stakeholder capitalism, let alone to public policy. Suffice it to say that many economists believe that government-imposed barriers to entry are typically required to protect the pricing power of firms from competition provided by new entrants that would be attracted by the profits earned by incumbent monopolists.[12] In this circumstance, it is appropriate to criticize the government for creating or perpetuating the market power of specific firms rather than the executives of those firms.[13]

To be sure, Posner implicitly acknowledges the potential complicity of government in making it legally possible for large companies to create and exploit their market power. However, he sees this outcome, in many cases, to be the result of lobbying and other interventions by representatives of large companies into the political process. He cites, as examples, lobbying efforts by companies to restrict foreign competition through, say, tariffs or to raise the costs of rivals through regulations that are particularly onerous for rivals to meet. Posner concludes that if the purpose of a business is to increase its profits, as Friedman argued, then it is clear-headed and justifiable for a business to use its political influence to dismantle the free market, which Friedman certainly would not have approved of.

Posner goes on to provide examples of business activities that (by implication) violate social norms, but which managers of powerful businesses can and do engage in regardless. One example is Facebook (now Meta) which Posner asserts broke its promises to respect its customers' privacy. He also mentions Twitter and Google (now Alphabet) as generating ad revenue by facilitating the transmission of hate speech. He cites Exxon and other oil companies for propagandizing against climate science and tobacco and software gaming companies for pushing addictive products on to children.

These specific condemnations of corporate behaviour can be debated. For example, hate speech for some is healthy debate for others. In any case, Friedman certainly never claimed in his op-ed that corporate executives were paragons of virtue. What is implicit in Friedman's shareholder model is that actions taken by managers that are manifestly in opposition to social norms will be punished in the marketplace over time. Indeed, the bad publicity

surrounding Meta's privacy practices has arguably contributed to a substantial reduction in the capitalized value of that company since Posner's article was published.

A more direct and potentially meaningful critique by Posner addresses the essence of the shareholder model, i.e., that business executives are the employees of the shareholders. According to Posner, business executives are employees of corporations, but the executives enjoy *de facto* control of the enterprise when it comes to key strategic decisions. Shareholders are entitled to vote on certain major corporate decisions, but CEOs typically bat away shareholders, particularly when the latter propose that corporations should act in a socially responsible way.

"According to Posner, business executives are employees of corporations, but the executives enjoy *de facto* control of the enterprise when it comes to key strategic decisions."

The principle-agent problem in the context of large, publicly owned companies was identified and discussed long before Friedman wrote his essay.[14] The practical relevance of the problem remains a subject of debate. However, if it was a practically relevant problem in the past, it is less so in the present. In particular, the growth of indexed investment funds and indexed Exchange Traded Funds (ETFs) at the expense of individual retail investing has resulted in the effective concentration of proxy voting power in the hands of a small number of leading institutional investors such as—in the United States—Blackrock and Vanguard Asset Management. The relevance of Posner's claim that the separation of ownership and management particularly disadvantages shareholders who support ESG causes is especially suspect given the emergence and rapid growth of ESG-themed investment funds and ETFs. The promise to buy large equity positions in ESG-compliant companies or to sell equity positions in non-compliant companies is a powerful market force that fund managers can use to modify the behaviour of corporate executives, particularly those whose compensation is tied in a significant way to their company's stock price. Ironically, the growing concentration of investment capital in the hands of a relatively small number of institutional and professional money managers has recently led to concerns that those investors exert too much rather than too little influence on corporate executives.

It is unclear from his essay how Friedman would address the issue of corporate lobbying that Posner raised. Friedman would likely not deny that corporations participate in the political process to gain economic advantages for themselves and that this sometimes results in political outcomes that make the country as a whole less well off. However, Friedman would likely argue that the underlying problem is not corporate lobbying but rather it is the expansive size of government in the economy that makes it financially worthwhile to enlist government to pass laws and implement regulations that profit those companies who lobby successfully. The suborning of stakeholder capitalism by political rent-seeking opportunities is precisely the slippery slope to socialism that Friedman warned against.

Concluding comments

Friedman's defense of shareholder capitalism remains controversial. However, more than 50 years after he wrote his famous commentary, most economists continue to support his main insights. In particular, most economists tend to agree that major externalities such as climate change are public policy issues and that it is misguided to blame companies for what amount to political failures to create the right public policies.[15] Financial economists also tend to agree that while corporate governance is imperfect, the shareholder capitalist model addresses issues created by the separation of ownership and management more effectively than alternatives, and they reject initiatives proposed by ESG advocates such as restrictions on corporate buy-backs of stock and legal mandates requiring companies to register and operate as public benefit companies.

"Most economists tend to agree that major externalities such as climate change are public policy issues and that it is misguided to blame companies for what amount to political failures to create the right public policies."

Perhaps the least productive contributions to the debate surrounding shareholder capitalism are claims such as those by the Business Roundtable (2021) that it is in the financial interests of businesses to implement ESG initiatives and abandon the focus on shareholders. Such claims ultimately rest on the notion that managers will ignore or be ignorant of profitable opportunities that lie outside traditional areas of business practice. There is simply no consistent evidence to support such claims.

Given the length of time that Friedman's critics have been at work and the depth and breadth of their attacks on his defense of shareholder capitalism, the continued robustness of his fundamental insights is nothing short of remarkable.

Endnotes

1 Fraser Institute will be publishing a series of essays that that identify and evaluate in detail the major criticisms of Friedman's defense of shareholder capitalism. For an earlier essay that identifies and rebuts positions of some of Friedman's most well-known critics, see Henderson (2020).
2 The acronym ESG stands for Environmental, Social, and Governance imperatives for socially responsible management.
3 For a discussion of PBCs, see Mayer, Strine, and Winter (2020).
4 Indeed, later authors recognized that constraining the principle-agent problem as Friedman described it was an important benefit of shareholder capitalism. See, for example, Mehrotra and Morck (2017).
5 A later section of the essay will discuss this argument further.
6 Friedman noted that, as a practical matter, corporate executives will typically not have the information to understand how their actions will contribute to the achievement of any specific social end.
7 The classic reference in the stakeholder capitalist literature is Freeman (1984).
8 An example might be the case where a manager is confronted with the choice of hiring a minority candidate for a job when that candidate is not necessarily best qualified for the job.
9 An example would be providing after-sales service to consumers in order to create customer goodwill that results in increased profits but terminating the after-sales service if it is found to be unprofitable.

10 Indeed, a growing number of corporate proxy fights revolve around the ESG positions taken by prospective board members.

11 See Cornell (2021) for a review of the relevant literature. Forthcoming essays to be published by the Fraser Institute will discuss in more detail the theoretical and empirical linkages between ESG rankings and shareholder returns.

12 The seminal article in this literature remains Demsetz (1973).

13 For a relatively recent discussion of trends in industrial concentration and changes in industry competitiveness, particularly in online business sectors, see Varian (2019).

14 The earliest seminal contribution to this literature is Berle and Means (1932). One claimed manifestation of the separation of ownership from management that goes back to Berle and Means but that persists to the present is that managers aim for short-run profits at the expense of long-run profits, since the tenure of managers is relatively short. For a rebuttal of this claimed principal-agent problem, see Asness's comments in Strain, Asness, Lipton, and Hubbard (2021).

15 See Hubbard and Strain's comments at Strain, Asness, Lipton, and Hubbard (2021) among others for this defense of Friedman's thesis. Still, many ESG critics maintain that companies have the financial and technical resources to address public policy issues that governments have failed to address and, therefore, that companies should address those issues.

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ESG Investing and Asset Returns

Steven Globerman

Executive Summary

ESG investing is an investment strategy that incorporates environmental, social, and governance (ESG) information in the investment decision-making process. There is a growing interest in ESG investing, and thus a large and growing empirical literature examining the returns to ESG investing. At the same time, the demand for more and better information about firms' ESG activities is increasing. In response to this demand, many jurisdictions (e.g., the US Securities and Exchange Commission) are considering ESG reporting mandates to encourage ESG investing by helping the investors smoothly identify firms with better ESG metrics (green firms) from the inferior ones (brown firms).

In this essay, we provide a summary of the previous theoretical and empirical academic studies examining the relationship between ESG investing and asset returns. We then explain how these findings can be arguably relevant for evaluating the public policy of mandatory ESG reporting. We only focus on how this policy can potentially change the cost of capital and consequently give firms incentives to improve their ESG performance, which is the intended goal of this policy.

Many claim that the return to ESG investing is negative. The main conceptual framework that supports this claim is that investors have non-pecuniary preferences for green firms, and thus they are willing to accept lower expected returns for holding stocks and bonds that green firms issue. Thus, these firms benefit from lower financing costs (cost of capital) in the capital market. So green firms can invest more and grow more. Moreover, brown firms will have an incentive to improve their ESG practices to lower their financing costs to remain competitive. If the channel through investors' preferences works, ESG investing may have a positive social outcome as long as empirical evidence confirms that ESG investing can significantly

decrease the expected returns (decrease the cost of capital for firms). In this scenario, mandating ESG reporting may be justified if investors have difficulty identifying green firms from brown firms, and if firms can provide better ESG information to investors under the mandatory regime.

In contrast, many ESG advocates claim that there is no trade-off between ESG investing (doing good) and asset returns (doing well). The main conceptual framework that can support their claim is that green firms have higher profitability or lower ESG-related risks, while investors cannot readily identify green firms from brown ones. Therefore, green assets are underpriced and so provide higher expected returns for investors who hold them. In this scenario, mandatory ESG reporting might be justified as long as firms can provide better and more ESG information to investors under the mandatory regime.

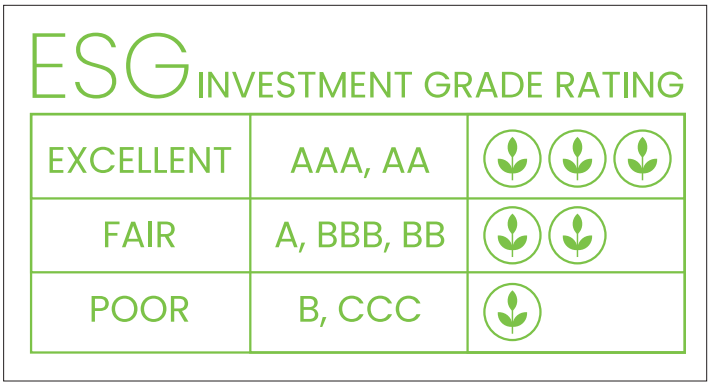
In this essay, we find that the results of empirical studies examining the relationship between ESG investing and asset returns (cost of capital) are inconclusive. Many studies find positive or negative relationships, while many do not find any significant relationship. This result can shed light on the claim that mandating ESG reporting can have a positive social impact by systematically changing firms' costs of capital. If there is no agreement on how ESG investing is associated with risk-adjusted investment returns (cost of capital), advocates of mandating ESG reporting face a burden of proof to show that this policy can have a net positive social impact.

1. Introduction

ESG investing is an investment strategy that incorporates environmental, social, and governance (ESG) information in the investment decision-making process. Investors can find information about the ESG activities of the firms mainly through ESG rating agencies, as well as reports issued by companies. Rating agencies provide information to the public about the ESG performances of the firms. For example, firms with lower carbon emissions (E), a higher regard for employees' health and safety in the workplace (S), and more diversity in leadership (G) have better ESG ratings.

Asset managers are increasingly applying[1] ESG investing[2] to buy stocks and bonds of firms that are aligned with ESG goals. As a result, there is a large and growing empirical literature examining the returns to ESG investing. Investors can have different incentives to incorporate ESG information in their investment decision-making. Some investors may find ESG

information financially material. This material information can help investors better evaluate the financial risks and returns of a firm. Some investors may have social objectives in addition to financial incentives and would like to buy the stocks and bonds of firms with better ESG performance. Both groups of investors would like to have access to relevant information about the ESG activities of the firms.



With growing interest in ESG investing and demand for more and better information about firms' ESG activities, many jurisdictions (e.g., the U.S. Securities and Exchange Commission) are considering ESG reporting mandates to encourage ESG investing by helping investors to identify firms with better ESG metrics (green firms) from the inferior ones (brown firms).

In this essay, we provide a summary of the theoretical and empirical academic literature examining the returns to ESG investing. We then explain how these findings can be arguably relevant for evaluating the public policy of mandating more expansive ESG reporting. A comprehensive cost-benefit analysis is needed to fully evaluate this public policy. In this essay, we do not do a cost-benefit analysis of mandated changes to ESG reporting. Rather, we discuss a specific potential source of benefit that can arise from price changes of capital market assets.[3]

In a public policy debate, one should identify the market failure that allegedly creates a need for regulation, as well as how the regulation can solve the issue. In the ongoing discussion about mandatory ESG reporting, the main ostensible market failure is that firms underperform in their ESG activities compared to the socially optimal level. For example, it can be argued that firms should have lower carbon emissions (E in ESG), or higher diversity in leadership (G in ESG). There can be various sources of this market failure. The potential source focused on in this report is that investors are broadly uninformed about the ESG performance of firms and, therefore, cannot identify green firms from brown firms. Investors can potentially use ESG ratings that ESG agencies provide to identify green firms. However, Berg, Koelbel, and Rigobon (2019) document that the ESG ratings from the main six rating providers disagree substantially.

How can mandating ESG reporting drive change by giving firms an incentive to improve their ESG performance?[4] The potential channel that we focus on is that mandating more ESG reporting can make investors better informed about the ESG performance of individual firms and thereby change their investment decisions in the capital market. Firms raise funds (capital) through the capital market, whether through issuing stocks, bonds, or borrowing from financial institutions. If investors can better identify green firms, they may invest more in green firms and divest from brown firms. This reallocation in investors'

> "The policy of mandating more expansive ESG reporting can drive change and therefore improve social efficiency through asset price changes in the capital market."

portfolios can increase the prices of the stocks and bonds of green firms. Green firms therefore benefit from lower financing costs in the capital market. Hence, green firms can invest more and grow relative to brown firms. Moreover, brown firms will have an incentive to improve their ESG practices to lower their financing costs to remain competitive. Therefore, the policy of mandating more expansive ESG reporting can drive change and therefore improve social efficiency through asset price changes in the capital market.

How can the empirical findings of returns to ESG investing for investors (cost of capital for firms) be relevant for evaluating the public policy of mandatory ESG reporting? We examine the theoretical literature on ESG investing. In particular, we discuss how various theoretical frameworks might justify the mandate, and what these frameworks predict for returns to ESG investing. If the empirical tests documented in the literature are consistent with the relevant conceptual framework, the existence of a net social benefit to mandatory ESG reporting could be potentially justified. Below, we highlight two dominant conceptual frameworks that can be identified in the literature.

In this essay, we provide a summary of the academic literature surrounding ESG investing to assess whether there is conclusive evidence on the relationship between ESG investing and asset returns. In the next section, we summarize the theoretical studies examining the relationship between ESG investment and asset returns. The goal of this section is not to review complicated mathematical models. Instead, we want to summarize the channels through which ESG investing can potentially affect the expected returns to and cost of capital. In section 3, we discuss the empirical studies examining the relationship between ESG investing and returns. We conclude that the empirical evidence is inconclusive. In Section 4, we provide some explanations for why the empirical results examining the relationship between ESG investing and returns find mixed results.

In Section 5, we conclude from inconclusive empirical results examining returns to ESG investing that we do not know whether mandatory ESG reporting can reduce the cost of capital for green firms. As such, the advocates of mandating ESG disclosures should clarify how mandating ESG reporting can have any net positive social impact.

2. Theoretical frameworks

In contrast to the argument made by some prominent investment managers that "Green Investing" offers higher risk-adjusted returns to investors, many academics assert that the return to ESG investing is negative (e.g., Hong and Kacperczyk, 2009).[5] The main conceptual framework that supports this claim is that investors have non-pecuniary preferences for green firms, and thus they are willing to accept lower returns for holding stocks and bonds

that are issued by green firms (Berk and van Binsbergen, 2021). In fact, investors should sacrifice financial returns (doing well) for following their ESG concerns (doing good). In this framework, ESG investing implies better social outcomes only if investors tilt their investment portfolio toward green firms so that they can materially increase the stock and bond prices of these firms compared to brown firms. If investors can materially increase the asset prices of green firms, these firms will face lower financing costs (lower cost of capital) so that they can invest more and grow more, which drives better social outcomes. If the channel through investors' preferences works, ESG investing may have positive social outcomes as long as empirical evidence confirms that ESG investing is associated with significantly lower expected returns (lower cost of capital for firms). In this scenario, mandating ESG reporting may be justified if investors cannot distinguish green firms from brown firms, and if firms provide better ESG information to investors under the mandatory regime.

"If investors can materially increase the asset prices of green firms, these firms will face lower financing costs (lower cost of capital) so that they can invest more and grow more, which drives better social outcomes."

Second, many ESG advocates claim that the outperformance of ESG strategies is beyond doubt; there is no trade-off between ESG investing (doing good) and asset returns (doing well) (Kynge, 2017, September 3). The main conceptual framework that can support their claim is that green firms have higher profitability and/or lower ESG-related risks, while these firms do not inform their investors of this material information. Therefore, green assets are underpriced and so provide higher expected returns for investors who hold them. In this scenario, mandatory ESG reporting might be justified as long as firms can provide better and more ESG information to investors under the mandatory regime.

The standard conceptual framework to analyze the interaction between ESG investing and asset returns is based on the single-period Capital Asset Pricing Model (CAPM) developed by Sharpe (1964) and Mossin (1966). CAPM describes the relationship between the expected return and the risk of investing in a security. The model shows that the expected return, or simply the average return, on a security is equal to the risk-free return plus a market risk premium. The market risk mainly exists because economic cycles are unpredictable. If the economy is in a boom, dividends and stock prices are higher; if the economy is in a recession, the dividends and prices are lower. An investor who buys a well-diversified portfolio of stocks (e.g., an S&P 500 index fund) expects to receive an excess return compared to holding government-issued bonds, which provide guaranteed coupons regardless of economic cycles. Note that market risk exists even in a well-diversified portfolio. The implication of CAPM is that if the expected return of the stock of firm A (say 7 percent) is higher than that of firm B (say 6 percent), it means that firm A is riskier with higher price volatility. Because of the extra risk in stock A, the investors who buy those stocks expect to get an extra 1 percent return. Therefore, other than risk premium, stock A should not provide an excess return (Alpha).

Alpha is a term widely used by investors. It is a measure of the performance of an investment after removing the risk premium. Based on CAPM, the alpha of all stocks should be zero. The extensions to CAPM (e.g., the three-factor pricing model) incorporate risk factors in addition to the market risk to explain the expected returns. The intuition behind all these extensions is the same. As long as there is a known risk factor, it is already reflected in the price and return of the stock as a higher risk premium. Adjusting for all these risks, the stock should not be able to outperform the benchmark index (zero alpha).

In this section we discuss two main channels through which ESG investing can affect expected returns: 1) investors' preferences and 2) ESG-related risks. Then we discuss under what conditions theory predicts that ESG investing can provide higher expected returns.

Investors' preferences

Investors' taste for ESG criteria is the primary channel in the theoretical models to rationalize how ESG investing can affect expected returns. Heinkel, Kraus, and Zechner (2001) is the first paper that incorporates tastes for ESG in an asset pricing model. The authors assume that green investors do not like the firms with polluting technologies (E in ESG). These green investors boycott, in an investment sense, the brown firms. In this environment, there are fewer investors available (less demand) to hold the stock of brown firms, causing those share prices to fall. This implies a lower cost of capital for the green firms as they can issue stocks with higher prices and raise more financial capital. This creates incentives for the brown firms to follow practices to become green, which results in presumed positive social outcomes. The lower cost of capital means lower expected returns for green investors in equilibrium. Yet green investors are not unhappy because they enjoy non-pecuniary returns, i.e., increased personal satisfaction from holding green stocks.

"Green investors boycott, in an investment sense... brown firms. In this environment, there are fewer investors available (less demand) to hold the stock of brown firms, causing those share prices to fall."

The claim that green investors get a lower expected return in equilibrium while green stocks' prices increase to higher levels can be confusing. To clarify, I provide a simple example. Suppose that there are two firms: a green firm (say a battery maker), and a brown firm (a fossil fuel firm). For simplicity, suppose that both are initially trading at the identical stock price of $100. Moreover, let's assume that the expected return of both is identical at 6 percent. Now assume that investors become concerned about ESG issues and would like to hold firms with better ESG ratings. The short-term effect of this change is that the stock price of the green firm increases as investors bid up the price of the green firm's shares in order to buy them, and the stock price of the brown firm drops as demand for those shares declines. Suppose that the green firm is now priced at $105 and the brown firm is priced at $95. During the period over which the price of green is rising and the price of brown is falling, investors' return will be higher for the green company than for the brown company. However, after

the transition period, the expected return of the green firm falls below 6 percent, say to 5 percent, and the expected return to the brown firm rises above 6 percent, say to 7 percent.

Why will the green firm have a lower future expected return in the new equilibrium? The reason is that, in the new equilibrium, investors' desire to hold green firms for reasons beyond their expected monetary return. So the investors who hold green stocks are fine with a lower monetary return of 5 percent because they get the equivalent of a 1 percent non-monetary return from being socially responsible. Similarly, the investors who hold brown stocks expect to receive a higher monetary return of 7 percent to compensate for the non-monetary loss of 1 percent.[6] So both groups of investors get a total return of 6 percent in equilibrium (i.e., after the transition period) if we consider both monetary and non-monetary returns. Therefore, during the period of transition in which the preferences of investors are being reflected in changing stock prices, green stocks outperform brown stocks. After the transition period, green stocks will underperform the brown stocks. This can be one explanation for why the results of empirical studies investigating the effect of ESG investing on asset returns are mixed. We discuss this further in a later section.

Berk and van Binsbergen (2021) argue that ESG investing implies lower expected returns (cost of capital). They argue that for ESG investing to have an impact it must change the cost of capital materially. They find a simple expression for the change in the cost of capital from ESG investing: (1) the fraction of ESG investors, (2) the fraction of green stocks, and (3) the correlation between the asset returns of the green and brown stocks. They carefully estimate these parameters from data. They find that the effect on the cost of capital is small, and, hence, the expected returns for green investors and brown investors are almost equal. They argue that the risk and return of the green stocks and brown stocks are highly similar, so they are highly substitutable. An investor can easily get the same expected return and risk in a portfolio with or without brown stocks. Another reason for finding a small effect is their claim that only 2 percent of the investors are green investors, which is a very small fraction.

Expected ESG-related risks

In addition to investors' preferences, risk can also affect the expected returns for green or brown firms. If ESG is a risk factor, it can affect the expected return of the stocks in addition to other risk factors like market risk. For example, fossil fuel producers may face risks associated with climate or regulatory shocks to which renewable energy producers are immune. Cornell (2021) argues that if ESG is a risk factor, brown stocks should have a higher risk premium coming from ESG-related risk. Investors that buy green stocks will get

lower expected returns. Yet they are happy because they have a portfolio that hedges them against ESG-related risks. If there are ESG-related risks and investors do not know about them, the green stocks are underpriced. So those who hold them can enjoy higher risk-adjusted expected returns (positive alpha). If investors learn that there are ESG-related risks and green stocks can reduce that risk, they start buying those stocks which implies an increase in their stock prices. As in the case of the transition period discussed for preferences, green investors enjoy temporary higher returns. However, in the new equilibrium, the expected returns of the green investors are lower. Yet they are happy because they have a portfolio that insures them against ESG-related risks.

Luo and Balvers (2022) study the theoretical effect of divestment in brown stocks. They identify a boycott factor risk premium and show that this is positive. Pastor, Stambaugh, and Taylor (2020) also provide a model featuring agents with ESG preferences and ESG investing as a strategy for a hedge against climate risk. In equilibrium, green assets have negative CAPM alphas, whereas brown assets have positive alphas. Green assets' negative alphas stem from investors' preference for green holdings and from green stocks' ability to hedge climate risk. Therefore, the expected returns of green investors are lower in equilibrium.

Is there any theory that shows green stocks can outperform brown stocks?

So far, we have argued that both investors' preferences and ESG-related risks imply lower expected returns to ESG investing in equilibrium. We also argued that during a transition period when green stock prices increase, green stocks outperform brown stocks, but thereafter, brown stocks outperform green stocks. Beyond this channel, few other studies try to rationalize how green assets can outperform brown assets except under specific, usually transitory, conditions.

Unexpected ESG-related risks

Pastor, Stambaugh, and Taylor (2020) argue that if ESG concerns strengthen unexpectedly, green assets can outperform brown ones despite having lower expected returns. For example, if the government surprises investors by introducing new regulations that penalize firms with high carbon emissions, the demand for firms with low carbon emissions (good performance of E in ESG) increases. This results in higher prices for those stocks, so during the period that new information is incorporated into the asset prices, green stocks outperform brown stocks. Note that the shock should be unexpected. If it is an expected shock, it is already reflected in asset prices and an ESG-related risk premium. Moreover, note that this channel again provides higher returns for green assets only during a transition period.

ESG, profitability, and mis-pricing

Pedersen, Fitzgibbons, and Pomorski (2020) derive a model that includes investors whose preferences depend on ESG scores. Moreover, ESG scores can be used as a signal for profitability of the firms. They assume there are three types of investors: ESG-unaware, ESG-aware, and ESG-motivated. ESG-unaware investors are those who do not know that ESG scores are a signal for the profitability of the firm, so they do not consider ESG scores in their investment decision-making. ESG-aware investors know that there is a link between profitability and ESG scores, so they use this information. ESG-motivated investors are aware investors who also enjoy non-pecuniary utility from holding stocks with high ESG scores. Like previous studies, if the economy includes ESG-aware and ESG-motivated investors, ESG-motivated investors bid up the price of high ESG-scoring stocks. In equilibrium, the average ESG score of the ESG-motivated investors is higher, and their expected returns are lower compared to ESG-aware investors. If the economy only includes ESG-aware investors, the expected return of stocks is independent of ESG scores. The reason is that ESG scores are assumed to be a signal of profit, not risk. If firms with high ESG scores have higher profits compared to the low ESG score ones, the stock prices of firms with high ESG scores will be higher such that the expected returns of firms with any ESG score are equal. They argue that there is a case in which high ESG-scoring stocks outperform low ESG-scoring stocks. This is the case where the economy has a large enough fraction of ESG-unaware investors and ESG is a positive signal for profitability. If these assumptions hold, high ESG-scoring stocks deliver high expected returns. This is because high ESG-scoring stocks are profitable, yet their prices are lower than they should be, leading to relatively high future returns.

Disagreement in ESG ratings

The relationship between ESG investment and performance can also be ambiguous due to uncertainty in ESG ratings. When attempting to assess the impact of ESG information on investment performance it should be clear what is meant by "ESG information." There are a large number of organizations attempting to answer that question. Li and Polychronopoulos (2020) report that as of year-end 2019 they had identified 70 different firms that provide some sort of ESG ranking system. This problem would not be so bad if all the ratings were effectively similar, but this is not the case. There is a substantial literature documenting the divergence of ESG ratings for the same firms. The rating organizations differ not only in how to measure the various ESG criteria but also on the criteria that are deemed worthy of measurement.

"There is a substantial literature documenting the divergence of ESG ratings for the same firms. The rating organizations differ not only in how to measure the various ESG criteria but also on the criteria that are deemed worthy of measurement."

How does disagreement among ESG rating providers affect the relationship between ESG investing and expected returns? Avramov, Cheng, Lioui, and Tarelli (2021) answer this

question. They study the asset pricing and portfolio implications of an important barrier to sustainable investing: uncertainty about the corporate ESG profile. Consistent with previous studies in which there were no uncertainties surrounding the ESG rating of a firm, they show that ESG ratings are negatively associated with future performance when there is little uncertainty. They further show that the ESG-performance relationship could be insignificant or positive when uncertainty increases.

Berg, Fabisik, and Sautner (2020) document widespread changes (re-writing) to the historical ratings of Refinitiv ESG, a key ESG rating provider, which offers one of the most comprehensive ESG databases in the industry. To document the rewriting of the ESG scores, the researchers twice downloaded the same Refinitiv ESG data for the same set of firm-years at different points in time. They downloaded the first ("initial)" version of the data in September 2018, and the second ("rewritten") version two years later in September 2020. Across these two downloads, they document large re-writings of ESG ratings. They demonstrate that these changes affect tests that relate ESG ratings to returns. They find no difference between the stock returns during the COVID-19 pandemic in the initial data when they classify the data to high E&S and low E&S scores. However, they find higher returns for high E&S score stocks in the re-written data. They further show that the data rewriting is an ongoing rather than a one-off phenomenon.

3. Literature Review–Empirical Evidence

In this section, we discuss empirical evidence from previous studies for the relationship between ESG investing and asset returns. We first summarize the studies that find a negative association, then those that find no association, and finally those that find a positive association. The empirical strategy for most studies is to define two groups of assets (green and brown), and then compare their risk-adjusted returns. For example, green stocks can be those with higher ESG ratings and brown stocks can be those with lower ESG ratings. The main challenge in this line of research is to find risk-adjusted expected returns. If we want to compare the expected returns of green stocks with brown stocks, we should make sure the expected return does not include any risk differences that are not controlled for. In the language of CAPM, this line of research tries to correctly estimate the alpha. Berk and van Binsbergen (2021) argue that one important concern in this literature is that many brown stocks are concentrated in particular industries, so the results might reflect risk differences that are uncontrolled by the models and are attributable to industry-specific risks.

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Negative performance from ESG investing

Hong and Kacperczyk (2009) find that "sin stocks" (tobacco, alcohol, and gambling firms) are less widely held by norm-constrained institutions such as pension plans as compared to mutual or hedge funds that are natural arbitrageurs. Sin stocks also have higher expected returns than otherwise comparable stocks, consistent with them being neglected by norm-constrained investors and facing greater litigation risk heightened by social norms.

Raghunandan and Rajgopal (2022), show that ESG funds appear to underperform financially relative to other funds within the same asset manager and year, and to charge higher fees.

Bolton and Kacperczyk (2021) argue that firms with higher total carbon dioxide emissions (E in ESG) earn higher returns, controlling for size, book-to-market, and other return predictors. Barber, Morse, and Yasuda (2021) show that investors derive non-pecuniary utility from investing in dual-objective Venture Capital (VC) funds, thus sacrificing returns.

Baker, Bergstresser, Serafeim, and Wurgler (2018) and Zerbib (2019) focus on the bond market instead of the stock market. Baker, Bergstresser, Serafeim, and Wurgler (2018) study green bonds, which are bonds whose proceeds are used for environmentally sensitive purposes. After an overview of the US corporate and municipal green bonds markets, they study pricing and ownership patterns using a simple framework that incorporates assets with non-pecuniary utility. They find that green municipal bonds are issued at a premium to otherwise similar ordinary bonds. Zerbib (2019) used green bonds as an instrument to identify the effect of non-pecuniary motives, specifically pro-environmental preferences (E in ESG), on bond market prices. They found a small negative premium: the yield of a green bond is lower than that of a conventional bond. On average, the premium is -2 basis points—or (negative) two hundredths of one percent.

Chava (2014) focuses both on the equity and bond markets to analyze the impact of a firm's environmental profile on its cost of equity and debt capital. Using the implied cost of capital derived from analysts' earnings estimates, Chava found that investors demand significantly higher expected returns on stocks excluded by environmental screens (such as hazardous chemicals, substantial emissions, and climate change concerns) compared to firms without such environmental concerns. Lenders also charge a significantly higher interest rate on the bank loans issued to firms with these environmental concerns. These results suggest that exclusionary socially responsible investing and environmentally sensitive lending can have a material impact on the cost of equity and debt capital of affected firms.

El Ghoul et al. (2011) examine the effect of corporate social responsibility (CSR) on the cost of equity capital for a large sample of US firms. They find that firms with better CSR scores enjoy cheaper equity financing. In particular, their findings suggest that investment in improving responsible employee relations (S in ESG), environmental policies (E in ESG), and product strategies contribute substantially to reducing firms' cost of equity. Their results also show that participation in two "sin" industries, namely, tobacco and nuclear power, increases firms' cost of equity. These findings support arguments in the literature that firms with socially responsible practices have a higher valuation and lower risk.

No significant difference in performance from ESG investing

Fish, Kim, and Venkatraman (2019) ask whether or not an investor would sacrifice a portfolio's performance in order to achieve a socially responsible portfolio. They collected ESG scores from Bloomberg and historical performance on various securities in both the United States and Europe in order to construct various portfolios. They show that minimal differences existed between the returns of the ESG-weighted portfolios and the non-weighted portfolios.

Hartzmark and Sussman (2019) find that investors value sustainability: being categorized as low sustainability resulted in net outflows of more than $12 billion while being categorized as high sustainability led to net inflows of more than $24 billion. Experimental evidence suggests that sustainability is viewed as positively predicting future performance, but they do not find evidence that high-sustainability funds outperform low-sustainability funds. The evidence is consistent with the view that non-pecuniary motives influence investment decisions.

Unlike other studies, Berk and van Binsbergen (2021) do not estimate risk-adjusted returns. Instead, they identify the effect of ESG scores on expected returns by following firm changes in ESG status. When firms are either included or excluded from the leading socially conscious US index (FTSE USA 4Good) they find no detectable effect on the cost of capital (expected returns). They conclude that current ESG investment strategies have had little impact and will likely have little impact in the future.

Positive performance from ESG investing

Edmans (2011) focuses on employee satisfaction (E in ESG) and stock returns and shows evidence that the "100 Best Firms to Work for in America" outperformed the industry benchmarks between 1984 and 2009.

Khan (2019) finds nonfinancial performance measures, such as ESG measures, are potentially leading indicators of companies' financial performance. He developed new corporate

governance and ESG metrics. The new metrics predicted stock returns in a global investable universe over the tested period, which suggests potential investment value in the ESG signals.

Nagy, Kassam, and Lee (2015) find that ESG can add alpha. They find portfolios that incorporate ESG as an investment signal outperformed the MSCI World Index over the sample period while also increasing their ESG profile.

Gompers, Ishii, and Metrick (2003) argue shareholder rights (G in ESG) vary across firms. Using the incidence of 24 governance rules, they constructed a "Governance Index" to proxy for the level of shareholder rights at about 1,500 large firms during the 1990s. An investment strategy that bought firms in the lowest decile of the index (strongest rights) and sold firms in the highest decile of the index (weakest rights) would have earned abnormal returns of 8.5 percent per year during the sample period. They found that firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures, and made fewer corporate acquisitions.

Kempf and Osthoff (2007) ask whether investors can increase their performance by incorporating socially responsible screens into their investment process. To answer this question, they implement a simple trading strategy based on socially responsible ratings from KLD Research and Analytics: they buy stocks with high socially responsible ratings and sell stocks with low socially responsible ratings. They find that this strategy leads to abnormally high returns. The maximum abnormal returns are reached when investors employ the best-in-class screening approach, use a combination of several socially responsible screens at the same time, and restrict themselves to stocks with extreme socially responsible ratings.

4. Why is the Empirical Evidence Mixed?

There are three plausible reasons for the mixed empirical evidence: 1) there is a transition period; 2) there is no standard ESG measure; and 3) there are uncontrolled risks.

Transition period

Cornell (2021) argues we might observe contrasting evidence for the relationship between ESG ratings and returns during a transition period to a new equilibrium. For example, when the investors begin to realize that moving to a greener portfolio will reduce ESG-related risks or more investors gain non-pecuniary utility from holding green assets, green asset prices and investors holding the assets earn excess returns. So, the results of the empirical studies may quite depend on what period is studied.

Pedersen, Fitzgibbons, and Pomorski (2020) find that if an ESG score is a signal for higher profitability of the firms and a significant fraction of investors are unaware of this, a stock with a higher ESG score will outperform the one with a low ESG score. The reason is that the higher profitability of these stocks is not fully understood by the market, so they are underpriced.

No standard ESG measure

Berg, Koelbel, and Rigobon (2019) document that ESG ratings from six dominant providers (KLD, Sustainalytics, Moody's ESG, S&P Global, Refinitiv, and MSCI) disagree substantially. This disagreement also contributes to the ambiguity in empirical evidence for the relationship between ESG ratings and returns because it is difficult to determine which firms are "high" ESG firms. Avramov, Cheng, Lioui, and Tarelli (2021) build a theoretical model to show how an increase in uncertainty surrounding ESG scores may result in observing a positive relationship between expected returns and ESG scores.

Uncontrolled risks

Berk and van Binsbergen (2021) argue that one important issue with many empirical studies investigating the relationship between ESG ratings and equity returns is that the risk of a firm and thus the risk-adjusted return of that firm should be correctly measured. If not, the observed "sin" premium could well be attributable to an incorrect adjustment for risk (Blitz and Fabozzi 2017).

Conclusion

There is a growing demand for ESG information and investing. In response, many jurisdictions (e.g., the US Securities and Exchange Commission) are considering implementing ESG reporting mandates to encourage ESG investing by helping investors more accurately identify firms with better ESG metrics (green firms) from those with inferior ESG performance (brown firms). The ultimate goal of mandating enhanced ESG reporting is to drive change by giving firms and incentive to improve their ESG activities. One potential channel for this policy to achieve its goal is through changing the cost of capital.

In this essay, we examine the theoretical literature on ESG investing. Specifically, we discuss how each framework can potentially justify an ESG-reporting mandate, and what the frameworks predict for returns to ESG investing. We highlight two dominant conceptual frameworks.

First, investors have a non-pecuniary preference for green firms, and thus they are willing to accept lower returns for holding stocks and bonds that are issued by green firms. If investors can materially increase the asset prices of green firms, these firms will face lower financing costs (lower cost of capital) so that they can invest more and grow more, which drives the intended social outcome, i.e., increased ESG corporate practices. In this scenario, mandating ESG reporting may be justified if investors have difficulty identifying green firms from the brown ones, and if firms provide better ESG information to investors under the mandatory regime.[7] However, we find that the empirical results examining the returns to ESG investing are inconclusive, so we do not know whether reporting regulations operating through the channel of investors' preferences will be effective or not in indirectly influencing corporate ESG practices.

Second, green firms may have higher profitability and/or lower ESG-related risks, while investors are broadly uninformed of this material information. In this case, green assets will be underpriced and so provide higher expected returns for investors who hold them. In this scenario, mandatory ESG reporting might be justified as long as firms provide better ESG information to investors under the mandatory regime. However, since we find inconclusive empirical results bearing upon this relationship, it is unclear whether the argument for remediating this possible information problem is relevant.

"Since there is no agreement in the literature on how ESG investing is associated with asset returns, advocates for mandating enhanced ESG reporting have not yet made a credible case for how this policy can have any net positive social impact."

In sum, since there is no agreement in the literature on how ESG investing is associated with asset returns, advocates for mandating enhanced ESG reporting have not yet made a credible case for how this policy can have any net positive social impact.

Endnotes

1 At the start of 2020, *Global Sustainable Investment Review* reports that global sustainable investment reached US$35.2 trillion in five major markets, which make up a total of 35.9 percent of total assets under management. Sustainable investment assets are continuing to grow rapidly in all regions, with Canada experiencing 48 percent growth over two years (2018-2020), the largest increase among the five major markets.

2 ESG investing can also be called corporate social responsibility (CSR) investing, or sustainability investing.

3 See Christensen, Hail, and Leuz (2021) for all potential costs and benefits from mandatory ESG reporting.

4 This is related to what Christensen, Hail, and Leuz (2021) refer to as the goal of the "broad approach" to this policy.

5 Another example: Lodh (2020, February 25).

6 The assumption here is that there is a disutility to holding shares of brown firms, and that investors must be compensated for this disutility.

7 Whether more intensive ESG behavior by firms has net social benefits is a separate and relevant empirical issue.

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The Fallacies Undermining Energy Security

Derek Burney

Russia's invasion of Ukraine is not only causing grievous harm to the Ukrainian people but is also triggering the need for a sensible recalibration of energy policy, especially by western democracies that are manifestly obsessed with climate change.

Canada and the United States should both hit the pause button on climate orthodoxy so they can unleash their extensive oil and gas resources to help staunch inflation, bolster growth at home, and seek to displace Russia as the key supplier to Europe and other markets. The wrong climate policy at the wrong time gave Russian President Vladimir Putin an undeserved financial bonus (in the form of higher oil and natural gas prices) enabling his brutal assault on his neighbour. Oil and gas are vital to our mutual security and our energy advantages should not be frittered away to geopolitical adversaries or sacrificed to illusory climate change prophecies. Geopolitical realism and energy realism go hand in hand.

> "Geopolitical realism and energy realism go hand in hand."

Our two countries should adopt a common strategy. Canada cannot act unilaterally on climate change oblivious to what the United States, our largest trading partner, is doing. A carbon tax is not part of President Joe Biden's plan for America. When combined with subsidies for exclusively American-made electric vehicles, Canada's competitiveness would face a double whammy.

President Biden has been forced by rampant inflation and the war in Ukraine to prioritize energy security at least partially, unleashing record amounts of crude oil from strategic reserves, urging drillers to pump harder to meet demand and lifting sanctions on Venezuelan oil while ignoring supply opportunities from Canada. His climate change policies are stymied in Congress.

Canada has made no moves to strengthen energy security. Instead, it has doubled down on climate change, increasing the carbon tax and announcing a $9.1-billion plan to reduce carbon emissions by at least 40 percent below 2005 levels by 2030. Expecting the goal to be met by relying on such renewables as wind, solar, and biomass stretches credulity. The fact that the plan was presented without a detailed analysis of the economic consequences is irresponsible. Since Canada has missed every goal it has ever set, it is unserious.

Successful investing—the deployment of capital based on expectations of future returns—is grounded in realism, not fantasy or pseudo-science. Constraints on supply, as implemented by Canada and the US, inevitably drove up oil and gas prices, making Canadians and Americans poorer and Putin richer.

Climate change activists are intolerant of rational debate. Those who try to temper discussion, noting that the pace and cost of a transition to renewables need more realistic assessments, or that the science is not "settled," are branded as heretics.

"Woke capitalism" and the ESG movement

Today's "wokeness" trend not only affects cultural, racial, and biological identities, but has given birth to the fallacy of "woke capitalism," underpinned by ESG (environmental, social and governance) tenets relentlessly pursued by elitist CEOs, major financial institutions, and central bankers. Inspired by dubious net-zero climate change projections, these tenets are being used to stifle a vital sector of North American economies.

> "ESG principles restrict entrepreneurs from responding properly to market signals and serving the interests of their customers and shareholders."

ESG principles restrict entrepreneurs from responding properly to market signals and serving the interests of their customers and shareholders. As James Freeman observed, "ESG is about controlling and forcing behaviors. It attempts to do through capital markets what activists and their government allies are unable to do through democratic processes—using economic force to drive a political agenda" (Freeman, 2022, April 25).

Politicians tend to follow the whim of the moment, ignoring hard truths about the impacts their actions will have on economic growth. Unlike elected politicians, woke investors are not accountable for the effects of their climate policies. CEOs, bankers, and financial institutions should focus more on basic economics, not virtue signaling, and leave the evangelizing on climate change to those who have created an industry for the cause (adapted from Burney, 2022, March 15).

Financiers and corporate chieftains should recognize the distinction between pragmatic prescriptions for economic growth and sophomoric crusades about an issue outside their expertise. A more realistic and expansive approach to energy would help contain inflationary pressures and serve our geopolitical security interests.

Politicians, notably in the US, fear the political consequences of enacting regulations and prefer to push the issues onto financial markets and their regulators—flagrant buck passing and very bad public policy.

ESG funds today command a market of $35 trillion. By 2025 that is expected to grow to $53 trillion (Diab and Adams, 2021, February 23). The scope for market distortions, and the costs therein, will grow exponentially.

The latest epistle in the ESG catechism comes from the US Securities and Exchange Commission's new climate disclosure regime requiring stronger quantification of a company's greenhouse gas emissions. SEC Chairman Gary Gensler claimed that forcing companies to make such disclosures is rooted in the concept of materiality. If investors say they need the information, it must be material. But Hester Peirce, the sole Republican Commissioner, dissented sharply saying, "Let's be honest about what this proposal is really trying to do. Although styled as a disclosure rule, the goal of this proposal … is to direct capital to favoured businesses and to advance favoured political and social goals" (Darwall, 2022, March 30).

Climate disclosure is not, as the SEC purports, about giving investors information about climate risk. Rather, its main purpose is to force companies to provide information so that shareholders, interest groups, and others can force "net-zero" targets on them through proxy votes and other forms of engagement. As Rupert Darwall indicated, "By helping investors impose their desired energy policies on American oil and gas companies, the SEC is undermining the national security prerogatives of the Biden Administration and eroding America's ability to meet the challenges of a dangerous world" (2022, April 18).

This is a case of overreach by the SEC. First of all, "net-zero by 2050" is the policy of the Biden Administration but it has no legal status in the United States and, given the prospects for the November elections, is not likely to gain that status.

Nonetheless, the regulatory initiative will likely push investments in oil and gas into private rather than public companies and away from Wall Street-listed enterprises to overseas ones, especially non-Western companies less vulnerable to climate activism, where regulations and investor oversight are weaker if not non-existent—the dark side of woke capitalism. The net result risks being negative to America's national interest and to the SEC's place in constitutional governance.

The SEC proposal was staunchly denounced by Senator Pat Toomey, the ranking member of the Senate Banking Committee for hijacking the democratic process and distaining the authority Congress gave the SEC. "With inflation at a 40-year high, gas prices sky-rocketing, and Russia waging an energy-funded war, the last thing the American people need are unelected regulators advancing policies by partisan vote that will cause energy costs to

further rise."[1] Senator Joe Manchin, Democratic Chair of the Senate Energy and Natural Resources Committee, expressed similar opposition, saying the proposals go against the regulatory body's stated mission, and that such policies add undue burdens on (fossil fuel) companies (Franck, 2022, April 4).

Inevitably the issue will move to the courts.

ESG-related quantitative metrics and analytical frameworks are inconsistent and unreliable. Besides, companies like Amazon are gaming the system by boosting their ESG ratings while hiding the Scope 3 emissions of suppliers because the system has neither uniform standards nor measures of enforcement. Only a small minority of manufacturing and service companies report Scope 3 emissions, which are the result of activities from assets not controlled by the reporting organization but that the organization also indirectly impacts in its value chain.

As reported in the *Globe and Mail*, there are serious problems with rating the ESG performance of companies, including widely conflicting approaches and estimates used by data analysts (Bein, 2022, April 18). When S&P delisted Tesla from its ESG list, Elon Musk labelled the notion of ESG as "a scam, one weaponized by phony social justice warriors" (Beals, 2022, May 23). Inexplicably, S&P rates Russia's leading bank, Sberbank, which was sanctioned by both the US and the EU following Russia's takeover of Crimea, higher than America's largest bank, J.P. Morgan. Similarly, S&P gave China's state-owned China Petroleum and Chemical Corp a higher ESG rating than ExxonMobil and Chevron despite China's flagrant human rights abuses (Freeman, 2022, April 25).

> "The real challenge is to accept the risk of technological innovation and provide positive incentives, like tax credits, to encourage change."

Ignored in all the ESG mania is the utility of encouraging, not demeaning, technological innovation to reduce emissions, as has been taking place in Canada's oilsands over the past 20 years. The consequences of innovation are not instantaneous. The real challenge is to accept the risk of technological innovation and provide positive incentives, like tax credits, to encourage change.

As more decisions in Canada are driven by US financial markets, that will ultimately lead to a loss of sovereignty as well as a loss of energy security. We need a coherent, less self-defeating approach.

The transition to renewables is problematic

The transition to renewable energy will take much longer than the perky forecasts emanating from global climate change summits suggest, and the promise of renewables has been oversold. Russia's invasion of Ukraine aggravated matters even further by injecting turmoil into world energy markets.

As Jack Mintz and Ron Wallace observed in a paper for the Macdonald-Laurier Institute, "Current North American and European energy policies are problematic as they ultimately

undermine economies, energy and national security… Limiting production of fossil fuels in the West at rates faster than can be reasonably and economically replaced with alternative power would lead to market instabilities, power interruptions and price increases" (Mintz and Wallace, 2022).

Attempting to honour net-zero by 2050 "much of Europe went massively green, tossed away energy it had, which was both sensible and reliable, and signed on to the fantasy of net zero" (Murphy, 2022, March 30). Now they are desperately trying to switch gears by jettisoning plans intended to meet the 2050 target and reducing excessive dependence on Russia.

Eighty percent of the energy base for today's $86 trillion global economy comes from hydrocarbons. Moving to a net-carbon-free energy system for a $185 trillion economy in 2050 and accomplishing much of that by 2030 simply will not happen. We need to challenge climate orthodoxy and shake off woke constraints on our hydrocarbon industries.

Developing countries like India and Nigeria see hydrocarbon energy as essential to their economic growth aspirations whereas climate change is seen as an elitist concern addressed most vigorously by developed nations that are at the top of the economic pack.

Nigeria, with a population of more than 215 million and a per capita income that is one-twelfth that of the US, depends on oil and gas for 70 percent of its budget and 40 percent of its GDP. No wonder it, along with China and India, pushed out its "net-zero" commitment later into this century, long after the current leaders will have left office.

The extent to which the world depends on oil and gas for much more than energy also needs to be better understood. Oil and gas are deeply embedded throughout modern life. As Daniel Yergin stated in *The Atlantic*, "Plastics are used in wind towers and solar panels, and oil is necessary to lubricate wind turbines… The air frames of the Boeing 787, Airbus 350 and F-35 Joint Strike Fighter jet are all made out of high-strength, petroleum-derived carbon fibre" (Yergin, 2021, November 27). What will substitute for these inputs? The number of passenger planes is expected to double in the next two decades. They are unlikely to run on batteries. Nor will the tens of thousands of semi-trucks essential to the distribution of goods across North America.

"The extent to which the world depends on oil and gas for much more than energy also needs to be better understood. Oil and gas are deeply embedded throughout modern life."

Is the science really settled?

Climate change has been perceived as a debate between true believers and deniers with no middle ground for realism. Many in the media, politics, and academia have concluded unequivocally that "the science is settled." Yet, others like Steven Koonin (formerly a top science adviser to the Obama Administration) offers a more nuanced perspective (Koonin, 2021). He dispels popular myths and unveils little-known truths, for instance, that global temperatures actually decreased from 1940 to 1970. Moreover, the models used to predict the future are not able to describe accurately the climate of the past, suggesting that they are inherently flawed.

"Climate change has been perceived as a debate between true believers and deniers with no middle ground for realism."

In reviewing Koonin's book, William W. Hogan, professor of Global Energy Policy at Harvard Kennedy School, observed, "The science of climate is neither settled nor sufficient to dictate policy. Rather than an existential crisis, we face a wicked problem that requires a practical balance of costs and benefits" (Hogan, Undated).

Koonin states that heat waves are not more common today than in 1900, tornadoes are not trending up, nor are droughts, hurricanes, or flooding. He criticizes the media for claiming, without evidence, that extreme weather is somehow related to human activities.

He accepts that fossil fuel emissions resulting from human activities likely do have an impact on the climate, but the scale of the challenge is uncertain and probably will not be an insurmountable problem for humanity in the foreseeable future.

As for prescriptions, Koonin offers two Plan Bs: more research into geoengineering, which includes changing the reflection of the Earth so it absorbs less energy from the sun, and capturing carbon dioxide and disposing of it, along with a greater focus on adaptation, the latter being the more feasible approach. Humans have always adapted to extremes and will continue to do so. Yet, the extreme measures enacted or proposed to control the supposed man-made contributions to climate change are not justified by the evidence. Even more troubling is the fact that the costs of these proposals will amount to trillions of dollars and will destroy industries and the jobs that go with them—an existential crisis in a more immediate time frame.

The concerns of most people are immediate—inflation, health care, education, and economic growth are perennial, practical priorities that democratic governments ignore at their peril.

Canada stands unwittingly alone

Seemingly oblivious to convulsions in the world energy market following Russia's invasion of Ukraine and the priority need for energy security, Canada's government stands at the extremity of climate hypocrisy. Being perceived as naïve on world affairs means you are also deemed irrelevant.

While intensifying commitments to unrealistic climate goals, the same government continues to throttle our ability to develop and transport our substantial oil and gas resources. We have not been able to increase outputs to help the US and European allies and instead have urged allies in Europe to invest even more in renewables at a time when countries such as Germany are obliged to resuscitate coal and nuclear production.

Europe is a market that North America should serve reliably. Yet hypocritically, just before claiming that Canada "would look at options around LNG to help wean Europe away from Russian gas" (Tumilty, 2022, March 9), the government rejected a proposal for an LNG facility north of Quebec City intended to do just that. LNG exports from our West Coast have been stymied by lawless protests and regulatory constraints.

Aided and abetted by foreign-funded activists, woke capitalists, and disciples of ESG, we are punishing responsible hydrocarbon production and driving a political wedge between regions that is divisive and dangerous to national unity.

> **"Ensuring access to reliable, affordable energy is vital to our economic growth and national security."**

Ensuring access to reliable, affordable energy is vital to our economic growth and national security. Establishing a common strategy for energy independence with the United States would do more for our well-being than obsessing over climate change, bearing in mind that Canada is 1.6 percent of the global emissions problem. That Canadian tail will not wag the dog on climate change.

Endnote

1 Quoted by CNBC's Pippa Stevens on April 4, 2022.

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Market Forces Already Address ESG and "Stakeholder Capitalism" Concerns[1]

Eugene F. Fama

There is currently much discussion of stakeholder capitalism, the proposition that firms should be run in the interests of all their stakeholders, including workers, various types of securityholders, and perhaps customers, and not just shareholders. My theme is that contract structures—the contracts negotiated among a firm's stakeholders—address stakeholder interests.

Contracts play a vital role in directing economic activity, but contracts can be costly to write and enforce, and the broader the set of stakeholders included in the contracting process, the more difficult it is for firms to operate efficiently. If all relevant stakeholders have the right to influence a firm's decisions regarding production and the distribution of profits, agreement about how these activities are to be carried out is unlikely to be achieved at reasonable cost.

A solution in this context is to structure relatively simple contracts whereby almost all *stakeholders* receive "fixed payoffs" or payment amounts. In return, the firm's *shareholders* get to make most of the decisions and enjoy (or suffer) the financial gains (or losses) resulting from the firm's behaviour. For most firms, the efficient contracting structure involves fixed promised payoffs for most stakeholders, with financial risks largely borne by the shareholders who have most decision rights.

In a competitive environment, fixed payoffs should reflect the risk of shareholders acting in an opportunistic way towards other stakeholders, e.g., failing to live up to the mutually agreed terms of contracts. Contracts that embody more risk of opportunism will require higher fixed payoffs. And as with any contract, the prospect of contract renegotiation limits

potential bad faith or opportunistic behaviour by firms who will likely be penalized by higher fixed payoffs in future contracts.

> **"Properly structured contracts between firms and stakeholders allow firms to deliver products demanded by consumers at the lowest possible cost, and competition among contract structures pushes toward this outcome."**

Properly structured contracts between firms and stakeholders allow firms to deliver products demanded by consumers at the lowest possible cost, and competition among contract structures pushes toward this outcome. This competitive process is likely to be more effective and efficient than externally imposed "top-down" governance structures with catchy names like stakeholder capitalism, which are likely rife with unintended consequences.

ESG (environmental, social, and governance)

If you follow the news, you've also likely heard of something called ESG, an acronym meant to spell out a set of behavioural standards for firms.

The G (governance) is easy to address. In a competitive market environment, the firm has incentives to choose a governance structure that allows it to deliver products to customers at the lowest cost. Constraints on governance choices (for example, laws that specify the racial or gender mix of boards of directors) likely introduce inefficiencies that consumers ultimately pay for in higher prices.

E&S (environmental and social) issues are more complicated. If environmental and social goals become a goal in consumer decision-making—for example, if consumers opt for free-range chicken and beef, which is more expensive to produce than would be true using alternative production techniques—firms will provide free-range poultry and meat without direct or indirect government regulations. Consumers vote at the checkout line and the economy produces the "right" amount of free-range poultry and meat. By responding to consumers' preferences, firms operating in competitive markets provide solutions to many E&S problems.

Asset markets (real estate, stocks, bonds) can also address E&S issues. Most asset-pricing models assume investors are only concerned with the expected risk-adjusted returns generated by their investments. In fact, investors might also care about the environmental and social actions of firms. As early as 2007, E&S considerations, (known as socially responsible investing) started showing up in the asset management industry. Today, there's a wide range of E&S investment products.

So what are the costs and benefits to firms who choose products and production techniques oriented toward E&S goals?

If some investors value the E&S actions of firms, a switch from E&S indifference to E&S virtue will reward firms with higher share prices, which imply lower costs of capital for virtuous firms. But higher share prices imply lower expected returns to shareholders. Moreover, even if all of a firm's investors agree that more E&S is better than less (or vice-versa), they are unlikely to agree on which specific E&S actions and in what amounts are preferable. This creates a decision quagmire for managers seeking to satisfy the divergent E&S interests of different shareholders.

For example, an E&S virtuous firm may transfer half of its annual profits (that would otherwise accrue to shareholders) to outside groups that fight for E&S issues (an environmental organization, for example). But for some investors, 50 percent may be too much; for others, too little. There will also likely be disagreement about how the 50 percent is split among different E&S actions.

How to resolve this problem? Hart and Zingales (2017) argue that since shareholders hold the decision rights, a shareholder vote is a possibility. But choosing the specifics of a question may itself prove difficult. A vote also implies winners and losers, and the possibility of unexpected actions that may offend the E&S tastes of some investors will likely make investors less willing to bear the costs of E&S commitments by firms.

Some ESG proponents argue that firms should prioritize shareholder *welfare*, not shareholder *wealth*. But again, shareholders have divergent tastes and interests. Firms that prioritize shareholder wealth rather than shareholder welfare will likely incur lower contract costs.

ESG and externalities

ESG proponents make many assumptions including that firms that prioritize shareholder wealth ignore the side effects or unintended consequences of their actions.

But is this true?

Consider this example. Suppose there are two ways to produce a product—the cheap way produces pollution that costs the firm nothing; the expensive way controls pollution but at some cost to the firm. If consumers are indifferent to pollution, dirty producers will drive out clean producers (Shleifer 2004). But if some consumers value less pollution or can be convinced by E&S arguments to value less pollution, they can vote for less by paying more for the version of the product produced cleanly (but at higher cost). The end result is a mix

of clean and dirty products that consumers vote for with their purchases. It seems that the market solves this ESG problem—but not necessarily and probably only partially.

Now suppose all consumers care about pollution, and dirty producers offer the same products as clean producers but at lower prices. Despite their distaste for pollution, some consumers will likely choose the products of dirty producers because they perceive that their individual choices have little effect on the total amount of pollution. In other words, there is a free-rider problem. Everybody would pay more for the products of clean producers if they could be convinced that other consumers would not cheat and buy dirty products.

> **"In the end… E&S activism to shape the tastes of consumers and investors may be more effective than regulation to address environmental externalities."**

A potential solution is to control dirty production with government regulation. But even with the government-imposed solution, there are tradeoffs of costs for benefits that change with the amount of pollution—and these tradeoffs change with the evolution of production technology that can better control pollution. In the end, imperfect though it may be, E&S activism to shape the tastes of consumers and investors may be more effective than regulation to address environmental externalities.

This is not to say that E&S consumer activism is a perfect remedy to environmental externalities. For example, suppose all consumers value (and are willing to pay for) less pollution, but all consumers don't buy all products (e.g., most men don't buy lipstick). In deciding whether or not to produce with less pollution, firms weigh the benefits to them of selling environmentally favourable products at higher prices versus the associated higher costs of producing those products. But this likely means they will ignore the benefits of less pollution to consumers who don't buy their products and will therefore pollute more than society ideally desires.

Indeed, it's difficult to find activities free of side effects and unintended consequences. For example, candy bars and sugared drinks are potentially toxic for consumers with a tendency towards diabetes. One might argue that personal freedom demands that such consumers eat and drink what they please since they bear the costs and benefits. But they don't bear all the costs if other people help pay for their health care through higher premiums for health insurance or socialized health care. Smoking and hard drugs are similar examples.

When pressured, the political process might address these problems but the solution will likely be clumsy at best. Given the inefficiencies of government regulation, activism that induces consumers and investors to value E&S-friendly products may be a better (though imperfect) alternative because it's essentially a market-oriented approach that better adjusts to unpredicted negative outcomes than political solutions.

Finally, ESG activism is likely to accomplish more by working through consumer tastes rather than investor tastes. Each consumer can react to each ESG action with respect to a specific product according to their tastes. But an investor is committed to the firm's set of ESG actions. As previously noted, given the divergent tastes of investors, the somewhat unpredictable ESG actions of firms will likely produce equally uncertain payoffs. The result is likely to be limited participation in ESG investment, even by investors committed to ESG action.

"Finally, ESG activism is likely to accomplish more by working through consumer tastes rather than investor tastes."

Conclusions

Generally, bottom-up market forces, while imperfect, especially in the presence of externalities, better address the issues raised by proponents of stakeholder capitalism and ESG than top-down government initiatives.

Endnotes

1 This essay is an abridged and edited version of Eugene F. Fama (2020), Market Forces Already Address ESG Issues and the Issues Raised by Stakeholder Capitalism, Harvard Law School Forum on Corporate Governance <https://corpgov.law.harvard.edu/2020/10/09/market-forces-already-address-esg-issues-and-the-issues-raised-by-stakeholder-capitalism/>, published in 2021 as "Contract Costs, Stakeholder Capitalism, and ESG" in European Financial Management 27: 189-195.

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Corporate Philanthropy: Stay in Your Lane

Marvin Olasky

In 1990 a Gatorade commercial told viewers to "Be Like Mike" (YouTube, 2006), but some chose not to when Michael Jordan refused to endorse a Democratic candidate for the US Senate, Harvey Gantt. Politics-first activists blasted Jordan for saying, "Republicans buy sneakers, too," but I think he was exactly right. Thirty years later he elaborated, "I wasn't a politician when I was playing my sport. I was focused on my craft." Jordan was staying in his lane.

Some business executives haven't heeded Jordan's advice. They go out of their lane and become Lady Bountifuls tossing coins from their carriages via company contributions programs. I can understand the inclination. Dolly Parton in the 1980 film *Nine to Five* belted out a reason for corporate philanthropy: "Working 9 to 5, what a way to make a living. Barely getting' by, it's all taking and no giving" (Parton, 1980). Some employees whose salaries are greater than "barely gettin' by" feel in a different way that they are taking, and they want a sense of giving.

One argument for corporate philanthropy is that it's in the corporate interest, a way to retain excellent employees who want their companies to have a more obvious linkage to benevolence. But here are two questions: Are business executives with talent in providing goods and services likely to be wise when they leave their lane and make contribution decisions concerning social problems? Are contributions that please some shareholders and stakeholders likely to damage a company's standing among others?

These are not new questions. Forty years ago, Democrats portrayed Ronald Reagan's tax and budget cuts as unfair to the poor. One of my tasks in 1982 in the Du Pont company public affairs department was to assess CSR, corporate social responsibility, that year's equivalent of ESG. Then on my vacation I wrote an article for *Fortune* based on interviewing White House

officials and assorted senators and CEOs regarding that year's new new thing, the President's Task Force on Private Sector Initiatives (Olasky, 1982, Sept. 20: 130).

The task force's best-known members were Common Cause founder John Gardner, who had been Lyndon Johnson's Secretary of Health, Education, and Welfare, and Kenneth Dayton, chairman of the executive committee of the Dayton Hudson department store chain. Dayton for years complained that corporations gave only one percent of their pretax profits to charity: He wanted it to be five percent.

The task force did not go that far, but recommended that by 1986 every American company, large or small, should give two percent of pretax net income to "nonprofit organizations engaged in public service" (Olasky, 1982, Sept. 20: 136). The task force also recommended doubling corporate "mobilization of their human resources in volunteer capacities." Its musings did not have the force of law, but advocates thought the prestige of a conservative president would make a big difference. "Reagan's task force is advancing a concept of corporate social responsibility that many of his followers have fought against," said Stanley Karson, director of the Center for Corporate Public Involvement (Olasky, 1982, Sept. 20: 136).

Karson offered a decade-old parallel: "Just as Nixon was the one man who could bring us closer to China, maybe Reagan through his task force will be the one to finally break down conservative business resistance in this area." In 1982, that seemed possible. Lloyd Dennis, senior vice president at the First Interstate Bank of California, said, "The juices are flowing. Public affairs heads are pushing the use of corporate resources in social areas. Their views are seeping up to chief executives" (Olasky, 1982, September 20: 136).

> "...corporations on average still donate about one percent of pretax net income (.94% in 2018)"

Other task force leaders I interviewed went even further. E.B. Knauft, director of policy development for the Private Sector Initiatives task force, called for corporations to weigh a manager's community involvement in his job performance and compensation ratings. That worried Alexander Trowbridge, president of the National Association of Manufacturers and a task force member: He wanted executives to know manufacturing, not social work, and he worried that the two percent goal might be just the start, with expectations escalating.

The most telling interview was with Mike Deaver, Reagan's top PR aide. He laughed at doom-laden forecasts and said the task force was all "public relations." He said the White House wouldn't do anything with the task force's recommendations. He predicted that nothing would change (Olasky, 1982, Sept. 20: 136).

Deaver was right. Dayton's proposals have wandered in the wilderness for 40 years, and corporations on average still donate about one percent of pretax net income (.94% in 2018) (McClimon, 2020, January 16). Three recent trends, though, are worth observing in the way my dentist says, regarding a tooth that may be developing a cavity, "we'll put a watch on that":

- In 2020 the United States, which was always in the top 10 for donating and often number 1, fell to number 24 of the 114 countries surveyed. Canada, also usually in the top 10, fell to number 25. Indonesia and Myanmar leapt to first and second place (Charities Aid Foundation, 2021: 15 and 18). The COVID-19 pandemic may have had an impact: The 2022 results may be more telling.
- In some other countries with venerable charitable traditions, official tax records show fewer people are making donations. The Fraser Institute showed that in 2019, the latest data year, only 19 percent of Canadian tax-filers listed donations: That's down from 25.5 percent in 2000 (Fuss and Li, 2021). In Australia, 29 percent of taxpayers claimed a charitable donation, the first time in 40 years that the percentage fell under 30 percent (Mcgregor-Lowndes, Balczun, and Williamson, 2021).
- Several other countries have put into practice what both their own economists and the US task force suggested. The government of India in 2013 decreed that all companies except small ones had to contribute two percent of their profits. Each company must create a Corporate Social Responsibility Committee to decide who should receive that two percent: Groups devoted to fighting hunger, promoting education and vocational skills, improving health, ensuring environmental sustainability, or empowering women, are eligible (Grant Thornton International, Undated: 4-5).[1]

Some observers are concerned about a possible "crowding out" effect if an ESG surge creates corporate philanthropy quotas. In the US, it's true that corporate contributions play only a minor role in the overall philanthropic world—four percent of total philanthropy (Giving USA, 2021). But in the 1930s increased governmental social expenditures crowded out at least 30 percent of private giving to fight poverty. It became easy to say, "I pay taxes to support x, y, or z, so why should I donate?" (Bredtmann, 2019).

Proponents of expanded corporate philanthropy argue that such spending would increase public awareness of nonprofits and result in more donations of money and time. Research published in the *Journal of Consumer Psychology*, though, suggests the opposite. In one study, participants with play money reviewed two nonprofit organizations (similar in mission, main programs, and degree of government support) and had to decide how much they would donate. The only difference between the two: the majority of the funding for one charity came from corporate sponsors, the other heavily relied on individual donors. Individuals chose to give less to the nonprofit with corporate sponsors (Bennett, Kim, and Loken, 2013: 293-294).

That result is in line with the theory of "social loafing," which refers to the finding that individuals work and contribute less when they are part of a collective than when they are individually responsible for the outcome (Latané, Williams, and Harkins, 1979). Example: The College of Idaho, founded in 1891, began receiving in 1991 a share of the profits of the big supermarket chain Albertson's, Inc., and renamed itself Albertson College of Idaho. (Alumnus Joe Albertson had met his wife in a College of Idaho chemistry class.) Individual contributions dropped, and the institution's name in 2007 became once again the College of Idaho (Bennett, Kim, and Loken, 2013: 290).

Such "loafing" is particularly likely if other members of a collective are rich, as many big corporations are perceived to be. This is speculative: We don't know what will happen if corporate philanthropy increases. It's more clear what will happen if companies "turn over their decision-making on contributions to community foundations," as task force policy director Knauft suggested 40 years ago: "We should make sure that corporations aren't just giving to the petroleum geology departments of universities" (Olasky, 1982, Sept. 20: 130).

The corporate executive I knew best from writing many speeches for him was DuPont senior vice president Dick Heckert, later the CEO. He had a PhD in organic chemistry and knew a lot about that and business, but he didn't pretend to know much about subjects in the humanities and social sciences. He became chairman of the National Association of Manufacturers and thought a petroleum geology department was exactly what an oil company should support, since its executives would be able to assess it more accurately than they could evaluate a program in literature or art.[2]

> "...business executives with talent in providing goods and services are often unwise when they leave their lanes."

I learned during the 1980s that business executives with talent in providing goods and services are often unwise when they leave their lanes. For example, defense contractor Honeywell was showing community-spirited interest in the arts by financing the production of a musical, *Peace Child*—but it turned out that *Peace Child* showed how the US "military industrial complex" was purportedly the world's major obstacle to peace. (Two years later the Berlin wall came down, and two years after that the Soviet Union fell apart because it could not keep up with US efforts.) Honeywell also underwrote a seminar series by "peace activists" attacking military spending. Because appeasement signifies weakness, several activists dug graves on Honeywell property as soon as the seminars ended, while others blocked Honeywell's entrance until the police arrived.[3]

Such corporate anti-corporate donations did not surprise economist Milton Friedman, who had long noted that business executives "are capable of being extremely far-sighted and clear-headed in matters that are internal to their businesses. They are incredibly short-sighted and muddle-headed in matters that are outside their businesses" (Friedman, 1970, Sept. 13: SM 17). But Friedman was not against corporate philanthropy tied to a company's business:

"It may well be in the long-run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government. That may make it easier to attract desirable employees. It may reduce the wage bill or lessen losses from pilferage and sabotage or have other worthwhile effects" (Friedman, 1970, Sept. 13: SM 17).

Economist Milton Friedman

I saw this close-up during the 1980s. It was fine for Irving Shapiro, the Du Pont CEO during most of my five years in the corporation, to comment on Superfund clean-ups of environmental hazards: Part of that was the chemical industry's responsibility.[4] It was also fine for Du Pont, with headquarters in downtown Wilmington, Delaware, to increase employee satisfaction and protect its real estate interests by working to improve downtown Wilmington. But Du Pont executives had no expertise in broader social issues, and it was wise to leave decisions on them to people chosen by voters.

Milton Friedman also understood a public relations justification: If donating a small piece of profits turns a potential customer into an actual one, a corporation can indeed "generate goodwill as a by-product of expenditures that are entirely justified in its own self-interest" (Friedman, 1970, Sept. 13: SM 17). If companies wishing to increase employee and customer satisfaction want to have a philanthropic role, they can contribute the most by staying in their lanes and donating to groups in their area of expertise. A company that produces food for millions might send a donation to Food for the Hungry. A company that builds houses might support Habitat for Humanity.

"If companies wishing to increase employee and customer satisfaction want to have a philanthropic role, they can contribute the most by staying in their lanes and donating to groups in their area of expertise."

Friedman rightly noted, though, that going outside the lane turns the corporate executive into "a civil servant, even though he remains in name an employee of private enterprise," and he should be "selected through a political process" (Friedman, 1970, Sept. 13: SM 17).[5] That's even more true now due to the impact of polarization. ESG proponents say that companies with improved ESG ratings are showing potential customers "we care"—but care about what?

Major League Baseball found that out when it moved its 2021 All-Star game from the Atlanta area to Denver, because Georgia had adopted election rules that some said had racist intent. The move to a state with voting laws at least as stringent as Georgia's, though, cost the Atlanta metropolitan area (more than one-third African American) at least $100 million, and did nothing for baseball's popularity (Harsanyi, 2021, April 26).

Some corporations may conclude that the way to maximize employee and customer satisfaction concerning corporations is to roll the ball to the United Nations, which in 2015 adopted Sustainable Development Goals and gave countries 15 years to ensure universal access to abortion if they wish to be on the international honor roll: "Any government which fails to ensure sustainable access to high-quality abortion care within the reach of anyone who needs it cannot claim to meet that requirement" (IPAS, 2020: 1). But as Danielle Butcher wrote, "Abortion is not an environmental policy," and half of a typical US company's customers are likely to agree (Butcher, 2021, December 9).

> **"If a company thinks it will improve sales by impressing upon customers that a small portion of what they pay will support a charity unrelated to the company's business, let the customer decide."**

Many countries are highly polarized politically, making it unlikely and possibly impossible for a company to back particular non-profit organizations and win universal applause from shareholders and stakeholders. If a company decides it will improve employee morale by having a philanthropic program that includes giving to organizations outside a company's lane, let employees decide individually where the money should go. If a company thinks it will improve sales by impressing upon customers that a small portion of what they pay will support a charity unrelated to the company's business, let the customer decide.

While I'm not impressed with broad corporate giving programs, I am not saying that all ESG concerns are without merit. For example, sustainability is important. In the chemical industry and others, relying on single-use containers often means wasting resources. Employing reusable IBCs (intermediate bulk containers) for big quantities of liquids and powders often makes ecological and economic sense. The important thing is using expertise to work on problems that executives and employees know intimately instead of pretending to know it all.

Executives also have the opportunity to develop secondary expertise in realms outside their own, perhaps because of their own failings. I was not a fan of Mike Deaver, Ronald Reagan's Deputy Chief of Staff. When I interviewed him 40 years ago, he seemed utterly cynical and smug. Deaver left the Reagan administration in 1985 and became a consummate Washington wheeler and dealer: *Time* put him on its cover in 1986 as the example of a person drunk with power who used White House connections to enrich himself (*Time*, 1986, March 3).

Then Deaver went too far. During a seven-week trial for perjury in 1987, Deaver said he suffered from alcoholism that blurred his memory so he didn't remember making some lobbying telephone calls. The jury was unimpressed: Deaver ended up with three years' probation, a $100,000 fine, and a requirement to do 1,500 hours of community service (Langeveld, 2009, February 12). He stayed within his secondary lane—alcoholism—by volunteering at Clean and Sober Streets, part of a massive homeless shelter 1.5 miles from the White House. Deaver stuck with the program and served as Chairman of the Board for 16 years. I visited the organization in 1995 and was impressed.

Henry Pierce, chief operations officer of Clean and Sober Streets, recalled that "Mike fell in love with the program and became our guardian angel, responsible for keeping the doors open to the thousands of people we've treated.… He would be on hand for every graduation ceremony, and helped place many of them in their first real jobs. He saw the potential in each one of us, and gave his heart to the individual as well as the program" (Clymer, 2007, August 16).

Hearing that story made me feel differently about Deaver, and Deaver's work helped people appreciate Clean and Sober Streets. The time he invested changed him. That was worth more to him, and more to the organization, than a monetary contribution.

Endnotes

1 Implications of Companies Act, Grant Thornton International (New Delhi), pp. 4-5.
2 Personal conversations on the ninth floor of the Du Pont Building in downtown Wilmington, 1979-1982. For more on Heckert, see Ainsworth (2010, January 25).
3 Personal conversations on the ninth floor of the Du Pont Building in downtown Wilmington, 1979-1982.
4 Shapiro and Kaufmann (1984): 48-50 on dealing with toxic wastes.
5 "If they are to impose taxes and make expenditures to foster 'social' objectives, then political machinery must be set up to guide the assessment of taxes and to determine through a political process the objectives to be served."

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ESG is Corporate Socialism

Bruce Pardy

Introduction

According to Milton Friedman, in a capitalist society the sole role of business is to make money. "[T]here is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud" (Friedman, 2002: 133).

ESG, the "Environmental, Social, and Governance" model of business administration, operates on the opposite premise: that the responsibility of business is to achieve social good. Also known as "stakeholder capitalism" and "corporate social responsibility", under ESG, companies must endorse and pursue progressive social and political objectives. In the words of Michael McCain, president and chief executive of Maple Leaf Foods, the role of business is "to channel resources to tackle the monumental social and environmental issues of our time, including our climate crisis and food insecurity. Leading this effort cannot be confined to government, NGOs or social activists. It can only succeed with the direct engagement of forward-thinking business leaders" (McCain, 2022, January 14).

ESG's vision of social good is not a neutral, benign vision of a better world but an ideological agenda with an emphasis on climate activism, critical race theory, and central planning. Inside the corporate structure, ESG undermines the duty of officers and directors to act in the best interests of the corporation, thereby empowering management at the expense of shareholders, creating an executive aristocracy. From the outside, ESG assesses corporate value by measuring commitment to political goals rather than profitability, thereby threatening companies who dissent from its mandates.

Capitalism, socialism, and corporations

Capital is property: land and buildings, machines and vehicles, money and credit, intellectual property such as patents and trademarks, and so on. "Capital-ism" is a political and economic system in which those who own property are the ones who decide what the property is used for. Capitalism, in other words, simply gives full effect to private property rights.[1]

Socialism is the opposite: a system in which someone other than the owner of property decides the purposes to which the property shall be put, putting the interests of society before and above the rights of the property owner.

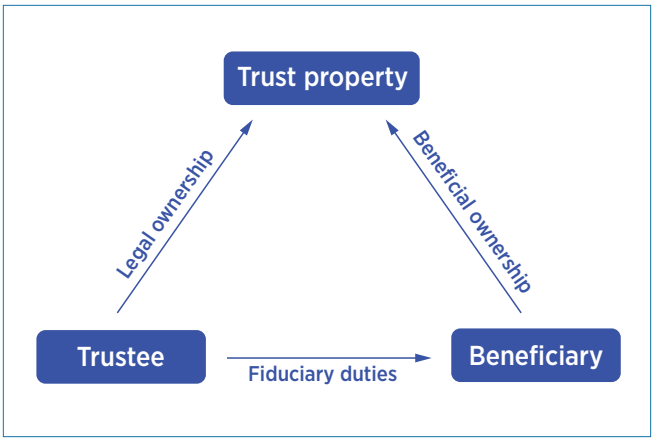
Corporations exist because statutes say that they can. But why have them at all? Compared to individual persons, who must operate businesses either as sole proprietors (a business operated by an individual in his own name) or partnerships (a contractual relationship between individuals running a business together), corporations can pool capital more easily in greater amounts. Many persons can buy shares and thereby contribute resources to the enterprise. Unlike becoming a partner in a traditional partnership,[2] shareholders are protected by limited liability for the acts of the corporation, making it less risky to invest. Because corporations can concentrate capital, they can be more efficient and economically powerful than other forms of business, controlling more assets, employing more people, and potentially achieving "horizontal integration" (producing a wide array of related products), and/or "vertical integration" (owning and operating its own supply chain).[3]

The danger is that corporate executives will wield the economic might of their corporations to influence the political sphere and governments will demand that companies pursue public policy goals, a scenario often referred to as "corporatism" (Stuttaford, 2020, July 9; Darwall, 2021). The danger of executive power is mitigated by what has traditionally been the core feature of corporate governance: the fiduciary duty of officers and directors to act in the best interests of the corporation.

Undermining the duty to act in the best interests of the corporation

Shareholders own the corporation. Officers and directors run it. What legal principles should apply when property owned by one person is controlled by another?

A useful analogy is the trust. A trust is a property relationship in which one person, the trustee, holds property for the benefit of another, the beneficiary. The beneficiary is said to hold "equitable title" to the trust property, while the trustee holds legal title. The trustee is empowered to deal with the property—to keep, invest, sell, safeguard, and so on—and the



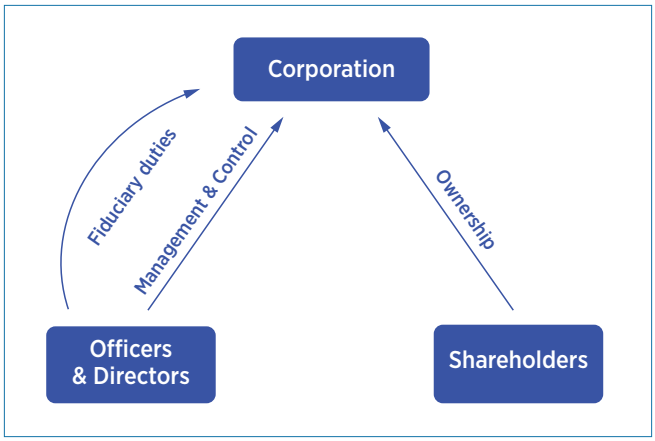
beneficiary is entitled to the benefit of that property, whether to investment returns, to the whole property once the beneficiary reaches a certain age, to be housed in the trust property if it is a residence, or the like. The beneficiary's entitlements are defined in the terms of the trust.

The trustee owes fiduciary duties to the beneficiary to hold and control the property with a reasonable degree of care and skill for that person's benefit. "The fiduciary relationship impresses the office of trustee with three fundamental duties: the trustee must act honestly and with reasonable skill and prudence, the trustee cannot delegate the office, and the trustee cannot personally profit from its dealings with the trust property or its beneficiaries" (*Canada v. Canada North Group Inc.*, [2021] SCJ No 30 at para 48).

The relationship between a corporation's shareholders and its officers and directors is abstractly similar. Shareholders own the corporation, but officers and directors deal with its assets and run the business. That is a trust-like relationship: one group holds the beneficial interest in the property and the other controls it. Traditionally, officers and directors are thought to owe a fiduciary duty comparable to that of a trustee. For example, the *Canada Business Corporations Act* (RSC 1985, c. C-44) states:

> 122 (1) Every director and officer of a corporation in exercising their powers and discharging their duties shall
>
> (a) act honestly and in good faith with a view to the best interests of the corporation; and
>
> (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

Although the source of this obligation is statutory, the duty is fiduciary in nature (*Peoples Department Stores Inc. (Trustee of) v. Wise*, [2004] SCJ No 64 at para 32; *McClurg v. Canada*, [1990] 3 SCR 1020 at para 23). It requires directors and officers "to manage the company according to their best judgment; that judgment must be an informed judgment; it must have a reasonable basis. If there are no reasonable grounds to support an assertion by the directors that they have acted in the best interests of the company, a court will be justified in finding that the directors acted for an improper purpose" (*Maple Leaf Foods Inc. v. Schneider Corporation* (1998), 42 OR (3d) 177 at para 34 (CA)). The duty is owed not directly to the shareholders as individuals, but to the welfare of the corporation, whose success and profitability will amount to benefit to the shareholders as a group (*Maple Leaf Foods Inc. v. Schneider Corporation* (1998), para 35; *McClurg v. Canada*, [1990] 3 SCR 1020, note 9, quoting Welling, 1984: 614).



The fiduciary duty owed by the directors and officers, like the duty of a trustee, is necessary to ensure that they do not use corporate resources in their own interests or for their own purposes. The best interests of the corporation are generally those actions that maximize the value of the corporation, which in the broad sense reflect the interests of the shareholders in generating a return on investment (*Peoples Department Stores Inc. (Trustee of) v. Wise*, [2004] SCJ No 64 at para 42; Berle, 1932: 1367, quoted by Yalden, 2002: 10). In Canada, corporate law has traditionally been based on the notion that management is to work for the interests of shareholders (VanDuzer, 1997: 346).

The primacy of the corporation's bottom line does not prevent companies from treating employees, creditors, suppliers, and customers fairly, from doing good deeds in the community, or from complying with laws and regulations. Any action that enhances profits, such as generating community goodwill, maintaining a content workforce, developing good relationships with suppliers and creditors, and staying out of legal trouble, will be consistent with the duty. If consideration for employees, creditors, suppliers, customers, environmental causes, and community interests is consistent with and enhances the company's prospects, such as by attracting new customers through its good works, then no problem arises. However, when executives pursue good deeds that conflict with the company's financial interests, they may breach their duty to act in the best interests of the corporation. As the Supreme Court of Canada has stated:

> "When executives pursue good deeds that conflict with the company's financial interests, they may breach their duty to act in the best interests of the corporation."

> … directors owe a fiduciary duty to the corporation, and only to the corporation. People sometimes speak in terms of directors owing a duty to both the corporation and to stakeholders. Usually this is harmless, since the reasonable expectations of the stakeholder in a particular outcome often coincide with what is in the best interests of the corporation. However, cases… may arise where these interests do not coincide. In such cases, it is important to be clear that the directors owe their duty to the corporation, not to stakeholders, and that the reasonable expectation of stakeholders is simply that the directors act in the best interests of the corporation. (*BCE Inc. v. 1976 Debentureholders*, [2008] 3 SCR 560 at para 66)[4]

Thus, any decision made by officers or directors must have as its object the betterment of the corporation in the financial sense. The fiduciary responsibility of officers and directors is to increase the corporation's profits. Milton Friedman would approve.

But that is not how ESG works. ESG corporate governance demands that directors and officers act in the interests of a wide array of "stakeholders." Stakeholders can include other groups of people, such as employees, creditors, suppliers, and customers, but also inanimate interests, including environmental causes such as climate action, and social goals such as DIE (diversity, inclusion, and equity) quotas.

"ESG corporate governance demands that directors and officers act in the interests of a wide array of 'stakeholders.'"

Stakeholder governance makes shareholders just one of numerous stakeholders to be considered in management decisions. Stakeholder governance dilutes directors' and officers' fiduciary duties and broadens their discretion. It provides executives with a mandate to put corporate assets towards political causes that they deem important. It turns companies into social welfare institutions and gives business leaders licence to pursue "social good" at their discretion with other peoples' money. Friedman wrote:

> Few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible. This is a fundamentally subversive doctrine. If businessmen do have a social responsibility other than making maximum profits for stockholders, how are they to know what it is? Can self-selected private individuals decide what the social interest is? Can they decide how great a burden they are justified in placing on themselves or their stockholders to serve that social interest? (Friedman, 2002: 133-134.)

Social credit scoring for corporations: rejecting profit as the corporation's measure of value

Markets are patterns of exchanges that make both parties better off. When parties transact, they trade property rights. If I pay my neighbour $100 for his old bicycle, I am acquiring his property rights in the bike in exchange for my property in the money that I hand to him. We make this exchange because I would rather have the bike than my $100, and vice versa. If that were not so, the trade would not occur.

A business sells products or services when people perceive that they will be better off to purchase than not. A successful company, therefore, is successful because it satisfies wants and needs of its customers. This is Adam Smith's invisible hand in action:

> It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.… he intends only his own gain; and he is in this, as in many other cases, led by an invisible hand to promote an end which was not part of his intention.... By pursuing his

> own interest he frequently promotes that of the society more effectually than when he really intends to promote it. (Smith 1776: Book 1, Chapter 2)

Profits reflect the company's value (assuming the absence of government intervention or policies protecting the company from competition).

> "ESG rating agencies assess business comportment with progressive values to determine their 'sustainability,' in what amounts to social credit scoring for corporations."

But not with ESG, which rejects the notion that profits measure value, and instead treats profits as an evil by-product of capitalism. ESG rating agencies assess business comportment with progressive values to determine their "sustainability," in what amounts to social credit scoring for corporations.

Companies found lacking in the kind of environmental, social, and governance policies preferred by ESG advocates risk low scores and denunciation. Individual and institutional investors rely on agency reports to make investment decisions, and banks and other financial institutions to make credit decisions. ESG empowers a sophisticated "woke mob" to demand that corporations pursue certain preferred objectives.[5] As Friedman put it, "the doctrine of 'social responsibility' involves the acceptance of the socialist view that political mechanisms, not market mechanisms, are the appropriate way to determine the allocation of scarce resources to alternative uses" (Friedman, 1970, September 13). As ESG reporting becomes standard and increasingly mandatory, so must ideological compliance. Along with digital currency and digital identification, both presently in development, ESG represents centralized, political supervision of the economy.

Conclusion: Undermining capitalism and Western civilization

Michael McCain of Maple Leaf Foods laments what capitalism has done to the world. Planet Earth, he says, "is on fire." Inequality and social injustice, he suggests, has risen to intolerable levels. Like many business leaders, McCain adopts the premises of ESG. He proposes a "new Charter for Capitalism," the first element of which is to "recognize multi-stakeholders equally, rejecting the primacy of shareholders, by including the environment, natural life and society as equally critical stakeholders" (McCain, 2022, January 14.)

In embracing ESG, no doubt some business leaders believe they are doing good. They fail to grasp that ESG is a Trojan horse that undermines capitalism[6] and their own free societies. Once a singular focus on making profits comes to be regarded as unacceptable, business decisions will no longer belong to businesses to decide on their own. Instead, the moral and political content of corporate actions will require technocratic supervision. Friedman wrote, "the external forces that curb the market will

not be the social consciences, however highly developed, of the pontificating executives; it will be the iron fist of Government bureaucrats" (Friedman, 1970, Sept 13.)

ESG threatens the end of apolitical commerce, establishing instead a collectivist, illiberal, manipulated economy.

Endnotes

1 Capitalism: "The economic system based on private property and private enterprise. Under this system all, or a major proportion, of economic activity is undertaken by private profit-seeking individuals or organizations, and land and other material means of production are largely privately owned. Under capitalism parts of the economy may be in public ownership. The government may impose certain regulations on the activities of the private sector regarding public health and safety, enforcement of competition, and protection of the environment" (Black, Hashimzade, and Myles, 2009: 33).

2 In traditional partnerships, partners are legally responsible for anything any member of the partnership does. In recent decades, limited liability partnerships have become possible in many jurisdictions in some circumstances.

3 In the production of a car, for example, it is possible for one company to own more than one of the many businesses that produce distinct products or services that together combine to create the product for sale in the showroom: the mine that digs the iron ore; the smelter that produces the steel; the engineering department that designs the motor; the stamping factory that shapes the steel into parts; the assembly plant that puts the parts together; the financing company that loans money for customer purchases; the transportation that takes the cars from the plant to the showroom; and so on. Without the corporate form, the argument goes, accomplishing such tasks would take the coordination of hundreds of sole proprietorships facing monumental organizational and contractual challenges.

4 Also see Peoples Department Stores Inc. (Trustee of) v. Wise, [2004] SCJ No 64 at para 43.

5 "The International Organization for Standardization has announced a new initiative to help businesses measure and improve their sustainability performance, to reduce their carbon footprints. With certain firms doing more harm than good in this area of environmental responsibility, rating agencies must continue to hold them accountable" (Impact Investor, 2022, June 21).

6 "The battle over ESG is a fight for the future of capitalism—for its continued capacity to generate economic growth and the higher living standards on which its legitimacy as an economic system rests. That legitimacy was not built by becoming an instrument of political power wielded by Wall Street oligarchs. The weaponization of finance constitutes a potentially lethal strategic move, one that would end capitalism as we know it" (Rupert, 2021: 17).

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The Circular Economy: (Re)discovering the Free Market

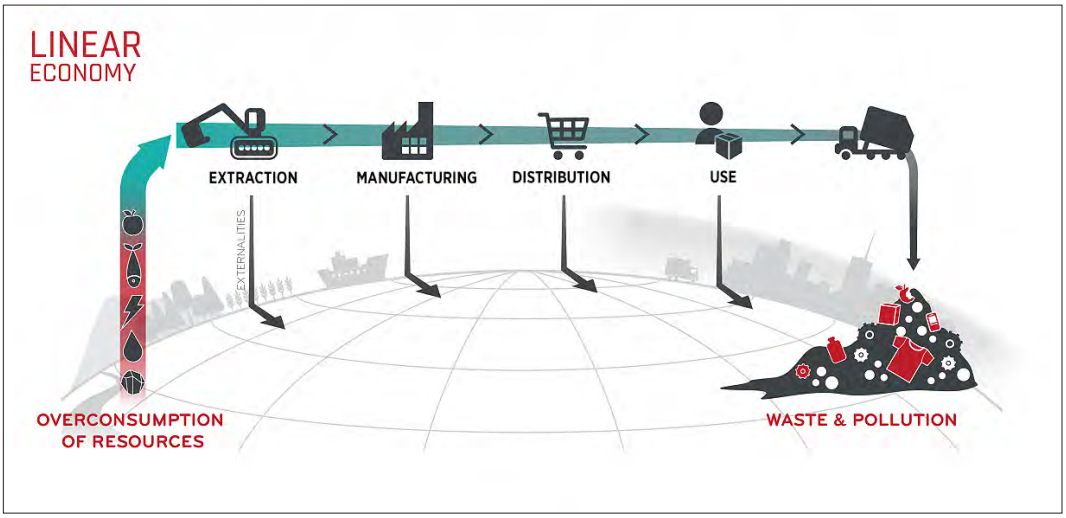
Pierre Desrochers

Introduction: The circular economy

The concept of a "circular economy" (CE) has been promoted lately by a wide range of prominent public and private organizations, all of whom speak of it as if it were a new idea. The list of proponents includes the World Economic Forum (WEF), the Organization for Economic Co-Operation and Development (OECD), the World Trade Organization (WTO), the United Nations Environment Programme (UNEP), the US Chamber of Commerce Foundation, and BlackRock Global Funds. Numerous international, national, and sub-national levels of governance, from the European Commission to the Chinese Communist Party, along with a wide range of academics and activists, have also supported various CE initiatives. In Canada, these include the federal government, the provinces of Quebec and Ontario, the cities of Toronto and Vancouver, the David Suzuki Foundation, and the University of Ottawa-based Smart Prosperity Institute. Larger coordination efforts to further advance the CE include the Global Alliance for Resource Efficiency and Circular Economy (GARECE), the Platform for Accelerating the Circular Economy (PACE), and the African Circular Economy Alliance (see Appendix 1; Brandão et al., 2020; and Tudor and Dutra, 2020).

The CE is typically presented as an innovative new idea, in contrast to the existing economy which is caricatured as a "take, make, waste" extractive "linear model" of traditional market economies. The current economic system is described as one in which resources are extracted, processed, and disposed of carelessly, resulting in uncontrolled release of waste materials and pollution emissions in all production stages (see Figure 1).

Figure 1: The Linear Economy



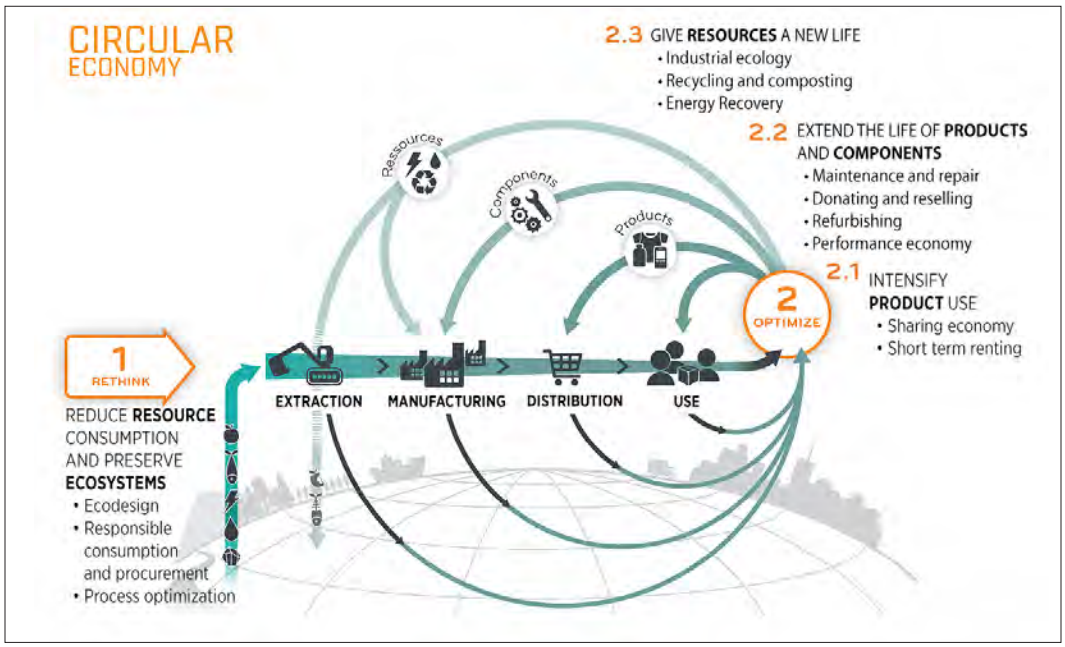
Source: Institut EDDEC and RECYC-Quebec (2018): https://www.recyc-quebec.gouv.qc.ca/sites/default/files/default_images/schema-economie-lineaire-mars2020-english.png.

Like many other organizations and governments, the World Resources Institute argues that "linearity in the global economy" has resulted in "significant societal challenges including resource depletion, climate change, waste, pollution and health hazards." These problems, in turn, "threaten long-term economic growth, jobs, security, health and environmental wellbeing" (World Resources Institute, undated).

In contrast to this description, a circular economy is said to be an alternative mode of production and consumption that maximizes the utility of scarce resources by constantly re-using and regenerating them in a cyclical pattern, manufacturing more durable products and benefitting from the potential offered by the sharing and services economy (Figure 2).

Environment and Climate Change Canada (2021) describes the CE as "a new way of doing business that extracts as much value as possible from resources by recycling, repairing, reusing, repurposing, or refurbishing products and materials—eliminating waste and greenhouse gas emissions at the design stage." A case in point is turning pulp-and-paper mill waste into renewable bioproducts. As a report published by the World Economic Forum (WEF) states, the CE is really about "[e]liminating waste from the industrial chain by reusing materials to the maximum extent possible [which] promises production cost savings and less resource dependence," in the process delivering "substantial net material savings, mitigation of volatility and supply risks, drivers for innovation and job creation, improved land productivity and soil health, and long-term resilience of the economy" (WEF et al., 2014: 18). The CE can thus play a crucial part in addressing problems ranging from global climate change and biodiversity loss to air, land, and water pollution. Its rapid adoption is deemed critical in light of the magnitude of current challenges, such as rising global population and affluence and the potential doubling in the production and consumption of resources in coming decades (Lacy and Rutqvist, 2015).

Figure 2: The Circular Economy



Source: Institut EDDEC and RECYC-Quebec (2018): https://www.recyc-quebec.gouv.qc.ca/sites/default/files/default_images/schema-economie-circulaire-mars2020-english.png.

> "Its proponents claim an estimated $4.5 trillion of value is 'up for grabs in the circular economy,' as if to suggest profitable opportunities to eliminate or reuse waste by-products are systematically ignored by private sector agents."

At this point the instinct of people appreciative of the free market will be to point out that competitive markets already provide an incentive to eliminate waste and make efficient use of costly inputs. In contrast, CE proponents claim an estimated $4.5 trillion of value is "up for grabs in the circular economy" (Lacy et al., 2020; see also Lacy and Rutqvist, 2015: xv), as if to suggest profitable opportunities to eliminate or reuse waste by-products are systematically ignored by private sector agents. Yet at the same time other proponents lament that the CE remains a "radical challenge to existing systems and business models" (Lacy and Rutqvist, 2015: x) as individual businesses are deemed unable to bring about systemic change on their own (Korhonen et al., 2018). To CE proponents, notwithstanding the alleged commercial benefits, achieving "competitive advantage from circularity" requires policy interventions such as:

- taxes to discourage the use of virgin materials and subsidies;
- mandatory requirements (including green public procurement policies) and other forms of support to increase recycling and secondary material content use;

- the creation of organizations that gather relevant knowledge and information and promote the CE;
- extended producer responsibility and product stewardship schemes;
- and eco-labelling and eco-design policies (Brandão et al., 2020; Lacy et al., 2020; Yamaguchi, 2021).

In short, a circular economy is apparently a vast opportunity for entrepreneurs, yet at the same time requires central planning since it is "an industrial system that is restorative or regenerative *by intention and design*" (WEF et al., 2014: 15, my emphasis).

> **"(CE) describes practices that have been an integral part of market economies from their very beginning. What is truly new is the misrepresentation of the market economy as linear, wasteful, and mismanaged..."**

The contradiction can be resolved by recognizing that while the concept of a CE is somewhat new, it describes practices that have been an integral part of market economies from their very beginning. What is truly new is the misrepresentation of the market economy as linear, wasteful, and mismanaged, thus providing a pretext for new forms of central government control. The private sector has been "circular" for as long as humans have used waste from one process, such as manure and bones from livestock, as an input to others, such as fertilizer for crops or a material to manufacture countless tools, jewelry, and toys. And the private sector has sought ways to minimize the waste of inputs for as long as humans have conducted commerce in any form, for the simple reason that inputs are scarce and costly. Past market actors did not need prodding by academics, activists, consultants, politicians, and bureaucrats to make the CE a reality.

While the point is somewhat obvious, the best way to demonstrate it is simply to quote what long-ago writers had to say about the concept of the CE, long before the current buzzword became popular.

The circular economy: Second nature in a competitive market

As researchers affiliated with the Smart Prosperity Institute (2020: non-paginated) acknowledge, "globally, businesses are already implementing a wide range of practices that incorporate circular economy principles, whether or not these practices are explicitly identified as circular, or part of a larger, company-wide greening strategy." One therefore wonders why previous generations of managers, engineers, technicians, and other business practitioners would have systematically neglected the creation of wealth out of freely available production residuals.

As it turns out, they didn't. A significant literature on by-product use goes back to the early days of industrial development (Desrochers 2007, 2011, 2012; Desrochers and Leppälä, 2010;

Desrochers and Szurmak, 2017). To give but a few illustrations, the chemist William Crookes observed in 1873 that "the progress of our great chemical manufactures during the last ten years, as exemplified in the International Exhibition of 1862, appears chiefly to have been directed towards the utilization of waste substances." An anonymous entry on the "utilization of waste materials" published in the 1886 *Hazell's Annual Cyclopaedia* describes how "in the earlier days" of many manufacturing branches "certain portions of the materials used have been cast aside as 'waste,'" meaning that they had "no useful purpose." It was then experimented with a "view to finding some profitable use for it." Over time, "in most instances the experiments have had more or less satisfactory results" and, "speaking generally, it may be said that such a thing as 'waste' is now hardly known in the arts" (Price, 1886: 464). At the turn of the twentieth century the American industrial chemist Leebert Lloyd Lamborn (1904: 16) observed that "If there is one aspect more than any other that characterizes modern commercial and industrial development… it is the utilization of substances which in a primitive stage of development of any industry were looked upon as worthless."

Arguably the most important writer was the journalist and publisher Peter Lund Simmonds who systematically documented and created a number of exhibits on the topic in the second half of the nineteenth century (Desrochers, 2009). In a catalogue published in the 1870s, he commented that the "manufacturer, of course, only considers as Waste the residues of the used raw and subsidiary substances which remain on his hands after he has obtained the principal and secondary products, and these have often in his eyes little or no comparative value. Many useful bye-products and valuable industries, however, sprung out of the profitable utilization of these" (Bethnal Green Branch Museum, 1875: 2). As a reviewer of Simmonds' 1862 book *Waste Products and Undeveloped Substances* put it: "It would be difficult to define what is 'waste' in the present day, so admirably and completely are the many substances, formerly neglected and thrown away, now utilized and converted into new and valuable products" (Anonymous, 1863: 254). Another reviewer wrote that the "great process of reconversion is the basis of art, as well as of nature. The latter has not any refuse material to throw away; she uses and reuses all that is left from her previous manipulations… And it is the perfection of art to run through the same circuit" (Anonymous, 1862: 332).

Past writers typically credited two types of incentives for these developments. Most important was the profit motive that enticed industrialists to find new ways of channelling as much of their inputs as possible through the economy rather than their backyards, rivers, or the atmosphere. In doing so, they reduced disposal costs and earned new revenues. The Scottish chemist and politician Lyon Playfair (1889: 269) thus argued that "as competition becomes keen, these waste products may become the largest source of profit." Simmonds' most explicit passage on the topic was probably the following:

> As competition becomes sharper, manufacturers have to look more closely to those items which may make the slight difference between profit and loss, and convert useless products into those possessed of commercial value, which is the most apt illustration of Franklin's motto that "a penny saved is twopence earned." (Bethnal Green Branch Museum, 1875: 4)

Two generations later, the Canadian-born economist Rudolf Alexander Clemen (1927: vii) viewed "the development of by-products in industry [as] one of the most outstanding phenomena in our economic life" and credited this outcome to the fear of being overwhelmed by competitors in the same or other industrial sectors. Modern conditions, he argued, made it "almost impossible materially to cut production and distribution of expense for the majority of commodities." In this context, "one of the most important opportunities for gaining competitive advantage, or even for enabling an industry or individual business to maintain its position in this new competition," was to reduce manufacturing expenses "by creating new credits for products previously unmarketable."

Another consideration occasionally discussed by past writers was the necessity of removing nuisances to other parties that could result in legal actions. To give but one illustration, Simmonds (1876: 39-40) observed that the stench resulting from the blood and offal at a large pork-packing establishment "had become such an offense to the neighbourhood, that the proprietors were threatened with a perpetual injunction." In time, they found a way to dry the refuse. The clean fat was converted into lard and the refuse into grease and grease oil. The remaining scrap, consisting of the bones of the head and feet and considerable meat, was then thoroughly mixed with the blood, dried, and converted into a valuable output. The whole process resulted in a smell comparable with that of a pot of boiled cabbage.

The circular economy and central planning

In addition to their ignorance of the historical drive toward circularity in market economies, proponents of expanding the CE through greater public planning appear to be unaware of the fact that this approach was tried and failed miserably in the communist world.

"...proponents of expanding the CE through greater public planning appear to be unaware of the fact that this approach was tried and failed miserably in the communist world."

Centrally planned attempts to maximize resource use revolved around an elaborate hierarchical input and output quota system of waste registration, collection, distribution, and reuse and a number of mobilization campaigns. As with everything else in such an economic system, however, these experiments did not live up to expectations as they suffered from a number of shortcomings. To summarize: 1) individuals lacked incentives to invest time and effort in the creation of goods other people were willing to pay for; 2) allocating resources rationally in the absence of a price mechanism, or when prices were systematically distorted by government policies, proved impossible; 3) a centrally planned system proved

unable to tap into the unique tacit knowledge and information that individuals possess about their immediate surroundings and particular line of work (Desrochers, 2004).

Perhaps the main differences between present-day CE literature and its historical antecedents, however, is their respective emphasis on intermediaries and the importance of product design. For instance, although he mostly discussed progress from the manufacturer's perspective, Simmonds (1876: 29) noted that the London Post Office Directory of 1873 listed upwards of 2,100 "Manufacturers, or Dealers, in Waste," but that this number was certainly far below the real total because it only enumerated householders and excluded many manufacturers located in the suburbs. He emphasized their beneficial role in gathering, sorting, and finding new markets for waste substances. Modern CE theorists, however, typically pay no attention to intermediaries and emphasize instead the need to (re)design products so they can be "upgraded, reused, or disassembled at end of life to access the valuable materials contained within" (Babbitt et al., 2021). Although the subject deserves more investigation, a case can be made that the world described by Simmonds and his contemporaries was one in which constant change and future beneficial developments for most people was the norm, whereas the perspective of CE proponents is much more static and less concerned about significantly improving standards of living.

"The predominant view among CE proponents that traditional market incentives provide little encouragement to turn polluting waste into valuable by-products is untenable and at odds with historical and present-day reality."

Conclusion

The predominant view among CE proponents that traditional market incentives provide little encouragement to turn polluting waste into valuable by-products is untenable and at odds with historical and present-day reality. Furthermore, CE proponents try to argue both that it represents significant opportunities for profitable efficiency gains, and that it will only happen if forced in place by government policies, which is a contradiction.

In reality the spontaneous CE nature of past market economies played an underappreciated role in delivering both economic and environmental benefits and explains in some part the long-standing failures of past predictions of environmental doom. We would be well advised to steer clear of attempts to replace the market-driven process of economic circularity with a centrally planned version.

Appendix 1: Organizations and Governments that Promote the Circular Economy (Selected)

Note: A long list of public and private organizations supportive of the circular economy concept can be found the Ellen MacArthur Foundation Network website: https://ellenmacarthurfoundation.org/network/who-is-in-the-network

International alliances

GARECE (Global Alliance for Resource Efficiency and Circular Economy)
https://ec.europa.eu/environment/international_issues/gacere.html
Note: GACERE was initiated by the European Commission and by the United Nations Environment Programme (UNEP), in coordination with the United Nations Industrial Development Organization (UNIDO).

PACE (Platform for Accelerating the Circular Economy)
https://pacecircular.org/
Note: PACE was created in 2018 by the World Economic Forum and is now hosted by the World Resources Institute.

African Circular Economy Alliance
https://pacecircular.org/african-circular-economy-alliance)

International organizations

CGRi (Circularity Gap Reporting initiative)
https://www.circularity-gap.world/
- Published reports (including various countries, partners and supporters)
  https://www.circularity-gap.world/about
- CGRI Circularity methodology
  https://www.circularity-gap.worldmethodology

OECD (Organisation for Economic Co-Operation and Development).
RE-CIRCLE: resource efficiency and circular economy
https://www.oecd.org/env/waste/recircle.htm

United Nations Environment Programme—Circularity
https://www.unep.org/circularity

World Economic Forum Circular Economy and Material Value Chains
https://www.weforum.org/projects/circular-economy
- Circular Economy for Net Zero Industry Transition
  https://www.weforum.org/circular-economy-for-net-zero
- PACE (Platform for Accelerating the Circular Economy)
  https://pacecircular.org/
- The Circulars Accelerator
  https://thecirculars.org/

WTO (World Trade Organization)—Trade policies for a circular economy
https://www.wto.org/english/res_e/reser_e/ersd202010_e.htm

WBSCD (World Business Council for Sustainable Development)—Circular Economy
https://www.wbcsd.org/Programs/Circular-Economy

World Resources Institute (WRI)—PACE (Platform for Accelerating the Circular Economy)
https://www.wri.org/initiatives/platform-accelerating-circular-economy-pace

UK-based organizations

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Environmental Markets vs. Environmental Mandates: Capturing Prosperity and Environmental Quality

Terry L. Anderson

Today everyone claims to be an environmentalist, but what constitutes environmental quality varies. For some, it avoids a "Malthusian trap," named for the Reverend Thomas Malthus, who, in 1798, postulated that humans would continue to reproduce until the population demands exceed their ability to produce food, after which famine, disease, and pestilence would check human population growth. Centuries later we still hear fears of "limits to growth" (Meadows, Meadows, *Randers,* and Behrens, 1962), of a "population bomb" (Ehrlich, 1968), of a "silent spring" (Carson, 1962) in which wild species go extinct due to human negligence, and of "the end of oil" (Roberts, 2004). For others, environmentalism has more to do with romantic views of nature as Henry David Thoreau observed in *Walden* and as John Muir believed untamed wilderness should be.

To these we can add environmental ethics as promoted by Aldo Leopold's *Sand County Almanac* (Leopold, 1966). Accordingly we should honour animal rights, recycle even when doing so does not save resources, and protect land from development.

All of these perspectives on environmentalism played a role in the passage of a regulatory alphabet soup in the United States—the WA (Wilderness Act, 1964), the CAA (Clean Air Act, 1970), the CWA (Clean Water Act, 1972), and the ESA (Endangered Species Act, 1973), to mention a few. These were all based on the premise that private individuals and companies will not be good environmental stewards, thus making command and control necessary to ensure environmental quality.

Unfortunately, many of these regulations have thwarted environmental and economic progress (Anderson and Leal, 2015). *Political Environmentalism: Going Behind the Green Curtain* documents several examples (Anderson, 2000). The Endangered Species Act has succeeded in protecting iconic species such as the grizzly bear, whales, and the bald eagle, but it has also made many species the enemy in a war of "shoot, shovel, and shut up" in which landowners kill endangered species when they find them rather than subject themselves to the regulations and restrictions that the discovery of such a species inevitably brings with it. Recall the spotted owl that was the poster child of protectionists wanting to stop logging in the Pacific Northwest in the late 1990s. Listing the spotted owl as endangered virtually halted logging on almost all of the national forests in the United States, but it also stopped private forestland owners from wanting the owls on their property and it encouraged, because timber prices increased, more logging on private lands. Similarly, a designation of endangered for the red-cockaded woodpecker in the Southeast has led to harvesting pine trees at a younger age before they become old-growth trees suitable for woodpecker habitat (Lueck and Michael, 2003).

Fishery management that focuses on season, catch, and equipment regulations has led to more intensive fishing during the season, greater bycatch (fish that weren't targeted for markets but were killed in the process), and fewer—but bigger and more efficient—boats. As a result, fish stocks in fisheries regulated this way declined rather than improved (Leal, 2005).

Finally, the century-old Jones Act, which prohibits foreign ships from carrying goods from one US port to another, has regulated US marine shipping in ways that have increased greenhouse gas emissions. The US commercial fleet is powered by far less efficient engines with higher emissions than less regulated foreign fleets. And, because of the reduced efficiency, it takes more ships to carry the same goods. As University of Chicago economist Casey Mulligan reports, "A sizable amount of the cargo that, without the Jones Act, would be shipped on coastal waters ends up on trucks congesting our highways and polluting our atmosphere, especially near large cities where many people live and breathe" (Mulligan, 2020, June 3).

It just keeps getting better

Despite the detrimental effects of regulations and the gloom and doom from environmentalists, all the evidence suggests, as the Beatles song put it, "It's getting better all the time," and the improvement is closely linked to human ingenuity, prosperity, and economic growth. Harnessing the power of human ingenuity is the key to economic and environmental progress.

One of the more systematic analyses of the relationship between prosperity and the environment is the environmental sustainability index (ESI) (World Bank, Undated a) developed by the joint effort of the World Economic Forum, the Yale University Center for Environmental

Law and Policy, and the Columbia University Center for International Earth Science Information Network. The group measured 145 nations based on 20 indicators and 68 related variables in order to give each nation a sustainability score. On the ESI scale for 2002, Finland came in first, with a score of 73.9, and Kuwait came in last, with a score of 23.9.

The most significant finding derived from the ESI study compares each nation's ESI score with its gross domestic product (GDP) per capita and shows that a strong relationship exists between wealth and environmental quality. The data follow the pattern of what economists call the environmental Kuznets curve, named after Nobel laureate Simon Kuznets (Pettinger, 2019, September 11). Generally, environmental quality declines in the early stages of growth and then increases after a certain threshold; the turning point varies with the environmental goods in question. As incomes rise people shift their focus from obtaining the basic necessities of life—food and shelter—to other goods and services. For a person living at a subsistence level, setting aside land for wildlife or reducing carbon emissions to reduce the potential for global warming is unfathomable. With higher incomes, people demand cleaner water, cleaner air, and other ecosystem enhancements. The higher demand for environmental amenities stimulates environmental entrepreneurship (Yandle, Bhattarai, and Vijayaraghavan, 2004).

More recent data on the ESI for 2015 to 2017 show that environmental quality is rising for 114 of the 135 nations for which data are available, with the world median ESI growing slightly. The United States experienced a year-on-year average growth rate of 2.39 percent between 2015 and 2017 (World Bank, Undated a). Lesotho had the highest year-on-year average growth rate at 21.56 percent (World Bank, Undated b). And Uruguay had the lowest year-on-year average growth rate at -16.78 percent (World Bank, Undated c).

"The correlation between environmental quality and economic growth is largely due to human ingenuity which flourishes when property rights are well defined and enforced and people are 'free to choose.'"

The correlation between environmental quality and economic growth is largely due to human ingenuity which flourishes when property rights are well defined and enforced and people are "free to choose" (Friedman and Friedman, 1980). Whether it occurs and whether it is positively correlated with environmental quality depend mainly on the institutions—especially secure property rights and the rule of law—within each country. Economic growth creates the conditions for environmental improvement by raising the demand for improved environmental quality and by making resources—natural and human—more abundant.

Seth Norton calculated the statistical relationship between various freedom indexes and environmental improvements. His results show that institutions—especially property rights and the rule of law—are key to human well-being and environmental quality. Dividing a sample of countries into groups with low, medium, and high economic freedom and similar categories for the rule of law, Norton showed that in all cases except water pollution, countries with low economic freedom are worse off than those in countries with moderate economic freedom, while in all cases those in countries with high economic freedom are better off

than those in countries with medium economic freedom. A similar pattern is evident for the rule-of-law measures (Norton, 2004).

> "Countries with lower freedom index scores, mainly those founded on socialism, have both less environmental quality and less prosperity."

On the other hand, countries with lower freedom index scores, mainly those founded on socialism, have both less environmental quality and less prosperity. Consider Venezuela, one of the world's more repressed economies. It ranks above only North Korea in the Heritage Foundation's freedom index. It has one of the 10 most biodiverse environments in the world and was a prosperous nation at the beginning of the twenty-first century. After decades of socialism, however, environmental quality has declined along with prosperity. Just how much the environment has deteriorated is difficult to say because the government restricts collection and dissemination of data. It has the third highest deforestation rate in South America, sewage pollution in its water supplies, soil degradation, and urban pollution.

Environmental markets to the rescue

Since the 1970s, when environmental regulations helped solve a myriad of environmental problems in the United States by picking the low-hanging fruit—stopping the killing of endangered species such as the bald eagle, designating over 100 million acres of wilderness where not even pedal bikes are allowed, and restricting emissions into the air and water—environmentalists have begun looking for better ways to achieve environmental goals. To be sure, some people may act with enlightened self-interest if they are motivated by what Aldo Leopold called a land ethic (Leopold, 1966). However, good intentions are often not enough to produce good results, which is why Leopold, the pragmatic environmentalist, declared, "Conservation will ultimately boil down to rewarding the private landowner who conserves the public interest" (Leopold, 1934: 202). This is also why the US-based Environmental Defense Fund's motto is "finding the ways that work."

Environmental markets are one of those ways. In the early days "free-market environmentalism" was considered an oxymoron, but markets have proved to be an effective tool for environmental protection. Water markets have thrived, creating higher prices for water and encouraging conservation. Where water has a higher value left instream, environmental groups have negotiated with diverters—farmers and municipalities—to leave more water in streams for fish and wildlife. By owning land or conservation easements that restrict land use, environmental groups in both the US and Canada, such as the Nature Conservancy, have been able to allow environmentally friendly energy production and protect grizzly bear habitat where there can be predation on livestock. Transferable fishing quotas have given fishermen a stake in ocean fishery management and efficiently improved fish stocks and allowable catches. Finally, emission trading programs for sulphur dioxide have virtually eliminated acid rain at far lower costs than regulatory mandates would have done.

None of these examples are meant to say that markets can solve all environmental problems. Rather, they suggest how property rights give owners an incentive to take account of the value of owned resources and the costs of using them in alternative ways.

Perhaps the hardest of all environmental issues to deal with using markets is climate change. The benefits of reducing the rise in global temperatures are diffuse across the world and across time, the benefits accrue over dozens or hundreds of years, and the costs accrue and are concentrated on companies that produce hydrocarbons and economies that depend on them. Couple this with the impossibility of defining and enforcing property rights to the atmosphere, and market solutions seem impossible.

That is why many economies resort to calls for "market-like" solutions which are really political solutions disguised as markets. A carbon tax is at the top of the list of these solutions. A governmentally imposed tax on carbon emissions equal to the social cost of carbon associated with global warming would encourage producers to reduce their use of hydrocarbons. Of the many problems associated with this solution, the difficulty of establishing the proper tax, the difficulty of enforcing it across nations, and the politics of distributing the tax proceeds make it a pipe dream.

The good news is that asset and financial markets are already responding to climate change. Increased rainfall raises the value of land for crops, lower snowfall reduces the value of ski resorts, rising sea levels and storm surges lower the value of beachfront properties. The result is that asset owners and investors facing higher variance in their returns are adapting.

Even if the atmosphere as a greenhouse gas sink and greenhouse gas emissions themselves are not priced, prices correlated with the effects of climate change will induce adaptation. For example, if climate change reduces the productivity of land for certain wheat production, the price of land will be high relative to its productivity. This generates an incentive for wheat farmers to seek new places for wheat production where land prices are lower. Hence, the 2012 *Bloomberg News* headline, "Corn Belt Shifts North with Climate as Kansas Crop Dies" (Bjerga, 2012, October 15). As Hoover Senior Fellow Edward Lazear puts it, "Economic incentives will induce people who are setting up new households, businesses, and farms to move to areas that are less severely harmed by warming temperatures" (Lazear, 2014, September 2).

"Even if... greenhouse gas emissions themselves are not priced, prices correlated with the effects of climate change will induce adaptation."

There is evidence that property owners who experience increased coastal flooding due to slowly rising sea levels are moving to higher ground. A paper by three Harvard University professors in the journal *Environmental Research Letters* tested the hypothesis "that the rate of price appreciation of single-family properties in MDC [Miami-Dade County] is positively related to and correlated with incremental measures of higher elevation" (Keenan, Hill, and Gumber, 2018, April 23). Using the value of 107,984 properties between 1971 and 2017, they found a positive relationship between price appreciation and elevation in 76 percent of the properties (82,068) in the sample.

A similar study by economists at the University of Colorado and Penn State found that beachfront homes in Miami exposed to rising sea levels sell at a 7 percent discount compared to properties with less exposure to coastal flooding (Bernstein, Gustafson, and Lewis, 2018). Moreover, the discount has risen significantly over the past decade. Comparing rental rates to selling prices of coastal homes, they found that the discount in selling prices "does not exist in rental rates, indicating that this discount is due to expectations of future damage, not current property quality."

Wine producers in California, Bordeaux, and Tuscany beware. A study by Conservation International published in the *Proceedings of the National Academy of Sciences* forecasts that wine production in California may drop by 70 percent and regions along the Mediterranean by as much as 85 percent over the next 50 years (Hannah, Roehrdanz, Ikegami, et al., 2013, April 23). The silver lining is that vintners will adapt by moving their grape production north, some predicting it will even move to places such as Montana, Wyoming, and Michigan, currently noted for their severe winters (Rathi, 2017, November 10).

In the future you may also see more signs on fruit saying, "Country of Origin—Canada." Canadian biologist John Pedlar sees more people in southern Ontario "trying their hand at things like peaches a little farther north from where they have been trying" (Grist, 2015, July 17). This is consistent with the US Department of Agriculture's Plant Hardiness Zone Map, which shows tolerant zones moving north (Charles, 2012, January 26).

Conclusion

For decades, economists have focused more on institutions than other factors such as resource scarcity or culture as the driving force in economic growth. Countries with more secure property rights and a rule of law that recognizes individual rights are more likely to prosper than those using mandates to guide human and physical capital investment and natural resource use.

The same institutions that promote economic growth also promote environmental quality. This is not to say that environmental mandates have no place, but the fact is that environmental markets align individual incentives with efficient resource use for land, minerals, water, fisheries, and air. The more that environmental markets can supplant environmental mandates, the better the chance for us to have both environmental quality and prosperity.

"The more that environmental markets can supplant environmental mandates, the better the chance for us to have both environmental quality and prosperity."

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Author's Note

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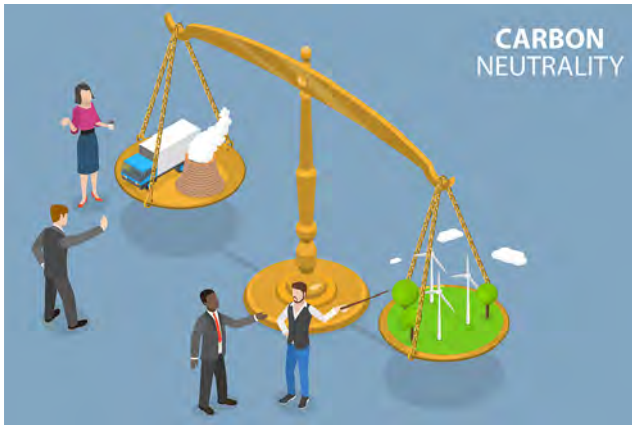
How Banning Carbon Fuels and Synthetic Products Will Hurt the Environment

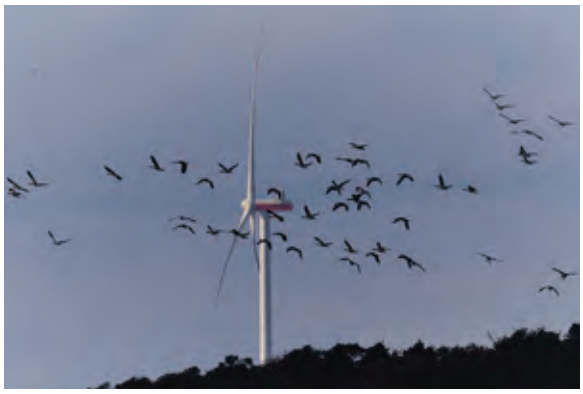
Pierre Desrochers

Introduction



Numerous politicians have committed their constituents to "Net-Zero" (or carbon neutral) objectives.[1] This is to be achieved by the "electrification of everything,"—through decentralized onshore and offshore wind and solar photovoltaic (PV) power generation; substantial conversions in the transportation (e.g., cars, light trucks) and building (e.g., electric cooking, space and water heating) sectors; reduced overall consumption (e.g., consumer goods, meat); and incremental improvements of all kinds (e.g., heat pumps, building insulation) to improve efficiency in energy use. This transition is to be facilitated by various government interventions, including new or higher carbon taxes and renewable mandates; a capping of greenhouse gas emissions and new carbon trading schemes; a ban on new GHG-emitting vehicles; and significant support for the development of hitherto nonexistent transformative technologies (e.g., giant batteries, hydrogen-fueled planes and cars, large scale removal of atmospheric CO_2) (see Williams, Jones, Haley, et al., 2021; World Economic Forum, Global Future Council on Net-Zero Transition, and the Alliance of CEO Climate Leaders, 2021; and Larson, Greig, Jenkins, et al., 2021).

In parallel to these developments, many environmental activists and politicians have demonized synthetic products derived from fossil fuels, culminating in a 2019 pledge by representatives of 170 nations to "significantly reduce" the use of plastics by 2030 (UNEP, 2019).[2] The Canadian government has since then set itself the task of guiding businesses and organizations to transition away from "problematic plastics" in order to reduce pollution and support the creation of a circular economy (Canada, 2022a). This policy is justified in the name of "current scientific evidence" that "indicates that macroplastic pollution causes



physical harm to wildlife on an individual level and has the potential to adversely affect habitat integrity" (Canada, 2022b). In practice though, Canadians, like residents of other advanced economies, release very little such substances into ecosystems (Schmidt, Krauth, and Wagner, 2017; and Schmidt, Krauth, and Wagner, 2018).

Both net-zero and plastic ban policies have not gone unchallenged. Apart from what are deemed unrealistic timelines, excessive costs, and lack of scalability or adequate substitutes, critics have pointed out that so-called "green energy" will have a greater direct impact on land-based ecosystems because of immutable characteristics, including:

- low power density that requires much larger land areas (e.g., solar and wind power require on average up to 90 to 100 times more land area than natural gas for electricity generation);
- the need for additional transmission lines as the best locations for the production of electricity from wind turbines and solar panels are often far from markets;
- the building of back-up power generation capacity (typically natural gas) to make up for the intermittent character of wind and solar power;
- greatly increased mining activities (e.g., lithium, rare earths) as wind turbines, solar panels, and electric car batteries require, on average, more than 10 times the quantity of materials of hydrocarbon-based alternatives;
- questionable carbon neutrality of bioenergy as woody biomass for electricity generation, corn and sugar cane for ethanol production, and oil palm and soybeans for biodiesel production all require large growing areas and substantial carbon-fuels-based inputs (e.g., fuels for production, transport, and processing; pesticides, fertilizers);
- lethal impact on fauna (e.g., impact of wind turbines on raptors and bats).[3]

> "None of the so-called alternatives could even be built and maintained without massive amounts of carbon fuels"

Needless to say, none of the so-called alternatives could even be built and maintained without massive amounts of carbon fuels (e.g., machinery, steel and cement production, composite materials, transport, installation, maintenance (including lubricants), potential recycling, and back-up power generation). Much research has also established that banning plastic straws, bags, packaging, and other single use plastic products, to say nothing of more comprehensive future bans of synthetic materials, can only result in increased demand for biomass-based and other materials (e.g., lumber, cotton, wool, glass, metals, clay) with greater overall environmental impacts (UNEP, 2020; and Ferrara, De Feo and Picone, 2021).

This essay briefly discusses one aspect of these controversies, i.e., the incidental environmental benefits of carbon fuels and synthetic products. As it will suggest, not only were they developed for good, practical reasons, but they also drastically reduced pressures on wild flora and fauna and contributed significantly to the gradual abandonment and eventual reforestation and potential rewilding of much marginal agricultural land. Banning them, especially when the world's population is now much larger than when they first displaced other inputs and technologies, will only recreate and exacerbate the problems they once solved.

The forest transition

Three decades ago, the Scottish geographer Alexander Mather coined the term "forest transition" to describe a significant change in the relationship between human population numbers and forested areas. Until the nineteenth century, he observed, economic and demographic growth resulted in the unavoidable declines in the size and overall health of forests, often accompanied by soil erosion, defaunation, and other forms of environmental degradation (e.g., desertification, siltation). As the old slogan went, "poor people make poor land." With rapid industrialization and urbanization, however, humanity not only witnessed its most significant growth in population and income per capita in history, but also an expansion of its forest cover in all advanced economies and in an increasingly large number of developing economies, including India and China. In the process, much of the remaining marginal wetlands, grasslands, and forestlands were spared from the plough (Mather, 1992).[4] Western Europe contains many such examples. For example, the forest areas in France increased from approximately 15 percent in the mid-nineteenth century to nearly 33 percent of the total land area in 2015 while in Austria the numbers went from approximately 40 percent in 1830 to almost 50 percent in 2010.[5]

"With rapid industrialization and urbanization, humanity not only witnessed its most significant growth in population and income per capita in history, but also an expansion of its forest cover in all advanced economies and in an increasingly large number of developing economies, including India and China."

The forest transition is typically traced back to a few key causes, most notably: [6]

- Natural regeneration and deliberate tree planting on former agricultural lands and other deforested landscapes (e.g., where hunter-gatherers had created grasslands on previously forested landscapes and on landscapes degraded as a result of excessive timber harvesting) made redundant with the intensification, increased productivity, and greater geographical concentration of agriculture (Kauppi, Sandstrom, and Lipponen, 2018; Ritchie, Roser, and Rosado, 2021).[7]
- Increased availability of atmospheric CO_2, greater rainfall since the middle of the 19th century, and, to the extent it can be traced back, a lengthening of the growing season,

have contributed positively to the efficiency of photosynthesis, hence to greater plant growth and to increased agricultural productivity (Zhu, Piao, Myneni, et al., 2016).

- International trade through which increased volumes of biomass are grown more efficiently in one country and consumed in another (Pendrill, Persson, Godar, and Kastner, 2019).
- The large-scale substitution of carbon fuels for fuelwood, beginning with coal in the nineteenth century (Wrigley, 2013).

> **"An ever-larger number of resources produced on the surface of the planet were replaced by better substitutes created from materials dug or pumped from below."**

The key development underlying these beneficial advances is that an ever-larger number of resources produced on the surface of the planet were replaced by better substitutes created from materials dug or pumped from below. One of the first writers of importance to expand on this idea was the German economist and sociologist Werner Sombart (1863-1941) in his turn-of-the-twentieth-century discussion on the "Emancipation from the Limitations of the Organic" and the transition from a wooden to a coal-fueled "iron age"[8] made possible by both carbon fossil fuels and carbon fuel-derived synthetic products. In 1944, the Harvard geologist Kirtley F. Mather (1888-1978) observed that a century earlier nearly 80 percent of all products used by human beings came from living plants or animals competing for resources on the Earth's surface. By the time of his writing, however, "only about 30 per cent of the things used in industrialized countries come from things that grow; about 70 per cent have their sources in mines and quarries" (Mather, 1944: 56). The idea that surface resources were increasingly supplanted by underground ones, however, is now typically associated with the late British historical demographer and geographer Edward Anthony Wrigley (1931-2022) who argued from the 1960s onward that our ancestors broke free from the "photosynthesis constraint" by accessing the "products of photosynthesis stockpiled over a geological time span."[9] As he wrote in a typical passage:

> The [organic economy] escaped from the problem of the fixed supply of land and of its organic products by using mineral raw materials. Thus the typical industries of the [Industrial Revolution] produced iron, pottery, bricks, glass and inorganic chemicals, or secondary products made from such materials, above all an immense profusion of machines, tools and consumer products fashioned out of iron and steel. The expansion of such industries could continue to any scale without causing significant pressure on the land, whereas the major industries of an organic economy, textiles, leather and construction, for example, could only grow if more wool, hides or wood were produced which in turn implied the commitment of larger and larger acreages to such ends, and entailed fiercer and fiercer competition for a factor of production whose supply could not be increased. Meeting all

> basic human needs, for food, clothing, housing and fuel, inevitably meant mounting pressure on the same scarce resource. (Wrigley, 1988: 5)

I now turn to a discussion of some of the past incidental environmental benefits delivered by carbon fuels and synthetic products.

On the environmental benefits of carbon fuels and synthetic products

A few centuries ago, shortages and rising prices for fuelwood and charcoal in British cities and towns created the incentive for a gradual switch to coal and the development of better combustion and coking technologies.[10] With the development of the steam engine, coal made possible new economic activities and the scaling up of earlier ones to unprecedented levels because of its unparalleled capacity to deliver much more plentiful and reliable heat, power, and feedstock. In turn, new and better energy sources, new processes, and new resources paved the way to further developments and new applications (see Smil, 2017). Refined petroleum products (gasoline, diesel, kerosene, and bunker fuels) thus proved a superior alternative to coal in the transportation sector while, when available, natural gas was preferable to coal and fuel oil in electricity production and home heating. These substitutions occurred because liquid fuels and natural gas have several technical and economic advantages over coal. For instance, refined petroleum products have a higher energy density and burn more cleanly while emitting less-polluting gases and particulate matter. They can be extracted without underground human labour. They are much easier to handle, transport, and store for uses in a wide variety of applications, again resulting in lower labour costs. They also provide more affordable feedstock for the production of a wide range of synthetic items. Energy scholar Vaclav Smil has calculated that, over the last two centuries or so, the growing and increasingly efficient use of carbon fuels has led to a 3,500-fold increase in the availability of useful energy (Smil, 2022).

“Over the last two centuries or so, the growing and increasingly efficient use of carbon fuels has led to a 3,500-fold increase in the availability of useful energy.”

Needless to say, before the development of technical advances such as scrubbers and catalytic converters, carbon fuels were environmentally problematic in many respects (e.g., smoke and soot). Coal and hydrocarbons, however, also displayed a range of incidental environmental benefits. The most obvious was that they paved the way to the forest transition. As the English economist William Stanley Jevons observed in 1865, “forests of an extent two and a half times exceeding the whole area of the United Kingdom would be required to furnish

Figure 1: Haitian Deforestation

Source: Adapted from NASA Science Visualisation Study: Haitian Deforestation (Visualizations by Alex Kekesi, released on October 25, 2002 https://svs.gsfc.nasa.gov/2640).

even a theoretical equivalent to [the country's] annual coal produce" (Jevons, 1865/1866). The most striking recent illustrations of the environmental benefits of carbon fuels burned for domestic uses are satellite images of the border between biomass-based Haiti and largely propane-based Dominican Republic taken two decades ago (Figure 1). Unfortunately, much illegal logging on the Dominican side has since been conducted by impoverished Haitians.

Another reasonably well-known example of the green benefits of carbon fuels is the displacement of whale oil as a lighting fuel by petroleum-refined kerosene (McCollough and Check, 2010), a transition whose environmental significance was not lost on a *Vanity Fair* cartoonist in 1861 (Figure 2).

Writing in 1945, the agricultural economist Karl Brandt observed that, following the First World War, the internal combustion engine in the forms of trucks, tractors, and combines was brought "into general use for agriculture, first in America and later elsewhere." As a result, "millions of horses were replaced, and millions of feed acres were released for food production," some of which would in time revert back to forests (Brandt, 1945: 135-136). The displacement of urban workhorses by trucks and cars also proved environmentally beneficial. Among other problems, vermin and flies were endemic in urban stables while excrement and carcasses were a source of deadly diseases such as typhoid fever, yellow fever, cholera, and diphtheria. In the late nineteenth century, New York City horses produced well over

Figure 2: Grand Ball Given by the Whales in Honor of the Discovery of the Oil Wells of Pennsylvania (1861)

Source: Vanity Fair (1861, April 20: 186).

four million pounds of manure each day, sometimes piling up to a height of between 40 feet and 60 feet in vacant lots (Desrochers, 2015, July 10; Morris, 2007).

It is probably fair to say that the incidental environmental benefits of synthetic products are less appreciated than those of carbon fuels. In short, the history of synthetic products begins in the middle of the nineteenth century with coal tar, at first an unwanted waste product of the coal gasification process used as a source of heating and lighting fuel in the nineteenth and early twentieth century. [11] At first, coal tar found limited uses as a protective coating for the hull of wooden ships and ropes, a last-resort fuel and for roofing. The first highly significant demand for coal tar, however, followed the introduction of the wood pressure-impregnation (or Bethell) process in 1838. This pickling or creosoting of timber—a process through which dried timber was placed in a container, subjected to partial vacuum and impregnated with heavy oils from coal tar—soon thrived on a large scale as a result of the increasing demand for wooden sleepers by the railroad industry, for wooden poles by the telegraph industry, and for various coastal structures which incorporated a significant amount of timber. This industry not only solved the tar disposal problem, but also significantly reduced both the cost of maintaining wood structures and, by tripling or quadrupling its useful life, the consumption of wood (see also Barger, 1951: 100-111).

It would take a few additional decades before the lighter fractions of coal tar found significant markets. The most significant breakthrough in this respect was William Henry Perkin's use of

it in his development of mauve dye in 1856, which was followed in short order by the creation of an ever-expanding range of synthetic dyes. Up until then, various dyeing substances had been extracted from plants (principally madder for reds, oranges, and browns, and indigo for blue), lichens, trees, insects, mollusks, minerals and guano. Synthetic dyes quickly put their natural competitors out of business as they offered a much greater range of colours (along the lines of a 10-to-1 ratio by the turn of the twentieth century), were cheaper, easier to apply, and delivered better finished products. They also liberated large swathes of agricultural land, then available for other agricultural productions, some of which eventually reverted to its natural state. At its peak in 1868, madder cultivation required between 300,000 and 400,000 acres while indigo plants could be found on more than 1,583,808 acres in 1897. On a local scale, the introduction of artificial scarlets resulted in the abandonment of the cultivation of cochineal in the Canary Islands and its replacement by sugar and tobacco plantations, while pressures on dyewoods and logwoods in other parts of the world were largely eliminated.[12] Reverting back to natural dyes would obviously entail significant environmental damage. Suffice it to say that several million acres would be required to make up for the approximately 20,000 tonnes annual consumption of synthetic indigo alone.

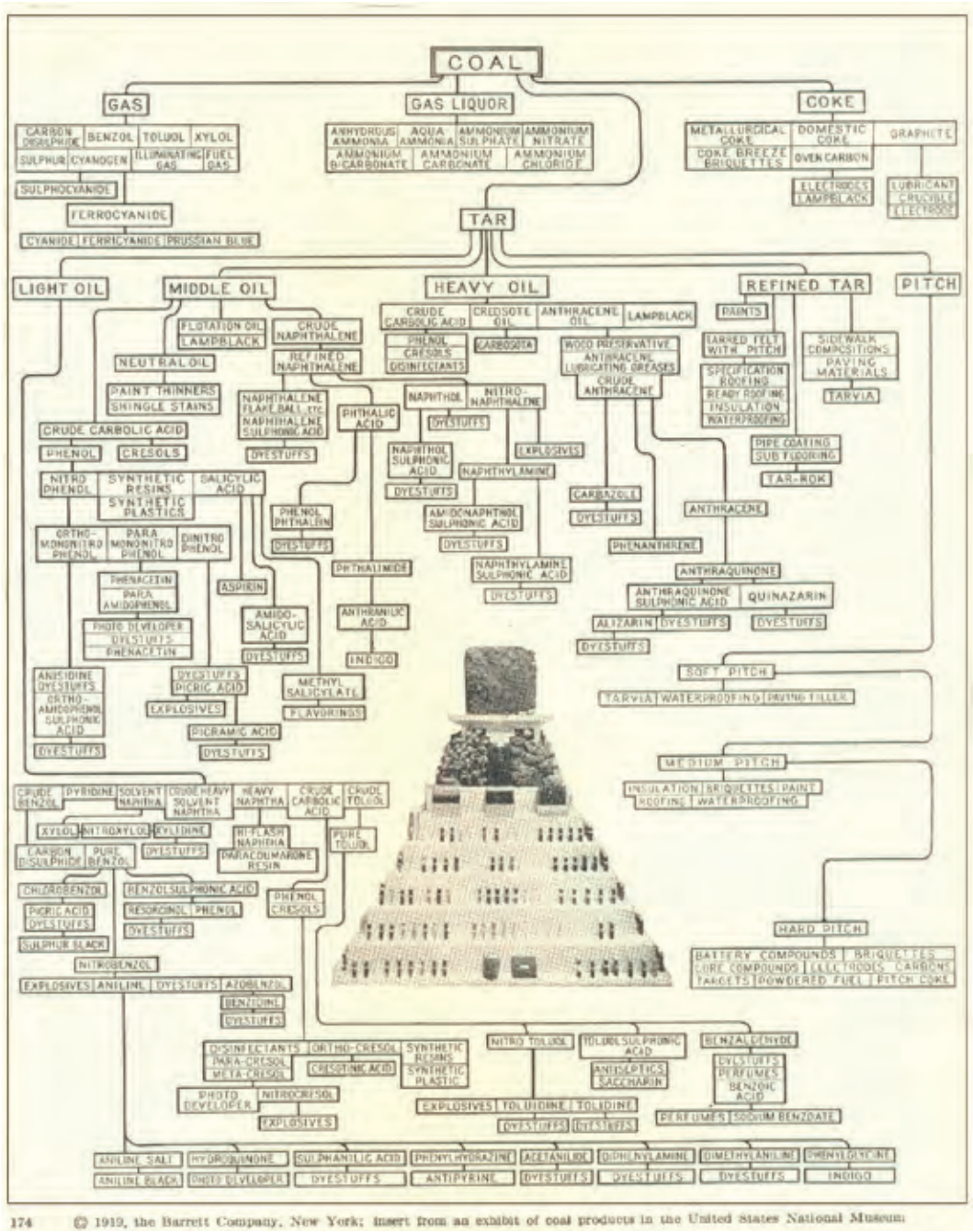
In time, advances in synthetic dye making served as a technological springboard for the creation of other tar-derived products ranging from explosives, medicines, and perfumes, to flavoring materials, sweeteners, disinfectants, and antitoxins, as well as tracing and photographic agents (Figure 3).

Coal tar was eventually supplemented and then largely displaced by cheaper, more easily available and more flexible petroleum refining by-products and natural gas (methane and natural gas liquids). To summarize some key chapters of a complex history, early kerosene producers were left with about 50 percent of the original material that was then of no commercial value. Beginning in the mid-1860s, a few by-products were created out of the liquid residue, most notably lubricating oils, greases, paraffin, petrolatum (or petroleum jelly, better known by the trademark Vaseline), candles, insect repellents, and solvents. Paraffin replaced vegetable and animal products (e.g., beeswax, tallow, spermaceti, vegetable oils, natural rubber) in the manufacture of candles, chewing gum, laundry sizing, as a sealant in wide range of uses (e.g., preserves, pharmaceutical, medical, and electrical equipment) and as a waterproofing agent for tents, boots, and coats (Williamson and Daum, 1959: 249-250).

Early petroleum by-products, however, were largely extracted from what was referred to as the "middle of the barrel." By contrast, lighter gasoline and most heavy residuals remained problematic.[13] The internal combustion engine (gasoline) and new furnace technology (heavy oil) soon changed the situation and created lesser problems than those that had existed before. By the turn of the century, the refining industry (and especially the Standard Oil Company) was selling over 200 by-products made from what had once been production residuals (Copp and Zanella, 1993: 156). Today over 6,000 products are manufactured from petroleum (Figure 4), ranging from fuels and lubricants to vitamins and textiles.

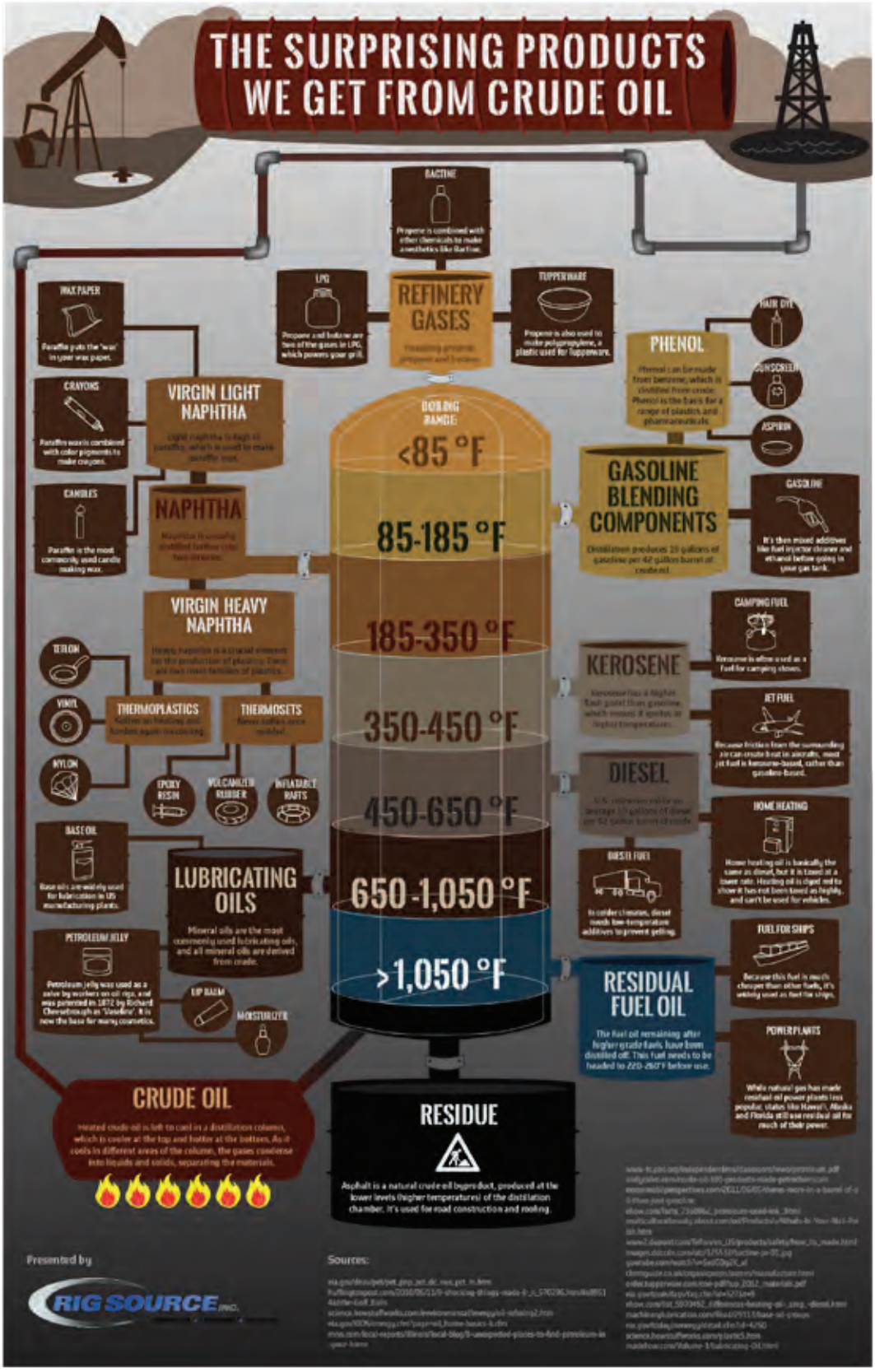
Most controversial today, the boom in plastics production can be traced back one century to the development of the "cracking" of crude oil to produce high quality gasoline, a process

Figure 3: Coal Products, 1919.



Source: The Barrett Company, New York, from an exhibit of coal products displayed at the United States National Museum.

Figure 4: The Surprising Products We Get from Crude Oil



that generated residual gases first burnt as waste, but that were eventually turned into a cheap feedstock for the production of polymers (Lox, 1992). The worldwide production of plastics grew from 20,000 tons in 1925 to 2 million tons in 1950, 150 million tons in 2000, and 370 million tons in 2019 (Smil, 2022). Energy scholar Vaclav Smil has recently suggested that poor countries replicating China's economic success would result in a 30-fold expansion of plastic manufacturing over the next 30 years (Smil, 2022). While many commentators will view this as a cause for concern, one should keep in mind that the development of plastics and other synthetic products has drastically reduced demand for wild fauna such as whales (e.g., whale oil, baleen, perfume base), birds (e.g., feathers), elephants, polar bears, alligators, and countless other wild animals (e.g., ivory, fur, skin); trees and other plants (e.g., lumber, firewood, charcoal, rubber, pulp, dyes, green manure); and agricultural products (e.g., fats and fibers from livestock and crops, wool, leather, dyes, and pesticides from plants). Far from being an environmental problem, plastics are part of the solution, provided their disposal is handled properly.

Conclusion

The development of valuable resources from substances extracted from below our planet's surface paved the way for the creation of a wide range of superior substitutes for products once manufactured from plants and animals such as biomass-based fuels, lubricants, fertilizers, building materials, fibers, leather, and other products. Although they are now often demonized, carbon fuels such as coal, refined petroleum products and natural gas, along with synthetic products such as plastics and composite materials, made it possible to meet the needs of growing and increasingly wealthier populations while gradually diminishing the human footprint on the landscape. The result has been a world increasingly more hospitable to humans and wildlife. Reverting back to biomass-based products on large scale can only undermine advances made in terms of expanded habitat for wildlife and greater biodiversity.

"Carbon fuels such as coal, refined petroleum products and natural gas, along with synthetic products... made it possible to meet the needs of growing and increasingly wealthier populations while gradually diminishing the human footprint on the landscape."

Endnotes

1 Remaining emissions can be compensated by removing carbon from the atmosphere through other anthropogenic actions, permanent underground CO2 storage, and the planting of trees. For additional details for Canada, see the Canadian Net-Zero Emissions Accountability Act (2021).
2 For concise discussions of the key issues, see Bailey, 2018; and Bailey, 2022.
3 For a recent, in-depth, and abundantly illustrated discussions of some key issues, see Larson, Greig, and Jenkins et al., 2021. For accessible synthesis and more critical discussions, see Zehner, 2012; Kiefer, 2013; Montford, 2019; and Mills, 2020.

4 For more detailed introductions and additional references, see, among others, Rudel, Coomes, Moran, et al., 2005; and Meyfroidt and Lambin, 2011.
5 Data for France and Austria are from Gingrich, Magerl, Matej, and Le Noe, 2022. For an interactive model of the evolution of the Western European forest cover between 1900 and 2010 and other data, see Wageningen University, Undated.
6 For a recent overview of the less controversial causes, see Gingrich, Magerl, Matej, and Le Noe, 2022.
7 The latter source was first published in 2017; the most recent revision is from June 2021.
8 Sombart's "limitation of the organic" thesis was discussed in both the first volume of his magnum opus *Der moderne Kapitalismus* [Modern Capitalism] from 1902 and his 1903 *Die deutsche Volkswirtschaft im neunzehnten Jahrhundert* [The German Economy in the Nineteenth Century]. The man most responsible for spreading Sombart's thesis in the United States was probably Lewis Mumford (1934).
9 For a short introduction to his work, see Wrigley, 2011.
10 In the same basic way charcoal is made out of wood, coke is a solid fuel made by heating metallurgical (bituminous) coal in the absence of air so that the volatile components are driven off.
11 For contemporary accounts, see, among others, Lunge, 1887; and Findlay, 1917.
12 For a more detailed account, see Desrochers, 2008.
13 In this context, air-gas machines refer to gas machines used to illuminate mills, factories, public institutions of all kinds and large mansions. Crude naphtha also found a market for gas illumination at the time.

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The Impracticality of Standardizing ESG Reporting

Elmira Aliakbari and Steven Globerman

Executive Summary

In recent years, rising frustration among investment managers and retail investors over the plethora of competing ESG reporting standards and rating agencies has led to calls for standardizing the mandatory disclosures of ESG information. While in theory having a universal ESG reporting framework—similar to what we have for financial reporting—would bring consistency to ESG reporting, in practice, serious implementation and enforcement challenges would arise from mandating a uniform set of ESG reporting standards that apply to all public companies. This essay discusses the challenges and argues that implementing and enforcing a standardized global ESG framework is impractical and would be extremely costly due to the distinctive features of ESG reporting, which differentiate it from financial reporting.

A significant challenge when mandating uniform ESG disclosure regulations and applying them to all public companies is related to implementation difficulties. In particular, identifying ESG materiality (i.e., defining what specific ESG issues are topics for reporting) will inevitably be arbitrary and unsatisfactory to many "stakeholders." ESG encompasses a broad set of issues including waste and water management, supply chain management, hiring and compensation, and climate change. Stakeholders' interests in ESG differ. Hence, so do their views of what is of material interest for corporate disclosure.

Adding to the identification challenge is the fact that the materiality of specific ESG information will depend upon company-specific attributes including geographic location, industry, and business model. Furthermore, given the likely divergence of viewpoints on the importance of specific ESG issues, standardizing ESG disclosure across public companies will

> "Broad standards would leave more room for managerial interpretation of what specific ESG information should be reported and could therefore result in ESG misreporting."

inevitably involve value judgments thereby making the process political and costly.

Supplying accurate and understandable information is another challenge facing efforts to standardize ESG-related disclosures. Given the scope of ESG issues that are of potential interest to varied stakeholders, it is likely that any disclosure standards implemented will be broad. Broad standards would leave more room for managerial interpretation of what specific ESG information should be reported and could therefore result in ESG misreporting. On the other hand, were specific standards to be applied generally, it would be likely that the standards would not fit the circumstances of any particular firm and, hence, would be of limited value to any set of stakeholders.

Supplying accurate and actionable ESG information in a standardized format is further challenged by the reality that much of the information that might be relevant to specific stakeholders is not quantifiable. Even when ESG behaviour and outcomes are readily measurable, assigning monetary values to them is often not possible. How can we, for instance, objectively assign a monetary value to the racial or gender composition of board membership? Without being able to aggregate the ESG-related activities and performances of disparate companies into a uniform metric, it will be impossible as a practical matter to rank companies by any standardized index.

Finally, effectively enforcing mandated common ESG reporting standards across all public companies would be challenging because ESG metrics are highly subjective, frequently rely on internal information, and lack external reference points such as industry benchmarks. Verifying ESG information for internationally diversified companies with large and dispersed supply chains would be extremely costly, if not impossible, because companies might not have ready access to the ESG information they are expected to report, particularly as the requisite information resides outside their legal jurisdictions.

Introduction

Businesses worldwide face growing pressure from investors and other stakeholders to disclose information about their Environmental, Social, and Governance (ESG)-related activities and impacts beyond the financially material information currently required by securities regulators. In response, numerous companies have voluntarily implemented ESG reporting standards, while a host of ESG rating agencies evaluate and rank companies using proprietary criteria. Today, the world of ESG reporting is a plethora of frameworks; there are more than 600 ESG reporting frameworks in use, many of which conflict with one another in terms of the rankings of individual companies and even the criteria used to rank companies (Boerner, 2021). Not surprisingly, some investors have expressed concern about a lack of comparable and reliable ESG information they claim they need to properly factor ESG considerations into their investment decisions (Bernow et al., 2019).

Rising frustration among investment managers and retail investors has led to calls for standardizing the mandatory disclosure of ESG information. For example, the CEOs of eight major public pension funds in Canada recently teamed up to demand that companies adhere to the recommendations made by the Sustainability and Accounting Standards Board and the task force on climate-related financial disclosures framework when reporting ESG disclosures (Globerman, 2022a). Perhaps the most prominent call for standardization comes from the World Economic Forum's International Business Council, which has proposed a set of common ESG metrics with the goal of driving a convergence of global reporting standards—ostensibly to provide asset managers and investors with better data for investment decision-making (Gagnon, 2021).

In the hopes of providing consistency and comparability in ESG reporting, five major reporting institutions, including the Sustainability Accounting Standards Board, the Global Reporting Initiative, and the Climate Disclosure Standards Board, are working together to develop a common framework with a single set of global reporting standards. In March 2021, the International Financial Reporting Standards Foundation (IFRS), which is responsible for setting global accounting standards, unveiled the creation of the International Sustainability Standards Board (ISSB), charged with developing "a comprehensive global baseline of sustainability-related disclosure standards" (Kummer, 2021). The ISSB plans to develop a uniform set of global ESG standards—similar to what the Internal Accounting Standard Board (IASB) does in the context of financial reporting—to address the proliferation of sustainability/ESG standards and standard setters.

> **"While in theory having a standardized ESG reporting framework... would bring consistency to ESG reporting, in practice serious implementation and enforcement challenges would arise from mandating a uniform ESG reporting standard for public companies."**

While in theory having a standardized ESG reporting framework—similar to what exists for financial reporting—would bring consistency to ESG reporting, in practice serious implementation and enforcement challenges would arise from mandating a uniform ESG reporting standard for public companies. This essay discusses the prominent challenges and argues that implementing and enforcing a standardized global ESG framework is highly impractical due to the distinctive features of ESG reporting, which differentiate it from financial reporting. Specifically, we discuss the challenges involved in defining materiality (section 1), defining the scope of standards (section 2), measuring and aggregating ESG information (section 3), and enforcing a universal ESG framework (section 4). The final section presents concluding comments.

1. Materiality

Multiple stakeholders with multiple views

Materiality is a core concept in the current world of corporate reporting of all kinds, including ESG reporting. This concept is used to define why and how certain issues are important to users of corporate reports, who have traditionally been presumed to be lenders or investors. Under current securities regulation practices in Canada, to be considered material information must have financial implications for investors. Defining materiality in the context of broad ESG reporting, unlike financial reporting, poses significant challenges, because materiality for ESG reporting is not a clear-cut concept. To illustrate the issue, we start with defining materiality in financial accounting, from where the concept originates. According to the Financial Accounting Standard Board (FASB), in financial accounting, an item of information is defined as material if the omission or misstatement of that item would affect the judgment of a reasonable person in making a financial decision (Messier et al., 2005).[1]

According to the FASB's definition, the target audience of financial reporting is stakeholders who have a financial interest in the firm (i.e., investors, lenders, and other creditors), and financial reporting is meant to provide financially material information to these stakeholders.

> "While the wide range of ESG issues may be of concern to a large set of stakeholders (consumers, employees, local communities, activists, governments, etc.), their concerns are not necessarily linked to the financial performance of specific companies or groups of companies."

This definition of materiality is difficult to apply to ESG reporting. ESG issues encompass a broad set of considerations including, among others, waste and water management, supply chain management, employee hiring and compensation, and climate change. While the wide range of ESG issues may be of concern to a large set of stakeholders (consumers, employees, local communities, activists, governments, etc.), their concerns are not necessarily linked to the financial performance of specific companies or groups of companies. Furthermore, different groups of stakeholders will likely have different opinions as to what is "material" non-financial ESG-related information. They may even have conflicting views on specific critical ESG issues such as the causes and consequences of climate change. In short, what is material non-financial ESG-related information from one stakeholder's viewpoint might not be material from another's.

To date, there has been no consensus on the key ESG issues and company practices that are most important for corporate disclosures (Ashley and Morrison, 2021). Unless one subscribes to a view that all ESG-related information is ultimately financially material, a view that is clearly indefensible, regulators must determine what specific ESG-related information should be included in a standardized reporting format. How regulators can be expected to

reach a consensus on this issue given the wide-ranging and often diverging interests of those calling for such standardized reporting has not been satisfactorily answered by proponents of mandated standardized reporting. The existence of multiple stakeholders with various and differing views on the importance of individual ESG issues would make determining "what" information is material and to "which stakeholders" an overwhelming challenge for those charged with developing a standardized reporting format (Christensen et al., 2021).

One might argue that narrowing the target audience for a standardized ESG reporting format to investors (and thereby ignoring other groups of stakeholders) would obviate the challenge. However, investors also have different views on the materiality of specific ESG-related disclosures. Some investors may only care about the financial consequences of corporate activities, while others may have non-monetary preferences and care about a company's impacts on the environment and society more generally, even if when those impacts have no likely financial consequences.

An increasing number of investors appear to make investment decisions by considering issues related to social norms that may or may not have financial consequences (Hong and Kotovetsky, 2012). Consider, for instance, an investor who disapproves of child labour. This investor will want to know if the company uses child labour in its supply chain (Christensen et al., 2021). Another investor might care about workforce diversity in terms of gender, race, and ethnicity, thereby needing information on these topics. Other investors may be concerned with governance issues such as diversity of corporate boards. Should companies be expected to provide information on their ESG-related practices that might be of interest to small groups of investors, especially when the information may not be financially material? How should regulators determine what ESG-related information is sufficiently "relevant" for reporting purposes given that ESG issues are broad, and that investors are likely to have different views on their importance? If it were costless to produce and report ESG-related information, the issue of what information to report would be moot. However, producing and reporting information is obviously costly.

In the context of ESG reporting, determining the materiality of specific disclosures is challenging no matter how broad or narrow the target audience. One might argue that narrowing the scope of the audience to investors and reporting only on ESG topics that are *financially* material to them would resolve the issue of defining materiality in the context of ESG reporting. However, even adopting this narrow focus would leave regulators with uncertainty about how to standardize financially material ESG information, as evidenced by, among other things, the absence of a clear empirical link between the ESG rankings of companies and the financial performances of those companies (Globerman, 2022b).

Fluidity and unpredictability of ESG issue materiality

Even in the context of financial reporting, what is deemed material information can change over time, for example in response to financial crises or corporate scandals (Hail et al., 2018). However, such changes are likely to be even more pronounced for broad ESG reporting, because ESG concerns generally encompass broad societal issues, and the public importance of such issues can change dramatically and unpredictably as a consequence of unanticipated exogenous factors such as environmental accidents, natural catastrophes, or protest movements (Christensen et al., 2021).[2]

To better appreciate the fluid nature of sustainability issues, one might consider the COVID-19 pandemic, which is an ESG issue with significant financial, environmental, and social consequences for firms, but an issue neither corporate executives nor securities regulators could predict (Jørgensen et al., 2021). Similarly, the #MeToo phenomenon is another issue affecting many companies whose growing social relevance was hard to foresee (Rogers and Serafeim, 2019). Identifying ESG-related issues that are not prominent today but may become prominent in the future and, therefore, identifying the ESG-related information that will be financially material to investors (and important to other stakeholders) in the future is an unreasonable expectation of regulators.

Company-specific ESG materiality

The materiality of ESG factors and their importance likely varies systematically across countries, industries, and firms (Amel-Zadeh and Serafeim, 2018; Eccles and Serafeim, 2013). For instance, water pollution could be a serious environmental issue in one country, whereas in another country corruption could be a critical issue. Supply chain challenges concerning labour standards could be a serious social issue for clothing manufacturers, but the same issue would not seem relevant for the banking sector. Utilities would face greater exposure to environmental risks than, for instance, software providers. Similarly, for a company that has a strategy to use low-cost labour in developing countries, human rights are more material compared to another company that uses skilled workers in developed countries (Eccles and Serafeim, 2013).

"Supply chain challenges concerning labour standards could be a serious social issue for clothing manufacturers, but the same issue would not seem relevant for the banking sector. Utilities would face greater exposure to environmental risks than, for instance, software providers."

Given that ESG issues and their importance vary depending upon company specifics (geographic location, industry, strategy, etc.), it is extremely difficult to identify a meaningful standardized format for ESG-related reporting and apply that format to all public companies. Katz and Mclntosh (2021) and Coates (2021) acknowledge this reality by noting

that while some ESG concerns touch every company to a greater or lesser extent, many ESG concerns are quite company-specific, and their importance can vary significantly based on the industry in which a company operates, the company's geographic location, and other factors. Therefore, no single ESG reporting format will properly cover all current and potential ESG issues for all companies.

"While some ESG concerns touch every company to a greater or lesser extent, many ESG concerns are quite company-specific, and their importance can vary significantly based on the industry in which a company operates, the company's geographic location, and other factors."

Overall, as a result of the wide-ranging issues encompassed within the term "ESG," the lack of stakeholder consensus surrounding priorities and preferences, the company-specific variations of ESG issues, and the continually evolving set of ESG concerns, application of materiality criteria to identify a standardized ESG reporting framework is extremely difficult, if not impossible.

2. Scope of ESG reporting standards

There is substantial variation in corporate ESG disclosure practices, partially reflecting the variation in companies' ESG issues and activities (Christensen et al., 2021). As discussed earlier, the company-specific relevance of particular ESG issues and activities mitigates the applicability of any standardized ESG reporting format.

One might argue that this challenge can be addressed by making the scope of the reporting format quite broad, thereby applying to a wide range of companies. However, a broad and generalized reporting format would leave more room for management's interpretation of what should be reported. As a result, managers might fail to report ESG information not to deceive, but because their interpretation of what should be reported differs from the intent of the standard setters. In addition, broadly defined reporting standards would give more leeway for managers to hide unfavorable information. As Christensen and Leuz (2019) note, if managers think disclosing some ESG information is risky or not in a company's best interest, with broad standards, "they will have more freedom to avoid disclosing it, whether that means making selective disclosures or burying unfavorable information in a boilerplate statement."

Given problems associated with mandating broad reporting standards, one might argue that any uniform ESG-reporting format should mandate in detail exactly what information companies should report, as well as how they should report, e.g., annual sustainability reports. However, implementing specific uniform standards also poses significant challenges. If standards are specific, they cannot be usefully applied to a broad set of companies and circumstances. The more specific the standard, the less widely applicable they become. Therefore, the more likely it is that the costs of collecting, processing, and disseminating

the required information will exceed any benefits to the "consumers" of the information. Moreover, detailed and specific disclosures could reveal proprietary information to competitors and thereby hurt companies' innovation incentives (Breuer et al., 2020). Overall, significant implementation challenges would arise no matter how specific or broad the scope of standards.

3. ESG measurement and aggregation

Another caveat about mandating standardized ESG disclosures is that the underlying social benefits of ESG-related activities are typically hard to quantify in monetary terms and therefore they cannot be integrated into quantitative models. Even though many ESG-related outcomes can be measures, e.g., the number of females on a company's board of directors, assigning monetary values to those outcomes is not always possible (Christensen et al., 2021; CFA Institute, 2015). For example, we can measure the number of minority group board members for a company, but there is no practical way of assigning a monetary value to the racial or gender composition of board membership.

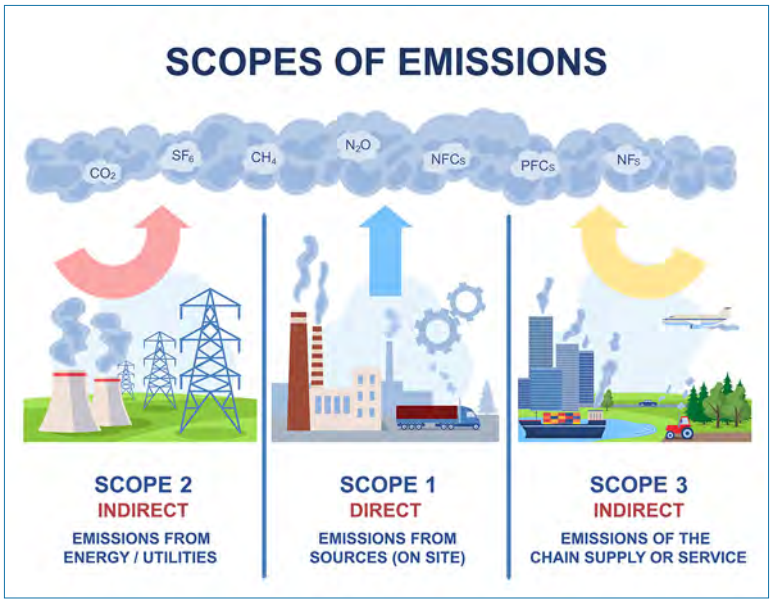
Kaplan and Ramanna (2021) underline this point by discussing the decade-long efforts of some accountants to quantify a CEO's statement that "employees are our most valuable asset." These efforts to put human resources on a company's balance sheet have failed because the employee valuations are either arbitrary and unverifiable or are irrelevant (such as how much money was spent historically on training or hiring employees).

Consider the issues with measuring and reporting environmental concerns. As part of climate-related disclosers, companies might be required to report their climate-related risks by quantifying the financial losses they could incur due to the physical impacts of climate change—the US Securities and Exchange Commission (SEC), for instance, has proposed new rules that if finalized, will require such climate-related disclosures for public companies. However, predicting the future impact of climate change relies on several assumptions fraught with uncertainties (Lewis, 2021). Boston University Professor Madison Condon has described some of the challenges involved in assessing climate risk as follows:

> Evaluating climate risk involves forecasting macroeconomic energy demand, guessing on the success of carbon regulation and future technologies, modeling the relationship between atmospheric gas concentrations and global temperatures, predicting how temperature rise will change the earth's climate systems, and calculating how those changes impact physical economic assets. The task requires skills beyond that of a typical financial

> analyst, colossal amounts of data, and models that have only begun to be built. Each step of estimation adds layers of uncertainty to risk projections. In some cases, particularly those longer-term and macroeconomic, the estimation of the economic impact of climate change may be dwarfed by this uncertainty. (Condon 2021, pages 72-73)

Similarly, as part of climate-related disclosures, companies might be required to calculate and report their generated greenhouse gas (GHG) emissions. A company's GHG emissions are classified into three categories. Scope 1 emissions cover direct emissions owned or controlled by a company (for instance, when a company runs its vehicles and boilers). Scope 2 emissions are indirect emissions from the electricity, heat, or steam purchased and consumed by an entity. Scope 3 emissions are all other indirect emissions that occur in an entity's value chain, including those generated by suppliers and distributors, the usage of products sold, and employees' business travel. More specifically, scope 3 emissions come from sources that the companies in question do not own or control, yet they account for over 80 percent of total GHG emissions (Bruce, 2021, February 11).



Companies must measure and report all three types of emissions to provide a complete picture of their carbon footprint. Currently, the SEC has proposed new rules that if finalized will require companies to report scope 3 emissions from their supply chains and customers if the emissions are material. However, calculating scope 3 emissions is a monumental, if not impossible, task. For instance, consider the case of Timberland, an American manufacturer and retailer of outdoor footwear. According to the 2009 estimates, more than 95 percent of the GHG emissions generated by Timberland fall under scope 3 (Pucker, 2021). Measuring those emissions for Timberland would mean tracking "the emissions generated by each supplier during the production and transportation of some 30,000 product components annually" (Pucker, 2021).

Nemeth (2022) also discusses the challenges involved in measuring scope 3 emissions. Consider a farmer who grows a potato. Scope 3 emission would require the farmer to calculate all GHG emissions that can be linked to him. As Nemeth (2022) explains, the farmer then needs to know how the potato gets to the store. Or even how the person who bought the potato from the store traveled to the store. Is the potato peeled? If yes, what happens to the peels? Is the potato boiled in an oven or cooked on a fire? And so on (Nemeth 2022).

In short, accurately measuring scope 3 emissions is immensely difficult, especially for companies with long, multi-jurisdictional, and complex value chains. Since scope 3 reporting would effectively require each company in a value chain to measure and report the total GHG emissions from the entire value chain, the same emissions could be counted multiple times over, resulting in a misleading measurement of aggregate carbon emissions (Kaplan and Ranmanna 2021; Mawani 2021).

"Even if the challenges associated with defining materiality could be overcome, and accurate measurement of the ESG behaviours of individual companies was feasible, rating agencies would still need to aggregate ESG information in order to create overall ESG scores."

Even if the challenges associated with defining materiality (section 1) could be overcome, and accurate measurement of the ESG behaviours of individual companies (this section) was feasible, rating agencies would still need to aggregate ESG information in order to create overall ESG scores. How should they weight, for example, environmental indicators, such as GHG emissions, or social indicators, such as the use of child labour in the supply chain? Will regulators determine which ESG indicators and categories are more or less important in order to assign individual weights?

Consider a company facing pressure from its stakeholders to reduce its greenhouse gas emissions. The company might switch to electric vehicles to achieve the goal of reducing its carbon footprint. But what if the raw materials used to create the batteries for the electric vehicles used by the company were mined using child labour? Any standardized format for making intra-ESG trade-offs when calculating overall ESG scores for companies will inevitably reflect the personal values of those proposing the format, and those values are likely to be heterogeneous and subject to change over time (Steffen, 2021). Hence, no one standardized format for evaluating the overall ESG performance of companies is likely to be objectively more reliable than some other standardized format.

This latter reservation is reinforced by a recent paper, "Aggregate Confusion: The Divergence of ESG Ratings," published in the *Review of Finance*. It documents the disagreement across the ESG ratings of companies done by six prominent ESG rating agencies. It found that the correlation between the ESG ratings ranged from 0.38 to 0.71, on a scale from -1 (showing total disagreement) to +1 (showing full agreement) (Berg et al., 2022). Put simply, the six rating agencies never all agreed on any company's ESG rating, and in most cases, there was little agreement among them. The paper found three sources of divergence: differences in which ESG indicators were included, their relative importance/weights, and how the indicators were measured. The rating agencies are for-profit companies that have strong financial incentives to provide "useful" information to their clients. Clearly, no one rating format is objectively more useful to investors and other consumers of the information reported, since multiple formats compete with each other in the marketplace.

4. Enforcement

An integral part of any new regulation is an enforcement mechanism. Evidence from the financial and accounting literature shows that enforcement is critical to successfully implementing reporting standards (Christensen et al., 2021). The same is likely true for ESG reporting—without proper enforcement, companies could misrepresent their ESG policies by providing unsubstantiated claims that would create more favourable impressions (i.e., greenwashing), although companies that do so run the risk of alienating important stakeholders if their misrepresentations are discovered. As discussed earlier, complex and broad mandated reporting standards increase the likelihood that firms will inadvertently misrepresent their ESG activities.

To make standards enforceable, regulators must be able to verify ESG information. However, verifying ESG information is likely to be difficult because, as Christensen et al. (2021) note, ESG metrics frequently "rely on internal information, are highly subjective and lack external reference points like price data or industry benchmarks, which would be helpful for verification" (Christensen et al., 2021: 84).

> **"When companies do not have full access to the ESG information they are mandated to report, perhaps because the relevant information is not routinely collected by those companies, verification will involve complex and costly auditing."**

In addition, when companies do not have full access to the ESG information they are mandated to report, perhaps because the relevant information is not routinely collected by those companies, verification will involve complex and costly auditing. Over recent decades advances in information and communication technologies coupled with low-cost labour and shipping have enabled companies across different industries to disperse their supply chains geographically so that the producers of goods are often located physically distant from input suppliers and end users. For instance, Apple phones, Nike shoes, and Hewlett-Packard laptops are all manufactured by far-flung contractors and not by the companies themselves (Kim and Davis, 2016). Given disaggregated global supply chains across many industries, how accurately can regulators audit the ESG information reported by multinational companies, including the environmental and employment practices of subcontractors?

Kim and Davis (2016) illustrate this challenge by examining the supply chain visibility of conflict mineral reports submitted to the Securities and Exchange Commission under Section 1502 of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act. The Act requires companies to declare whether their products contain "conflict minerals" originating from the Democratic Republic of Congo. The authors analyzed all conflict minerals reports submitted by over 1,300 companies listed on US stock markets. They found that almost 80 percent of the companies admitted they could not know for sure if their products contained

such minerals—despite having three years to investigate the question. Only 1 percent could declare with certainty that their products were conflict-free. Moreover, their analysis showed that internationally diversified companies and companies with large and more dispersed supply chains were less likely to identify whether their products contained conflict minerals.

The enforcement challenges discussed in this section are mitigated, if not completely eliminated, by restricting the scope of mandated ESG disclosures to corporate behaviours that are *financially* material to investors and that potentially affect firms' long-term value creation. This is currently the case in Canada, where public companies are obliged under securities regulation to disclose material risks to their financial prospects. However, if the scope of mandated and standardized ESG disclosure rules are broadened to encompass non-financially material ESG-related corporate information, enforcement costs will skyrocket, even as the information reported becomes less reliable.

"If the scope of mandated and standardized ESG disclosure rules are broadened to encompass non-financially material ESG-related corporate information, enforcement costs will skyrocket."

Conclusion

In this essay, we identify challenges to mandating a uniform set of ESG reporting standards. The challenges arise in defining ESG materiality, defining the scope of ESG standards, measuring and aggregating ESG information, and enforcing ESG standards. We argue that implementing and enforcing a standardized ESG reporting framework that is applied to all public companies is economically impractical, if not technically impossible, owing to the distinctive features of ESG reporting, which differentiate it from financial reporting.

It should be acknowledged that any set of regulations imposes costs. Hence, current regulations regarding mandated reporting of financially material information are subject to some of the same concerns as those associated with mandating a set of ESG-related disclosures that may have no material consequences for investors. However, the costs associated with mandated ESG disclosures that are applied uniformly across broad segments of national economies are certainly orders of magnitude greater than the costs associated with existing financial disclosure regimes.

Endnotes

1 The objective of financial reporting is to provide information about an accounting entity that is useful to "existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit" (FASB, 2018: 1).

2 A dramatic example is the increased public concern about racial equity after the killing of George Floyd by a police officer in Minneapolis in 2020.

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ESG Mandates and Managerial Efficiency

Sofia Johan

Introduction

This paper addresses the question of whether regulation-imposed environmental, sustainability, and governance (ESG) mandates affect the principal-agent relationship between shareholders and managers in public companies. In other words, are shareholders affected when a company's management prioritizes ESG considerations over profit-enhancing decisions? This question is part of a broader corporate governance debate that has been taking place in recent years on the relative benefits and costs of a legal system that increasingly reflects a stakeholder versus a shareholder orientation. Under the traditional shareholder orientation model, management is directly and only accountable to shareholders and is responsible for maximizing firm value. Under the stakeholder orientation model, management is responsible to a broader set of stakeholders that includes but is not limited to shareholders, such as workers and the society at large.

Regulation-imposed ESG mandates potentially affect the incentives of management to act solely or predominantly in the interests of shareholders. Regulation-imposed ESG mandates likewise affect the ability of shareholders to monitor and govern management when it pursues non-profit maximizing activities. This topic has been examined in an influential paper by Bebchuk and Tallarita (2020), who conclude that stakeholder capitalism "would insulate corporate leaders from shareholder pressures and make them less accountable." In the first part of this paper, I examine whether and how ESG mandates affect the incentives of managers to make efficient decisions that enhance shareholder value. I also go beyond the traditional

> "Mandatory ESG mandates distort managerial efficiency and exacerbate principal-agent problems between management and shareholders."

principal-agent problems discussed in the literature to consider the ability of shareholders to monitor the decisions of managers.

The examination of regulation-imposed ESG mandates and managerial efficiency also involves consideration of externalities, or costs or benefits that may be imposed by a firm on stakeholders other than its shareholders. Tirole (2001) even defines corporate governance as "the design of institutions that induce or force management to internalize the welfare of stakeholders." As such, the second part of this paper addresses the consequences of changes in the relationship between managers and shareholders resulting specifically from firms pursuing an ESG agenda. I document and assess both positive and negative externalities associated with regulation-imposed ESG mandates.

To briefly summarize, the evidence from the literature canvassed herein is consistent with the view that mandatory ESG mandates distort managerial efficiency and exacerbate principal-agent problems between management and shareholders. While there are potentially significant positive externalities linked to ESG mandates, there are also potentially significant negative externalities. There is no evidence that the positive externalities outweigh the costs from managerial inefficiencies and the negative externalities.

Managerial efficiency and shareholder-management agency problems under mandatory ESG reporting

Regulation-imposed ESG mandates fit within the stakeholder orientation of the firm but are inconsistent with the traditional shareholder orientation which requires firm management to maximize shareholder value. There is an abundant literature as to why the stakeholder orientation is less efficient than a shareholder orientation.

Stakeholders include third parties that are affected by management decisions including, for example, individuals and groups in the wider society who may be affected by pollution that the company in question is creating. Stakeholders also include consumers and employees that interact directly with companies, and who by their actions can influence corporate profits. Corporate actions that have an impact on shareholder value often internalize the effects on stakeholders, since the decisions of management affect such stakeholders. For example, companies may adopt more efficient environmental practices to obtain operating advantage. As such, not all shareholder value-maximizing decisions are inconsistent with those that maximize stakeholder value. For example, if shareholders value not having workers treated badly, as stakeholders also would, then shareholder value maximization would be consistent with not treating workers badly.

There are many agency costs between shareholders and management. Managers take actions on behalf of shareholders. Managers may pursue their personal interests at the expense of the interest of shareholders in maximizing value. For example, managers may consume perks or misuse corporate assets to advance or meet their personal interests. The classic example of a managerial agency problem is a manager's misuse of corporate assets (cars, jets, etc.) for personal reasons, such as golf trips or vacations. But there are numerous other types of agency problems. For example, managers may have personal ties to specific charities and causes that originate from their networks or early life experiences. Corporate resources that are directed to charities or causes could give rise to personal benefits for management, such as positive reputational effects in the community. Transactions between managers and their favourite charitable organizations have the potential to be non-arm's-length, in that managers derive personal benefits from these transactions.

Shareholders monitor companies, which helps lessen these agency problems, but monitoring is imperfect and can be costly. At best, governance can mitigate agency problems, but it cannot completely eliminate them. On the flip side, these agency problems can be exacerbated by regulation-imposed ESG mandates. These mandates encourage management to seek out non-shareholder value-maximizing activities. They may cause managers to divert attention from activities that maximize corporate value. And they increase the scope for management to favour their personal interests. It is easier for management to justify these apparently innocuous, beneficent activities under regulation-imposed ESG mandates, since managers who are seen as accountable to everyone are accountable to no one (Paquet, 2019). For example, if share prices are doing poorly, management can claim it is working to minimize the firm's pollution output, or improve employee welfare, or anything else that would excuse a lack of focus on share prices and value maximization. As such, with ESG mandates in place, it becomes harder for shareholders to monitor the activities of management and replace inefficient or underperforming managers.

A principal-agent problem that is particularly severe in the case of ESG decision-making by managers is that management is not privy to the total ESG exposures of shareholders. As such, management's ESG decisions on behalf of shareholders are apt to be inefficient. Management does not actually know the ESG preferences of shareholders, or the level of ESG exposure of the firm's shareholders. Management therefore cannot optimize the type or level of ESG exposure for shareholders as they are not privy to information related to shareholders' portfolio exposure to ESG factors. Delegating ESG decisions to management takes away from investor choice and is less efficient than having each shareholder make ESG decisions

> **"It is naïve to think that management will put other stakeholder interests above their own in implementing a regulatory-induced ESG mandate."**

for themselves, leading to suboptimal allocations of ESG (Fama, 2021). It is more efficient for each investor to decide for themselves what their own optimal level of ESG is.

It is naïve to think that management will put other stakeholder interests above their own (Bebchuk et al., 2020, 2023) in implementing a regulatory-induced ESG mandate. Management does not know the different and changing levels of ESG exposures of shareholders, or the optimal level and types of exposures for society. As such, it is easy for management to justify putting forward their own interests above those of others and to pay less attention to value maximization.

Externalities with stakeholder orientation

The arguments in the prior section do not consider the externalities associated with imposing a regulatory ESG mandate, and more generally a stakeholder versus shareholder orientation. Our understanding of these externalities has improved significantly with recent empirical work. This section reviews recent work on these externalities from stakeholder and shareholder orientations. We begin by highlighting some positive externalities associated with a stakeholder orientation and then review evidence on negative externalities.

There are at least five possible positive externalities with a stakeholder governance model. First, there is possible contagion in conduct. When someone sees another individual or firm doing good work, this may encourage other people to likewise do good things. For example, it has been well documented that there is interorganizational contagion in corporate philanthropy (Galaskiewicz and Burt, 1991; Mei and Wang, 2021). Likewise, society is better off when firms lead by example by encouraging others to not violate ethical standards or not cause other forms of societal harm such as pollution. (This argument, however, does not explain why managers should be the philanthropists with shareholders' money.) And if others see that managers are misusing or making inefficient ESG allocations, then equally there could be contagion in misconduct. It is not clear that contagion-positive ESG efforts would flow from a regulatory induced mandatory ESG program. Shareholders as philanthropists might be better at bringing about contagion in ESG efforts, but there would likely be less shareholder philanthropy when shareholders see that the management of companies in which they are invested are directing their money to ESG expenses.

Second, in relation to the positive externalities that are part of the contagion from doing good, there can be benefits from creating brand externalities. That is, the brand itself could help spread a "positive feeling" about ESG efforts. However, the owner of the brand name would internalize these benefits and it is very hard to quantify the extent to which brand

externalities bring about more ESG in broader terms. Padela et al. (2021) documents positive brand externalities that come from the ability to bring about a system that communicates social values and aspirations, thereby better inspiring and creating altruistic objectives. Importantly, however, Padela et al. (2021) also explain that many brand externalities are not positive and include, for example, manipulation, deception, and greenwashing.

Third, there are possible positive externalities associated with firms engaging in less risk-taking behaviour. For example, there is evidence that banks engage in less risk-taking behaviour under a stakeholder model compared to a shareholder model (Leung et al., 2019). In view of the global financial crisis of 2007-2009, there could be enormous societal benefits from a reduction in such behaviour for banks. However, less risk-taking is not necessarily a likely outcome of other firms adopting a stakeholder model. Other evidence on risk-taking is not as conclusive. For example, one might have expected other forms of risk taking such as earnings management to be less common under a stakeholder model than a shareholder model, but there is no empirical support for this proposition (Cumming et al., 2021). And less risk-taking is not necessarily a good thing. In a market economy, there is an efficient amount of risk that companies are expected to take with respect to entrepreneurial and innovative activities.

Finally, stakeholder versus shareholder orientations might influence tax avoidance strategies. The evidence shows that there are greater tax avoidance incentives under a shareholder model than a stakeholder model. One explanation is that profits are likely to be lower under a stakeholder model, so tax avoidance is a lower priority. Cumming et al. (2021) find strong evidence consistent with this expectation. In particular, using US data from 1998-2018, Cumming et al. (2021) show that after the adoption of a constituency statute that allows companies to consider factors other than shareholder profit when making decisions, the effective tax rate of firms increased from 0.570 percent to 1.903 percent. The higher effective tax rate under constituency statutes shows that firms are less aggressive in tax reporting and managing their tax liabilities when they are accountable to society more broadly and not just to shareholders. The larger tax base, in turn, has potential positive externalities for society more generally depending on what firms do with their increased retained earnings.

Stakeholder orientations may give rise to externalities that are not always positive. The first negative externality is perhaps one of the more shocking ones. Berg et al. (2021) document that a data provider, Refinitiv, appears to have been back-dating ESG scores, or rewriting history (although there are other possible interpretations, but they had not yet been found when this paper was written). Berg et al. (2021) found that their original Refinitiv data downloads

had ESG scores uncorrelated with stock price performance. However, at a later date, when they subsequently downloaded the same data (same firms and same dates) stock returns were more closely and statistically correlated with the companies' ESG scores. A further subsequent data download showed an even stronger connection. Berg et al. (2021) inferred that data providers have an incentive to engineer ESG scores so that they appear more correlated with stock returns to improve the value of the ESG data to those that purchase the data, including practitioners, academics, and policymakers. Of course false data might lead to false inferences, which in turn imposes a negative externality on society as it induces socially wasteful expenditures and ESG disclosures, among other things. This type of misconduct or fraud is potentially more likely to occur with ESG reporting than conventional financial reporting due to lack of consensus on standardized ESG reporting frameworks and standards.

"...misconduct or fraud is potentially more likely to occur with ESG reporting than conventional financial reporting due to lack of consensus on standardized ESG reporting frameworks and standards."

Second, investors may even be willing to forgo investment returns for a "good feeling" linked to the appearance of being a green investor. For example, Li et al. (2022) show that there are significant non-pecuniary benefits to green investment in the United States municipal bond market. Based on data from 2013-2022, the "greenium" premium is -2.3 basis points on average. The greenium premium appears to be more significant in states in which residents are more climate change aware. This greenium is an inefficiency because if investors are willing to trade financial returns for "warm glow" consumption benefits, firms operate less efficiently. There is a social cost as the consumer surplus is lower than it would otherwise be.

Third, Roberts (2022) shows that investors are willing to pay fund managers a premium to be associated with investment funds that promote ESG, even when there are no underlying differences in the assets. For example, Roberts (2022) compares index funds with low fees to funds that mimic such less expensive index-like funds, albeit with an ESG branding (i.e., the fees should be the same because the underlying investment strategy is essentially the same). He documents that some funds with ESG branding (and no other major differences) have fees that can be more than double. This type of socially wasteful expenditure of course has a negative externality, as capital is misallocated to funds that purport to be ESG-based but actually are not (against investors' desired outcome). Also, transaction costs are higher than they should be from an efficiency standpoint. The evidence from Roberts (2022) shows that investor attention is misallocated, and investors make mistakes when faced with ESG marketing.

Fourth, and related to the second point, there is a general greenwashing problem where firms simply make it appear as if they are ESG oriented when they are really not. Delmas

and Burbano (2011), among many others, document negative societal externalities with greenwashing due to negative effects on consumer and investor confidence in green products, which in turn leads to a misallocation of capital.

Finally, there is contagion in these negative externalities, and in misconduct more generally. Many psychological studies have shown that when individuals see others doing something bad, it encourages them to engage in similar bad behaviour as they see less stigma associated with doing the bad thing (Gino et al, 2009; Quispe-Torreblanca and Stewart, 2019; Rahwan, et al. 2019; Trevino and Victor, 1992). So, when firms engage in greenwashing, manipulate ESG data, and charge higher fees for faked green funds, among other problems, the negative consequences spill over to other firms, investors, and stakeholders more generally. Pushing firms to adopt a stakeholder orientation could therefore have negative consequences that extend beyond the firm due to misconduct incentives and contagion in misconduct. Greenwashing and manipulating ESG data may encourage others to engage in similar forms of misconduct, misreporting, and fraud. Managers see competitors getting away with these bad behaviours and engage in similar activities to minimize their own ESG compliance costs and attract investors, customers, and appease other stakeholders. Managers may derive career benefits from greenwashing by showing apparent compliance at low cost. Shareholders have less incentive than stakeholders do to monitor greenwashing, since it is in their financial interest to not report it.

Summary and conclusions

This paper began by listing the arguments around the inefficiencies associated with a stakeholder versus a shareholder orientation among companies. These inefficiencies include a lack of accountability and information asymmetries between a firm's management and its investors. On their own, these arguments can lead one to infer that stakeholder governance is less efficient than shareholder governance, consistent with the work of Bebchuk et al. (2020, 2023) and others.

The paper then analyzed externalities relating to stakeholder governance. These externalities can be both positive and negative. In the absence of greenwashing, data manipulation, and fee gouging for ESG investing, which are not insignificant concerns, stakeholder governance could lead to positive outcomes by lowering the incentives for firms to take on excess risks and practice aggressive earnings management, thereby bringing about greater financial stability. Further, firms are less likely to engage in tax avoidance under a stakeholder governance model.

> **"... empirical evidence to date shows that greenwashing, data manipulation, and fee gouging for ESG are all very real problems that create large negative externalities for society."**

But the empirical evidence to date shows that greenwashing, data manipulation, and fee gouging for ESG are all very real problems that create large negative externalities for society. The sum of the costs of these externalities is hard to quantify, but the evidence summarized in this paper suggests they are large. There is no evidence that any possible benefits of ESG externalities outweigh the costs of the negative externalities. And similarly, there is no evidence to suggest that any possible benefits of ESG externalities would outweigh the cost of managerial inefficiencies caused by mandatory ESG mandates.

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Does Adopting a Stakeholder Model Undermine Corporate Governance?

Steven Globerman

Executive Summary

The purpose of privately owned businesses has been an increasingly important issue confronting executives and members of corporate boards since Friedman's iconic 1970 essay that argued that the purpose of private businesses is to maximize profits, which equates to producing and distributing their products as efficiently as possible. Perhaps the most prominent challenge to Friedman's argument is the claim that a narrow focus on benefiting shareholders is inconsistent with benefiting society more broadly. Critics of Friedman's *shareholder* model of corporate governance propose that administrators of companies implement a *stakeholder* model. The stakeholder model of corporate governance prioritizes the interests of a range of different economic agents including consumers, employees, suppliers, local communities in which companies are located, and the physical environment in addition to shareholders.

The practical relevance of the stakeholder model has been questioned on the grounds that a profit-maximizing business will act in the interests of important stakeholders anyway, particularly consumers and employees, because it is profitable to do so. A business that ignores the interests of its customers will lose sales to companies that promote their consumers' welfare, while a business that "underpays" or otherwise takes advantage of its employees will find it more difficult to hire competent employees compared to rivals who offer competitive compensation packages and related conditions of employment. In this context, the stakeholder model is a relevant challenge to the shareholder model only if business behaviour

> "Mandatory ESG mandates distort managerial efficiency and exacerbate principal-agent problems between management and shareholders."

differs between the two models. Specifically, the models differ in their relevance only if promoting the interests of non-shareholders comes at the expense of shareholders.

Obviously, if the stakeholder model of governance is inconsistent with economic efficiency, it is possible that other stakeholders besides shareholders will fare worse under the stakeholder model of governance than they would under the shareholder model. Most obviously, a decline in efficiency implies that consumers will be charged higher prices and employees will earn less compensation. Suppliers will be paid less for their inputs, and communities will realize lower business tax revenues. In short, an argument can be made that many stakeholders would be better off if companies maintained the "traditional" shareholder model of corporate governance.

Bebchuk and Tallarita (2020a; 2020b) make a case for why the stakeholder model of corporate governance is inferior to the shareholder model from the perspective of overall social welfare. The reason is that senior executives and corporate board members are more likely to implement strategies and actions that benefit themselves at the expense of shareholders and other stakeholders. This is because it is more difficult for stakeholders to monitor the performance of executives and board members when the latter operate with broad, possibly conflicting, and difficult-to-measure objectives, as well as because the incentives to monitor the performance of executives and board members are weaker when there is a large number of principals whose interests are at stake. The potential for principal-agent conflict (i.e., a situation in which a company's management prioritizes its own pecuniary and non-pecuniary interests over the interests of shareholders) is relevant even when the shareholder governance principle guides corporate actions. In this context, Bebchuk and Tallarita's main contribution is their extension of the problem that principals have in ensuring that their agents act in their interest to the stakeholder governance model.

Proponents of the stakeholder model of corporate governance argue that adopting the model will promote corporate actions that address social pathologies such as climate change, discrimination, and income inequality. Conversely, Bebchuk and Tallarita argue that stakeholder governance will displace laws and regulations which are more effective instruments to address broad environmental and social issues. In this regard, Bebchuk and Tallarita's objection to stakeholder governance is similar to Friedman's admonition that private sector executives should not be expected to assume the roles of politicians in a democratic society.

While there is no direct evidence bearing upon the issues that Bebchuk and Tallarita discuss, there is some evidence from the performance of mixed enterprises suggesting that expanding the mandate of corporate executives to include environmental and social objectives is

likely to produce the worst of all possible worlds. Mixed enterprises are organizations in which there is both public (government) and private ownership. As such, mixed enterprises are meant to focus on achieving social goals such as reducing unemployment, while also making profits for their private owners. In fact, evidence suggests that mixed enterprises are less profitable that their privately owned counterparts, while they are also less likely to achieve targeted social benefits compared to their non-profit counterparts.

"Evidence suggests that mixed enterprises are less profitable that their privately owned counterparts, while they are also less likely to achieve targeted social benefits compared to their non-profit counterparts."

This and other indirect evidence suggests that the interests of society are more likely to be promoted by the wealth created by efficient businesses operating under a shareholder governance model than by mandating or otherwise pressuring companies to pursue environmental and social goals within a stakeholder governance framework. Increased wealth provides the financial and technological means to help address environmental and other social objectives.

Introduction

The past few decades have witnessed increasing demands on the part of prominent investment managers, academics, and environmental and consumer activists, among others, for senior executives and corporate board members to adopt one or another so-called stakeholder model in place of the traditional shareholder model.[1] The stakeholder model of corporate governance obliges senior managers and board members (henceforth referred to as administrators) to prioritize the interests of groups beyond shareholders in their corporate decision-making. In effect, under the stakeholder model, shareholders are only one of several constituencies whose interests should be considered by administrators in the latter's decision-making. Besides shareholders, stakeholders can include consumers, employees, suppliers, the larger communities in which organizations do business and, for many proponents of stakeholder governance, the natural environment. The stakeholder model of corporate governance can be seen as an evolutionary rebuttal of Friedman's (1970) iconic defense of the traditional shareholder model, which holds that long-run profit-maximization should be the sole objective of corporate administrators operating in a manner that adheres to broadly applicable legal and regulatory frameworks established by the state.

A recent specific focus of the ongoing debate surrounding whether the stakeholder model should be the dominant principle underlying corporate governance encompasses the ability of administrators to implement some version of the stakeholder model and whether the wider interest of society is best served by administrators adopting the stakeholder principle of corporate governance. Obviously, the latter issue supersedes the former issue, since if adopting the stakeholder model is not in the broad public interest, it then follows that

administrators should not adopt that model as the guiding principle of corporate governance. However, even if the stakeholder model is in some conceptually relevant ways a superior principle to guide administrative decision-making, it is irrelevant as a practical guide if administrators cannot operationalize it efficiently. Indeed, there has been an active recent debate surrounding the legal and practical constraints on administrators prioritizing a stakeholder model over a shareholder model.[2]

The main focus of this essay is on the feasibility of operationalizing a stakeholder model of corporate governance, as well as the plausible consequences of prioritizing the interests of stakeholders other than shareholders as the main principle of corporate governance. An important question raised by the latter consideration is whether the interests of stakeholders are better served by administrators pursuing a shareholder model of corporate governance rather than a stakeholder model.

The essay proceeds as follows. The next section summarizes the main arguments put forward by US scholars Lucian Bebchuk and Roberto Tallarita against the adoption by administrators of a stakeholder model of corporate governance. While several of Bebchuk and Tallarita's arguments are rooted in Friedman's original defense of shareholder governance, the recent debate surrounding the practical challenges to implementing a stakeholder governance model has primarily centred on Bebchuk and Tallarita's criticisms of alternatives to shareholder governance. The third section presents the main rebuttals to Bebchuck and Tallarita's analysis. Section four offers an assessment of the arguments for and against shareholder governance. Concluding comments are provided in the final section.

Bebchuk and Tallarita's critique of the stakeholder model

Before discussing Bebchuk and Tallarita's critique of the stakeholder model of corporate governance, it is useful to outline the main features of that model. As noted above, the core premise of the model is that there are other important stakeholders besides shareholders whose interests administrators should take into account when they set and implement corporate strategy and associated corporate activities. Two broad justifications have been offered in support of this expansive governance principle. The first is that incorporating the interests of stakeholders other than shareholders into administrative decision-making will enhance the long-run profitability of for-profit companies. The second and more nuanced justification is that stakeholder governance is socially desirable, even at the cost of reduced long-run returns to shareholders, to the extent that stakeholder governance helps address broad social problems such as climate change and income inequality.

Bebchuk and Tallarita (2020a; 2020b) dismiss the first justification as an "enlightened shareholder value" version of the stakeholder model. They argue that such an instrumental version of "stakeholderism" is not conceptually different from shareholder primacy, a point made by Friedman (1970) and others.[3] Any difference between the shareholder governance model and the stakeholder governance model is purely semantic, and therefore no good reason exists for administrators to adopt the stakeholder governance model.

With respect to the second justification, Bebchuk and Tallarita implicitly agree with Friedman's (1970) caution against having unelected private-sector administrators making broad social policy decisions. Specifically, they argue that incorporating the welfare of individual stakeholder constituencies into a business organization's objective function will inevitably oblige administrators to make tradeoffs, whereby some stakeholders will benefit at the expense of others. Making such tradeoffs, in turn, requires administrators to identify the relevant set of stakeholders and assign weights to the relative importance of the various stakeholders and their interests in order to make tradeoffs in a manner that increases the overall social welfare created by their administrative decisions. For example, a decision to substitute clean energy sources for carbon fuels will reduce an organization's carbon emissions and contribute in a very small way to ameliorating climate change. However, it is likely that the organization's costs will increase, with these higher costs passed on to consumers of the organization's products in the form of higher prices. An informed evaluation of this tradeoff would require administrators to assign relative values to their organization's contribution to mitigating climate change and to the associated economic harm to consumers. The tradeoff becomes even more complex if other stakeholders are involved. In this regard, it is likely that shareholders will be affected by the organization's higher costs of producing output, as will employees and other input suppliers if the organization's scale of operations or its competitive position within its industry is affected by its fuel use selection.

"(Bebchuk and Tallarita) argue that incorporating the welfare of individual stakeholder constituencies into a business organization's objective function will inevitably oblige administrators to make tradeoffs, whereby some stakeholders will benefit at the expense of others."

The ubiquitous nature of ongoing tradeoffs across various constituency groups and societal objectives under the stakeholder governance model obliges unelected private sector administrators to make complex and perhaps controversial judgment calls. Bebchuk and Tallarita question whether corporate administrators are competent to make such judgment calls.[4] More specifically, they argue that the comparative advantage in formulating and implementing public policy resides with regulators and politicians. In this regard, Bebchuk and Tallarita (2020a) acknowledge and accept that corporate activities can have adverse effects

on stakeholders and cite environmental harms as an example. They go on to argue that their preference for addressing such harms through government laws and regulations reflects their belief that laws and regulations are more effective and appropriate instruments for dealing with potentially adverse environmental and social consequences of business activity, as opposed to relying on the judgment calls of private-sector administrators.[5]

As will be discussed in more detail in the next section of this essay, a criticism of Bebchuk and Tallarita's defense of the shareholder model is that it too readily dismisses the ability of administrators to identify and prioritize the interests of different stakeholders. Another criticism is that their defense ignores the existential imperative for administrators to adopt a stakeholder model of governance because if they do not do so, the public may increasingly question the rationale for private ownership of businesses.[6] As a practical defence of the shareholder model, Bebchuk and Tallarita cite legal constraints on administrators that oblige them as fiduciary agents for shareholders to act in the interests of shareholders. They also argue that the compensation that administrators receive typically is closely tied to the financial performance of their organizations. Hence, changes in both the legal environment regarding the responsibilities of administrators and the structure of administrators' compensation would need to be implemented to facilitate the adoption of the stakeholder model.

If we accept for the moment that the legal environment surrounding corporate governance can be modified so that administrators face no potential legal liabilities for implementing stakeholder governance, the issue of particular relevance is how administrative behaviour would change if administrators operated under a stakeholder model rather than a shareholder model of corporate governance.[7] Bebchuk and Tallarita (2020a; 2020b) argue that the incentives for administrators to act opportunistically would increase significantly if shareholder governance was replaced by stakeholder governance. In this context, acting opportunistically means that administrators would use more of the organization's resources for their own benefit rather than for the benefit of stakeholders, including shareholders, than would otherwise be the case. Such behaviour could take the form of using corporate resources for perquisites such as personal travel, transportation, and entertainment, hiring friends and family members as employees or consultants, and simply taking more leisure time and devoting less time and energy to work.

There are two main reasons to expect more opportunistic behaviour on the part of administrators operating under a stakeholder governance model. One is that it is much more difficult to structure an effective compensation scheme for administrators when the objectives of the organization are ill-defined and difficult to measure than when they are clearly defined and readily measurable.[8] A second reason is that there will be less effective monitoring of the behaviour and performance of administrators the larger and more diffuse the set of principals in whose interests the administrators are presumably acting, since the benefits to any subset of principals from engaging in monitoring are dispersed among a much larger group of principals. This condition encourages free-riding in monitoring administrators.

Increased opportunism on the part of administrators applied across many business organizations almost certainly will translate to slower productivity growth in the private sector. This, in turn, means lower profits and likely higher prices for consumers and lower wages for employees. It also means lower tax revenues for governments, with concomitant fiscal pressure to reduce the growth of government spending on social programs. In this context, and following the logic of Bebchuk and Tallarita's analysis, a stakeholder model threatens to compromise the welfare not just of shareholders but of virtually all of society.

Criticisms of Bebchuk and Tallarita's arguments

Prominent academics and practicing legal experts have criticized the arguments against the stakeholder governance model as discussed in the preceding section. It is relevant to note that just as some of Bebchuk and Tallarita's arguments in favour of shareholder governance overlap those made by Friedman, so too some of the criticisms of Bebchuk and Tallarita's analysis overlap earlier rejections of the shareholder governance model.

Perhaps the most directly relevant criticism is the rejection of the Bebchuk/Tallarita argument that adopting the stakeholder model will encourage opportunism on the part of administrators and therefore will promote inefficiency with widespread social costs. Mayer (2022) claims that an increasing percentage of institutional and retail investors want the companies they invest in to pursue environmental, social and governance (ESG) objectives, as is implicit in the stakeholder governance model. While he acknowledges that this obliges directors and asset managers to monitor corporate performance and to make judgments about corporate initiatives to promote ESG priorities, he argues that they are capable of doing so, as long as companies have clearly stated corporate purposes, e.g., to reduce their carbon emissions by a given amount over a given period of time.

Mayer further argues that even though the outcomes of many ESG initiatives cannot be quantified in a standardized format that permits aggregation, e.g., units of a currency, non-monetary costs and benefits can be measured "in their own terms." While he does not spell out this notion precisely, Mayer suggests that corporate directors can make meaningful value judgments regarding corporate actions just as individuals facing personal tradeoffs can. Underlying the capability of directors to evaluate the decisions of senior management is a clear statement of the corporation's social purpose and explicit ESG-related objectives.[9]

Savitt and Kovvali (2022) dismiss concerns about directors acting opportunistically even if given the opportunity. They characterize Bebchuk and Tallarita as imagining that directors,

freed from the shackles of share-price maximization, will engage in a frenzy of self-interested behaviour, ordering corporate affairs to their own benefit without regard to corporate purpose or corporate value. They assert that no one who has actually advised a corporate board would give credence to this characterization of board members' behaviour. Rather, they maintain that the majority of directors are "decent and careful," and that norms matter to them. Moreover, if directors fail to perform their oversight function effectively, they can be voted out of their positions by shareholders and even sued. Savitt and Kovvali therefore highlight what is perhaps the main focus of the debate about corporate governance that Bebchuk and Tallarita raise. Namely, is the accountability of administrators significantly compromised if companies adopt the stakeholder governance model? This issue will be discussed more fully in the next section of the essay.

Savitt and Kovvali also reject the argument that environmental and social policy issues are appropriately in the decision-making domain of legislators and regulators, not corporate administrators.[10] They assert that external regulation of business and adherence to the shareholder governance model has been a failure, as evidenced by a worsening climate crisis and a burgeoning crisis of income inequality among other social pathologies. At a minimum, they argue, the widespread adoption of the stakeholder governance model will not render external regulation any less effective than it has been in the recent past—contrary to Bebchuk and Tallarita's views—although they stop short of arguing that private sector administrators will be more efficient and effective in addressing environmental and social issues than politicians and regulators have been.[11] They do assert that the public is increasingly exasperated by public officials who seem unable or unwilling to "step in," and so citizens are now demanding "better performance" from the corporations they interact with. Hence, they argue, the failure of companies to discard the shareholder governance model will therefore undermine public trust in the private sector, which over time poses an existential risk for capitalist enterprises.

"Savitt and Kovvali suggest that a commitment to stakeholders helps a company connect more deeply to its customers and enables it to adjust to the changing demands of society—which ultimately has an important bearing on long-term corporate profitability."

In summary, it should be emphasized that Bebchuk and Tallarita's critics do not argue that shareholder interests should be devalued under the stakeholder model, although how shareholders' interests remain uncompromised when the stakeholder model is implemented is usually not clearly explained. Savitt and Kovvali suggest that a commitment to stakeholders helps a company connect more deeply to its customers and enables it to adjust to the changing demands of society—which ultimately has an important bearing on long-term corporate profitability. However, this is merely a version of the enlightened shareholder value argument

for the stakeholder model. A more nuanced version of this argument is that the shareholder model encourages a focus on short-run profit maximization at the expense of long-run value maximization. This focus benefits administrators at the expense of shareholders who, for reasons not made clear by proponents of the stakeholder model, are supposedly unable or unwilling to hold administrators to account for sacrificing long-run wealth maximization in order to drive up share prices in the short run and thereby boost executive compensation tied to stock options and the like.[12]

Mayer (2022), among many others, accepts that shareholders are likely to suffer some financial penalty if companies abandon the shareholder model in favour of the stakeholder model. However, he argues that many shareholders are willing to accept a financial penalty in exchange for the companies in which they invest promoting broader social purposes beyond profit-maximization. The growth of the ESG-investing phenomenon suggests that a significant percentage of private investors seems willing to have their administrators follow a stakeholder governance model, although it is less clear that those investors are expecting and accepting of lower risk-adjusted financial returns by doing so.[13] If investors are so inclined and capital markets are relatively efficient, the lower risk-adjusted returns should be offset by so-called psychic returns, i.e., the psychological satisfaction of contributing financially to environmental and social causes. However, this is not a sufficient defense of adopting the stakeholder model since individual shareholders can make direct financial contributions to non-profit organizations and other worthy causes using the returns they make on their investments.[14] It is certainly possible that the foregone profits associated with departing from a shareholder model mean less rather than more financial surplus is available for environmental and social initiatives.[15]

In summary, Bebchuk and Tallarita's critics are compelled to address the issue of whether the effectiveness of administrators in serving the interests of ESG-oriented shareholders, as well as other stakeholders, will diminish significantly when their organizations switch from shareholder to stakeholder governance models. In particular, the "good" social outcomes that ESG-oriented shareholders might be seeking may not be realized if administrators appropriate or otherwise dissipate the returns that should have gone to shareholders and other stakeholders.[16] This concern returns the analysis to Bebchuk's and Tallarita's focus on the incentives and capabilities of administrators to act opportunistically, and whether these incentives and capabilities are conditioned by the choice of corporate governance model.

Determinants of opportunism and indirect evidence

As discussed in an earlier section of this essay, there are at least two prominent reasons to expect that moving from a shareholder to a stakeholder model will exacerbate principal-agent conflicts in companies, in this case conflicts between different groups of stakeholders, including shareholders, and administrators. One is that the proliferation of performance criteria will make it more difficult for shareholders and other stakeholders (i.e., principals)

to monitor the actual performance of administrators (i.e., agents), especially when the additional (to profitability) criteria are difficult to quantify. A second reason is that expanding the set of principals who prioritize different performance criteria, as will be the case when moving to a stakeholder model, is likely to reduce the incentives of stakeholders to monitor the performance of administrators. These two phenomena underlie the conceptual relevance of Bebchuk and Tallarita's criticism of the stakeholder governance model. However, the practical relevance of their criticism is ultimately an empirical issue.

Some insight into the empirical relevance of their criticism of stakeholder governance can be drawn from studies of the financial performances of companies that are relatively highly rated for their ESG performance compared to their less highly rated counterparts. While it is possible that the highly rated companies have found ways to monetize their ESG initiatives and are therefore still profit-maximizing, it might also be the case that highly rated ESG-oriented companies are more likely to have adopted a stakeholder model. The latter assumption, combined with an anticipated more problematic principal-agent relationship, leads to a prediction that highly rated companies on ESG metrics will have significantly lower financial returns compared to less highly rated companies.

Globerman (2022c) reviews the literature on returns to ESG investing and concludes that the available evidence shows no consistent relationship between a company's ESG alignment and the returns on equity, holding constant other factors influencing returns on equity shareholdings. This general finding is not direct evidence that stakeholder governance contributes to reduced firm-level economic efficiency and hence lower profitability because of administrative opportunism, as one would expect to see a consistent negative relationship between ESG rankings and returns to equity to be consistent with the Bebchuk and Tallarita argument. However, this evidence does cast doubt on the validity of the enlightened shareholder defence of the stakeholder model.[17]

The performance of "mixed enterprises," which are organizations in which government and private investors share ownership, provides indirect evidence bearing on the relationship between the stakeholder model and corporate governance. The mixed ownership model can be likened to the stakeholder model of corporate governance, inasmuch as government investors presumably have objectives different from those of private investors and take equity shares in organizations in order to promote strategies and actions that would not otherwise be implemented if the organizations were entirely privately owned. A finding that mixed enterprises perform less efficiently than enterprises that are entirely privately owned and

presumably pursuing a shareholder model of governance would be consistent with Bebchuk and Tallarita's basic argument.

Boardman and Vining (1991) provide a comprehensive analysis of the behaviour and performance of mixed enterprises. They note that the outcomes are different depending upon factors such as the degree of public versus private ownership and the extent of concentration or dispersion of private shareholdings. The degree of competition in the enterprises' main lines of business also influences their performance, holding ownership structure constant. They conclude that different ownership structures affect the extent to which mixed enterprises engage in profit maximization, socio-political goal maximization, or managerial utility maximization (i.e., administrator opportunism). Ownership structure also affects the degree of conflict between one owner and another, and between an owner and management. Overall, they assess both theory and evidence as suggesting that mixed enterprises do not achieve socio-political objectives nor attain the efficiency of private enterprises. In effect, mixed enterprises are the worst of both worlds. This overall finding is consistent with Bebchuk and Tallarita's concern about multiple objectives and disparate stakeholders compromising corporate governance, with associated adverse economic outcomes for shareholders and arguably unsatisfactory outcomes for a broader set of stakeholders.

Yet another stream of literature provides some insight into the behaviour of organizations that do not have relatively narrow and well-defined objectives and where management is not accountable to a single group of stakeholders with the power to reward and punish management based on the latter's performance. Specifically, Chant and Acheson (1972) and Acheson and Chant (1973) draw on the theory of public choice, and specifically the theory of bureaucratic behaviour, to analyze central bank monetary policy. At the time they wrote their articles, the legislation governing central banks typically provided a wide-ranging mandate with multiple, vaguely defined goals. While price stability was almost always one of those goals, it was not a well-specified goal, and its ranking relative to other goals was not necessarily clear, making decision-making difficult and accountability problematic.

Acheson and Chant argued that the vagueness surrounding the objectives of monetary policy and the opaqueness of central bank behaviour suited central bank officials who were empowered by these conditions to maintain their status and their organizational resources by evading public scrutiny and accountability. The ambiguity surrounding central bank objectives and the opaqueness of their behaviour was also consistent with the interests of central bank administrators given that central bankers were unsure that they could readily achieve any clearly specified set of objectives with the tools they had at hand.

In a more recent contribution, Schembri and Globerman (2023, forthcoming) link opaqueness and weak accountability surrounding monetary policy to the rapid inflation and above-average unemployment (stagflation) during the 1970s and 1980s, which, in turn, triggered widespread public dissatisfaction with the performance of central banks. Public

pressure for improved macroeconomic performance led to the adoption of specific and explicit inflation targets. At the same time, central banks were accorded independence from governments to achieve and maintain those targets. Schembri and Globerman conclude that the adoption of explicit numerical inflation targets and related governance and transparency reforms worked well to lower inflation from the much higher rates of the 1970s and 1980s and helped keep inflation low and stable for the subsequent three decades prior to the Covid-19 pandemic.

What central bank history suggests is that the nature of an organization's governance affects the behaviour of administrators and the performance of their organizations. In particular, it suggests that ambiguous organizational objectives weaken the accountability of administrators to the organization's stakeholders, which benefits the former and harms the latter. This experience supports Bebchuk and Tallarita's concern that the adoption of broad stakeholder governance models by for-profit companies will harm the interests of shareholders without necessarily benefiting, and indeed possibly even harming, the interests of other stakeholders.

Concluding comments

There is a lengthy academic literature discussing how the separation of ownership from management in large publicly traded companies creates conditions under which managers can pursue their own personal objectives and interests rather than creating wealth for shareholders.[18] Indeed, some critics of Bebchuk and Tallarita's position on stakeholder governance point to the diverse interests of the shareholders of large public companies as presenting a similar challenge as the stakeholder model to the principal-agent relationship.[19] However, rather than acknowledging that the principal-agent relationship will face yet additional challenges by expanding the scope of the competing objectives of greater numbers of stakeholders, Mayer (2022) and others argue that, if directors can be relied upon to hold managers accountable to shareholders, they can also be relied upon to hold management accountable to a larger and more diverse set of stakeholders.

While theory and evidence suggest that organizations will become less efficient and therefore less profitable when moving from a shareholder to a stakeholder governance model because of increased administrator opportunism and a focus on multiple objectives, no meaningful public policy concerns are raised as long as shareholders are knowledgeable and can sell their investments in less profitable companies in order to reinvest in more profitable companies.[20] Under such circumstances, it can be presumed that investors in organizations explicitly pursuing ESG initiatives under stakeholder governance principles have interests beyond maximizing the risk-adjusted rates of return on their investments. As such, legislation prohibiting fiduciaries from making investments in companies that publicly disclose their commitments to ESG initiatives will reduce the span of assets available to investors, which would make capital markets less efficient, other things constant.[21]

By the same token, legislation and regulations that directly or indirectly oblige companies to substitute stakeholder governance for shareholder governance also limit the set of assets available to investors and make capital markets less efficient. To the extent that a substantial number of investors want to "do well by doing good" and favour companies operating according to a stakeholder model, the favoured companies will enjoy equity price premia and lower financing costs, thereby enabling them to invest and grow relative to companies that do not adopt a stakeholder governance framework. If it turns out that administrator opportunism makes doing good too costly for investors, companies operating under a shareholder model will attract financial capital, thus enabling them to grow relative to companies operating under a stakeholder model.[22] In short, investors can express their corporate governance preferences in capital markets, which renders moot the issue of whether regulators should mandate the adoption of stakeholder governance.

To be sure, Bebchuk and Tallarita's critics are not primarily concerned about capital market efficiency. Those critics who claim they are defenders of capitalism assert that the survival of free market enterprises is contingent on those enterprises making a robust commitment to ESG principles and, therefore, to implementing a broad stakeholder governance model. Put simply, they argue that society is demanding that organizations abandon the shareholder model or else face legislation and regulations that might put them out of business.

"The ultimate supporting argument for shareholder capitalism is that the wealth created by companies committed to maximizing efficiency and long-run profitability underlies higher standards of living and the financial and technical capacity of societies to address environmental and social problems..."

It is beyond the scope of this essay to address this broad concern about the survival of capitalism. In this regard, Friedman's (1970) admonition to corporate leaders is relevant. He cautioned that while there might be short-term financial advantages to cultivating the good will of politicians by pursuing and publicizing their organizations' commitments to ESG initiatives, the longer-run effect is to undermine the legitimacy of corporate profitability and, therefore, the social role of private ownership of productive assets. The ultimate supporting argument for shareholder capitalism is that the wealth created by companies committed to maximizing efficiency and long-run profitability underlies higher standards of living and the financial and technical capacity of societies to address environmental and social problems that are identified through the democratic political process. In this context, the social legitimacy of private enterprise is inseparable from the shareholder governance model.

Endnotes

1 The first major academic contribution to the model of stakeholder capitalism is arguably Freeman (1984). The development of the stakeholder model of corporate governance in the literature, including the arguments for private-sector companies to implement the model, are discussed in detail in Globerman (2022a).

2 The prominent contributions to this debate include Bebchuk and Talarita (2020a and 2020b), Mayer (2022) and Savitt and Kovvali (2022). This debate has materialized, among other ways, in lawsuits by attorneys general in several US states challenging environmental, social, and governance (ESG) investing of state employee pension monies with a lawsuit against the federal government's Labor Department and in letters that assail proxy advisory firms that have supported shareholder motions proposing corporate ESG initiatives. See Ramones and Hudson (2023).

3 See Globerman (2022b) for a discussion of similar interpretations of enlightened shareholder value versus the stakeholder model.

4 Friedman (1970) argued that it is inappropriate to delegate the job of formulating public policy to non-elected officials.

5 Bebchuck and Tallarita provide no empirical evidence either in support or against the claim that laws and regulations are more effective than the judgment calls of administrators in addressing environmental and social problems.

6 Mayer (2022), among others, argues that the social legitimacy (and even the long-term survival) of private sector businesses is contingent on their acting in a socially responsible manner which, of necessity, means implementing the stakeholder governance model either explicitly or implicitly.

7 Edmans (2023) argues that administrators currently enjoy substantial scope under current securities regulations to make decisions that they think are in the interests of their organization's financial welfare, including ESG initiatives, even if shareholders disagree.

8 For a summary discussion of the challenges to designing and implementing efficient administrative compensation schemes when decision-making spans a portfolio of activities, many unclearly defined, and that engage an array of policy instruments, see Holmstrom (2017). Edmans (2023) asserts that when stakeholder objectives are in direct conflict, it is impossible as a practical matter to link the compensation of administrators to overall stakeholder performance.

9 Conversely, Edmans (2023) argues that if some stakeholder objectives are easily measured while others are not, by having compensation linked to performance, administrators will have an incentive to promote the measurable objectives, even if the organization as a whole would be better off if the difficult-to-measure objectives were prioritized.

10 In their context, the domain of legislators and regulators includes measures such as environmental protection, product safety, and labour protection and hiring practices.

11 Savitt and Kovvali identify the linkage between the stakeholder model and the crowding out of external regulation as being the most important issue that Bebchuk and Tallarita raise—and also the latter's weakest argument.

12 Edmans (2023) rejects the claim that the shareholder model leads to inefficient investment behaviour because of unduly short shareholder time horizons. He argues that in efficient capital markets, today's share price for any publicly traded security will reflect all known actions that affect a company's net present value, both short-run and long-run. Hence, current share prices will suffer if organizations deliberately sacrifice more profitable long-run business investments in favour of less profitable short-run business investments. A decline in a company's share price hurts all shareholders regardless of their investment time horizon.

13 ESG investment strategies encompass investing in companies that score highly on environmental and social responsibility league tables as determined by third-party, independent ESG rating services. Saad (2022) discusses recent polling by the Gallup organization showing that the potential for profit and loss is the main concern of investors when choosing a stock investment. A minority say they look into corporate governance policies, or the social values advocated by company leadership before investing. Venkataramani (2021) discusses survey research done by the Gartner Group which (contrary to Gallup's results) shows that 85 percent of investors considered ESG factors in their investment decision-making. Overall, investors consider ESG investments safer and more stable than alternative investments.

14 Obviously, companies can make direct charitable donations from their retained earnings rather than distributing dividends to shareholders who can then make donations. Whether corporate philanthropy is more efficient than private philanthropy is beyond the scope of this essay.

15 Edmans (2023) discusses empirical evidence showing that shareholder proposals made by single-issue investors promoting specific environmental or social actions typically destroy long-term firm value. Shareholder engagement is more likely to create "social value" when shareholders supporting environmental and social actions on the part of their company have identical objectives, which seems unlikely in most circumstances.

16 Whether the failure of administrators to be effective agents for stakeholders is the result of deliberate malice or simply not being up to the complex decision-making required is irrelevant in this context. For convenience of exposition, we ascribe reductions in the performance of agents to deliver desired benefits to principals to the opportunism of administrators.

17 Globerman (2022c) also discusses a number of methodological caveats to empirical studies of the relationship between ESG rankings and equity returns.

18 This stream of literature can be traced back to the seminal contribution of Berle and Means (1932).

19 For example, see Mayer (2022).

20 The relevant notion of profits here and elsewhere in this essay is risk-adjusted profits.

21 It might be the case that auditing and related costs increase when companies are required to "certify" disclosures about their ESG initiatives. Shareholders should be expected to bear such increased costs, as they do for standard financial audits.

22 In equilibrium, investors should be indifferent to any company's commitment to ESG initiatives, as every company's share price will fully reflect the pecuniary and non--pecuniary expected returns relative to other companies. This nuance is not of concern here, as the basic argument for the stakeholder capital model rests on an assumption that there is broad demand for changes in corporate behaviour, i.e., capital markets are currently not in equilibrium with respect to corporate governance characteristics.

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ESG Disclosures and the Decision to Go Public

Douglas Cumming

Introduction

An initial public offering (IPO) involves listing a firm's shares for sale on a stock exchange for the first time (known colloquially as "going public"). This essay analyzes of two questions critically. First, does mandatory environmental, sustainable, and governance (ESG) disclosure increase the net costs of going public, so that privately owned companies are less likely to do so? Second, if private companies are indeed less likely to go public, what are the associated economic costs of that choice?

Mandatory ESG *disclosures* are distinct from mandatory ESG *practices*. While both have costs and benefits, their magnitudes are likely to differ, and the conceptual arguments underlying their benefits and costs may also differ. In this paper, we focus on mandatory ESG reporting, not on ESG practices. Mandatory ESG disclosures are requirements that stock exchanges and securities regulators impose.

There is conflicting evidence on the impact of mandatory ESG reporting on stock market performance following an IPO. On one hand, some empirical evidence suggests that mandatory ESG disclosure improves IPO performance once the stock is listed. The rationale is that ESG disclosures lead to reduced information asymmetry, lower costs of capital, and higher share prices. This evidence could be used to imply that private companies filing for IPO approval should be mandated to issue ESG disclosures prior to their IPOs.[1] Further, this evidence could imply that all private companies that might someday list in public markets should be reporting ESG information even before going public. On the other hand, some empirical evidence shows that mandatory ESG disclosures harm the share prices of publicly traded companies, suggesting that the costs of such disclosures outweigh the benefits. This latter body of evidence is consistent with firms electing not to make ESG disclosures when

they are not forced to do so; said differently, if ESG disclosure contributes to higher equity prices and, therefore, to lower costs of capital, why would firms not voluntarily disclose ESG information even if they were not required by regulators to do so?

Overall, the available evidence reviewed in this paper shows that we should expect some firms to delay or avoid taking their companies public due to issues related to mandatory ESG disclosure. The efficiency of capital markets and the performance of the Canadian economy could be significantly affected by whether and how ESG reporting mandates and related compliance costs influence the incentives of investors and firm managers to avoid or delay going public, and, consequently, the performance of IPOs. We discuss different possible costs and benefits in the latter part of this paper.

Mandatory ESG reporting and the costs of IPOs

The costs of going public include various direct and indirect costs. Direct costs include the cost of the underwriter commission, which is normally 7 percent of the IPO proceeds for large US IPOs (Chen and Ritter, 2000), and can be as large as 50 percent of proceeds on smaller junior stock exchanges such as the Toronto Venture Exchange (TSXV) (Cumming and Johan, 2013). Direct costs also include disclosure costs associated with developing a prospectus (including the relevant legal, accounting, and auditing costs) necessary for preparing, disseminating, and certifying the required information (Friedman, 1970). For smaller IPOs, prospectus costs in Canada are up to $1 million; over $1 million for larger IPOs (Cumming and Johan, 2013). Direct costs are significantly higher with mandatory ESG disclosure (Wang et al., 2022).[2] Apart from the direct costs there are also indirect costs associated with IPOs. Indirect costs of an IPO most notably include "underpricing," or the discount on the initial price charged for shares listed on the exchange. Between 2001 and 2021 in the United States, the average change in price from the start of trading on the first day to the end of trading on the first day of an IPO was over 18 percent according to one estimate (Ritter, 2023a). Underpricing is higher on stocks listed in junior markets, which makes the costs of going public particularly high for junior companies; on the TSXV, for example, IPO underpricing is normally around 48 percent (Johan, 2010). More recent data show Canadian underpricing is on average 19.32 percent for small firms and 13.87 percent for large firms (Switzer et al., 2022).

Not only are IPOs underpriced in the short run, they also on average significantly underperform the overall market in the long run. That is, prices of IPO shares often increase shortly after they begin public trading, meaning that initial buyers of the shares realize capital gains in the first days of trading. However, the share prices typically go down in value after the

first day of trading, so that those who did not get in and sell immediately after the listing suffer capital losses over time. Ritter (1991) estimates that every dollar invested in IPOs over a 3-year period results in 26.9 percent loss compared to what it would have achieved if it was invested in a comparable established company. Underperformance is substantially worse for companies on junior stock exchanges such as the TSXV (Johan, 2010). IPOs only do as well as other matched publicly traded firms when they are backed by reputable venture capital funds due to their value-added, screening, and certification of the quality of the issuing company (Brav and Gompers, 1997).

In addition to underpricing costs, there are indirect costs associated with IPOs. First, mandatory disclosure involves a transfer of information to competitors and other parties external to the newly listed firm (Grewal et al., 2018). The company faces litigation and reputational risks after going public, including but not limited to risks of errors with public disclosures (Rogers et al., 2011). And when those mandated disclosures are expanded to include ESG or other matters which could be viewed as strategic or political, going public also involves political costs (Healy and Palepu, 2001).

The overall direct and indirect costs of mandatory ESG disclosure are difficult if not impossible to aggregate across different publicly traded firms. However, one way to infer these costs is to look at the response of share prices to the introduction of mandatory ESG disclosure. The most recent empirical evidence on mandatory ESG disclosure (Wang et al., 2022) shows that it causes a 1.1 percent drop in price across all affected firms. Firms in carbon-intensive industries have a larger negative price reaction. Firms with higher ESG scores have a less significant reaction.

Which types of firms bear the highest costs of mandatory reporting? Mandatory reporting costs are somewhat fixed regardless of the size of a firm. As such, they are more heavily borne by smaller compared to larger firms. Consistent with this idea, voluntary ESG reporting is more likely for firms with a higher market capitalization (Janicka and Sajnóg, 2022). Kotsantonis et al. (2016) explain that it is worth incurring these costs if larger firms can demonstrate for their particular sector that ESG disclosures are associated with operational improvements and reduced risks, and that the benefits will be maintained or increase over time. But not all firms are able to bear these costs; whether or not they can do so partly depends on their size and the industrial and firm-specific context.

> **"It is widely accepted that going public is quite costly and long-term investors face many risks in companies that have become newly public."**

In short, it is widely accepted that going public is quite costly and long-term investors face many risks in companies that have become newly public. The costs of going public are higher with mandatory ESG disclosure for IPOs. Many of the direct disclosure costs in IPOs are fixed and invariant to firm size, which makes the burden of the costs greater for smaller firms. To date, we are not aware of empirical evidence that shows exactly how long firms delay their decision to access capital markets and the proportion of firms that avoid going public altogether due

at least in part to mandatory ESG disclosure requirements; further research is warranted. Nevertheless, the existing evidence indicates that direct and indirect costs from mandatory ESG reporting can be expected to discourage or delay firms from going public.

Economic consequences of the impact of mandatory ESG reporting on IPOs

Securities regulation seeks to balance investor protection with the costs that firms bear to access public capital markets. Mandatory ESG disclosure could be beneficial for investors, albeit at a higher cost for firms to access public equity markets. In this section we discuss some of the possible benefits and costs on the wider economy associated with mandatory ESG reporting.

> "There is some evidence showing that ESG disclosure has benefits to the firms undertaking IPOs."

There is some evidence showing that ESG disclosure has benefits to the firms undertaking IPOs. Reber et al. (2022) find that voluntary ESG disclosure reduces IPO idiosyncratic volatility (firm-specific volatility that is uncorrelated with market movements) and downside tail risks (the risk that the firm's stock price crashes); the reasons Reber et al. offered are that more disclosures lead to less information asymmetry and the ESG disclosures provide greater brand credibility and social capital. Reber et al. (2022) also show that higher ESG ratings in IPOs are associated with lower firm-specific volatility and downside tail risk in the first year after the IPO. Economidou et al. (2023) show that in the US, IPOs with ESG ratings perform significantly better on the 1 to 3 year Tobin's Q (the market value of a company divided by its assets' replacement cost, which they find is 4 times higher for ESG-rated issuers than for ESG-unrated issuers) after the IPO date. Economidou et al. explain that companies' rationales for going public most likely drive the difference in behaviour between ESG-rated and ESG-unrated issuers: ESG-unrated issuers more often stockpile IPO proceeds as cash or working capital, and at the same time have 1.5 times higher financial slack. Fu et al. (2022) document that voluntary ESG disclosure reduces IPO failure risks, improves IPO long-run performance, and that these benefits are more pronounced the earlier the ESG disclosure. Fu et al. explain that ESG disclosures attract investor attention in IPOs, improve their social standing, and mitigate information asymmetries. It is possible that the IPO process makes ESG rankings more informative and valuable to shareholders than ESG rankings in other contexts, as other evidence shows less of a relation between ESG ratings and stock returns in the long run depending on the data examined (Berg et al., 2021). Consistent with the role of ESG disclosures in IPO performance, Amini et al. (2022) and Boulton et al. (2022) show that greater climate risks in the US and around the world do affect IPO performance.

There are at least three possible reasons why IPO disclosure could improve IPO performance (that is, performance measured in the ways discussed in the literature reviewed immediately above). The first explanation is that ESG disclosures are associated with a "greenium." That is, investors are willing to pay more for something that is associated with ESG, regardless of

expected performance. For example, Roberts (2022) shows that investors are happy to pay significantly more in mutual fund fees as a result of positive ESG branding. Similarly, Raimo et al. (2021) show that the cost of debt is lower for firms with better ESG disclosures. As such, ESG disclosure could help IPO performance by having a positive effect on investors' sentiment. That is, mandatory ESG disclosures do not necessarily improve firm quality and mitigate information asymmetry between firms and their investors, but do give investors a comfortable feeling that their investment decisions are doing something for society. (It is possible that voluntary ESG disclosures produce the same result under this reasoning.[3])

Unlike the first explanation, the second and third explanations provide a more positive view of mandatory disclosure and its effect on IPO performance. The second explanation is that mandatory ESG disclosure may improve the information environment of publicly traded securities, thereby reducing information asymmetry, agency conflicts, and adverse selection problems (Easley and O'Hara, 2004; Verrecchia, 2001), which in turn enables better monitoring by external stakeholders and operating efficiency improvements (Bushman and Smith, 2001). There is evidence from Krueger et al. (2021) that mandatory ESG disclosure around the world increases the availability and quality of ESG reporting and improves analysts' earnings forecasts. An improved information environment for IPOs is important as one of the primary reasons for IPO underperformance is the lack of information associated with a newly listed company. Future research could consider whether ESG information is financially material, and if so why IPOs would not need to report such information under current securities regulations. If the information proves to be not financially material, future research could consider why its disclosure improves analysts' earnings forecasts.

The third explanation is that mandatory ESG reporting can bring about real improvements to a firm's operations. For example, Krueger et al. (2021) show that mandatory ESG reporting reduces ESG violations and lowers the risk of stock price crashes. Furthermore, mandatory ESG disclosure could generate positive externalities by encouraging other firms to engage in more ESG activity (for a review, see Johan, 2023). As such, mandatory ESG reporting appears to have real benefits to society by improving the operations of companies.

It is hard to be certain which of these ideas best explains the available evidence of the impact of ESG disclosures on IPO performance. Certainly, more evidence on market sentiment towards ESG over a longer time could shed light on the strengths of the competing explanations. One issue with all these studies is that they are subject to a selection bias; specifically, which firms actually choose to go public in an environment that favours ESG disclosure and where some firms can easily afford the costs of ESG disclosure while others can't. Said differently, it is hard to assess the economic impact of mandatory ESG disclosure on IPO

performance because the types of firms that go public are not random and the evidence is likely to be positively biased by firms that derive relatively greater expected benefits or lower expected costs from mandatory ESG disclosure.

Are the benefits of ESG reporting as clear as they seem to be? In an important recent paper, Berg et al. (2021) analyze the main data provider of ESG ratings around the world: Refinitiv. Using the Refinitiv ESG data from different years, Berg et al. compared the relation between ESG ratings and firm performance for the same firms, only changing the data based on the time at which it was downloaded. The authors observed no correlation between ESG ratings and firm performance for their earlier downloads of the data, and then showed a weakly positive correlation between ESG ratings and firm performance from a subsequent download. They then further showed that for the most recent Refinitiv download of the data, the correlation was strongly positive. There could be different explanations for these findings. One is that Refinitiv appears to be backdating its data to make ESG ratings correlate more positively with firm performance, but this explanation is merely speculative. This type of problem is somewhat similar to "greenwashing" (companies making claims about their ESG activities that are either exaggerated or untrue). But this situation involves backdating data not merely for one publicly traded firm, but could be being done by a key data provider from which all investors, policymakers, and academics alike obtain their information on ESG ratings and other financial information. Importantly, though, Berg et al. do not have evidence that this is the explanation for what they found with the Refinitiv data. There could be other explanations for these differences that are unrelated to backdating or greenwashing, and it is entirely possible that the data were not intentionally changed to make the ESG ratings more correlated with returns.[4]

Greenwashing in the financial industry is commonplace.[5] And it is costly. Mandatory ESG disclosure involves costs, and firms have an incentive to recoup those costs by making their ESG performance look as good as possible. Greenwashing calls into question the aforementioned benefits of ESG in IPOs documented above.

Greenwashed ESG disclosures can exacerbate other agency problems. For example, executive compensation is an agency problem insofar as there are missing links between disclosure and the firm's performance. ESG reporting can exacerbate these agency conflicts (Bebchuk and Tallarita, 2022). ESG mandates enable management to excuse pay that is insensitive to performance. ESG metrics could be used to serve executive interests at the expense of stakeholder and shareholder welfare. That is, the simpler the firm's objective function (e.g., pure profit maximization), the easier it is for shareholders to monitor the performance of managers. Greenwashing could be significantly more pronounced under a mandatory ESG disclosure regime than a voluntary ESG disclosure regime because more listed firms would be forced to disclose data and spending where they perceive the costs for doing so exceed the benefits.

In sum, the efficiency of capital markets and the performance of the economy could be significantly affected by mandatory ESG reporting through (1) delaying or discouraging firms from seeking access to capital markets,[6] (2) changing IPO performance, and (3) misreporting information in the spirit of greenwashing, among other issues. To date, some empirical studies show benefits associated with ESG reporting on IPO share price performance; however, such evidence is based on firms that choose to go public and report their ESG activities. ESG reporting mandates and related compliance costs likely cause some firms to avoid or delay going public. Industrial organization economists have identified firms of below-efficient size as a significant contributor to Canada's relatively poor productivity performance. As such, regulatory and related policies that discourage firms from accessing capital in public markets is an especially salient issue. The evidence to date also shows that certain industries, such as carbon-intensive industries, would be relatively more damaged by mandatory ESG reporting. Mandatory ESG reporting would therefore cost certain provinces more than others depending on the comparative importance of different industries across the provinces. For example, the mining and oil and gas industries in western Canadian provinces would face higher costs if ESG reporting was mandatory. The broader economic costs of mandatory ESG reporting are exacerbated by other costs that include but are not limited to greenwashing.

"The evidence to date also shows that certain industries, such as carbon-intensive industries, would be relatively more damaged by mandatory ESG reporting, … [and] would therefore cost certain provinces more than others…"

Summary and conclusion

Going public is costly for issuing firms, and there are many risks for long-term investors in newly public companies. In view of regulatory goals that include mitigating the costs of accessing capital markets while maintaining investor protection, it is worth examining recent regulatory pushes around the world towards mandatory disclosure of an IPO firm's environmental, sustainable, and governance (ESG) record. This paper provided a brief overview of what we know to date.

There are some possible benefits of ESG disclosures. They can improve the information environment and mitigate information asymmetries in financial markets between firms, their investors, and analysts. ESG disclosures may even improve the operational efficiency of firms and mitigate harm caused by ESG violations. But the available evidence on ESG reporting and IPOs is hard to interpret in view of the non-random decision of firms to enter capital markets in an ESG reporting environment. When firms are already public, mandatory disclosure of ESG causes share prices to drop by over 1 percent, on average.

Whether or not the benefits of ESG disclosures in IPOs are real is unclear at this stage. ESG misreporting or "greenwashing" is commonplace. Prior data on ESG ratings have been

revised over time to become more correlated with returns (Berg et al., 2021). There are significant reasons to be concerned that mandatory ESG reporting can exacerbate agency problems between firms and their management, such as providing excuses as to why pay is insensitive to performance (Bebchuk and Tallarita, 2022). The reporting and enforcement costs for ESG disclosures are high.[7]

Mandatory ESG disclosures could discourage firms from entering public markets, thereby limiting entrepreneurial opportunities by making one of the main channels for accessing capital more expensive. These costs would be disproportionately greater for smaller firms and for firms in carbon-intensive industries; as such, in Canada, mandatory ESG reporting could lead to higher costs for firms in western provinces.

Endnotes

1 Countries with mandatory ESG reporting are listed in Krueger, Sautner, Tang, and Zhong, 2021: Table 1.
2 Additional research is needed to estimate the percentage of the costs to small- and medium-sized enterprises of going public that are directly attributable to mandatory ESG disclosures.
3 Voluntary ESG disclosures could have an even more pronounced impact when they are in response to events such as natural disasters; see Fiordelisi et al. (2023).
4 I contacted one of the Berg et al. authors in April 2023 to ask for other possible explanations. The author mentioned that they are currently searching for those explanations but as yet have not found any.
5 One European study found that in "42% of cases, green claims were exaggerated, false, or deceptive" (Courtnell, 2023).
6 The decline in the number of IPOs in Canada in recent years has been reported in Pandes and Tingle, 2022, October 17. Similarly, the decline in the number of IPOs in the US is reported in Ritter (2023b).
7 A recent US estimate put the expected 2023 costs at $8.4 billion (see Uyeda, 2022).

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ESG Investing and Financial Returns in Canada

Steven Globerman

Executive Summary

ESG investing incorporates environmental (E), social (S), and governance (G) considerations into investment decisions. Until recently, ESG-themed investing comprised an increasing share of investments made by professional money managers and retail investors.

Financial industry executives and regulators who have promoted ESG-themed investing argue that it will enhance investment performance either by increasing asset returns and/or by reducing investment risk.[1] However, empirical studies, on balance, find no consistent and statistically significant evidence of a positive relationship between the ESG rankings of individual companies or portfolios of companies and the financial performances of those companies or investment portfolios.

Most empirical studies have focused on US-based publicly traded companies. To our knowledge, this study is the first to focus on returns to ESG-themed investing for Canadian-based public companies. Using data from MSCI, a leading ESG ratings provider, we estimate the statistical relationship between changes in ESG rankings of companies and changes in equity returns for those companies using a sample of 310 companies listed on the Toronto Stock Exchange between 2013 and 2022.

Our study finds that neither upgrades nor downgrades in ESG ratings significantly affect stock market returns.

1. Introduction

In Canada, sustainable investing[2] has experienced remarkable growth, increasing from CAN$1 trillion in 2014 to CAN$3 trillion in 2022. As per the *Global Sustainable Investment Review* (GSIR) 2022, Canada has distinguished itself with the highest proportion of sustainable investing assets compared to its total managed assets, at 47 percent. This figure exceeds those of other jurisdictions, including Europe at 38 percent and the United States at 13 percent.

Theoretical models suggest that investor demand for ESG-themed equity and bond portfolios could profoundly affect financial markets, corporate behaviour, and potentially social welfare. In theory, investors who prefer "green" companies with high ESG ratings will allocate their investments toward these companies and away from "brown" companies with low ESG ratings. In the limiting case, this preference can lead to an investor boycott of brown firms. If a significant number of investors reallocate savings towards green companies and away from brown companies, the increased demand for green assets could substantially increase their stock market value. Consequently, green firms might benefit from lower financing costs, as a higher market value allows those firms to raise given amounts of capital while issuing fewer shares. The resulting reallocation of savings might also allow green firms to secure loans at lower interest rates. This reduced cost of equity and debt financing makes it more economical for green firms to invest in growth and expansion, thereby encouraging them to invest and grow faster than their brown company counterparts, other things being constant. If this approach works, it potentially leads to an economy with ostensibly desirable social outcomes, as the economy increasingly will be dominated by green firms that follow ESG practices.[3]

The empirical impact of ESG investing in Canada is still a subject of debate.[4] Advocates for ESG investing maintain that it can lead to higher returns for investors. The *2023 Canadian Responsible Investment Trends Report* (RiA, 2023) reveals that institutional investors in Canada consider improved expected returns as the second highest[5] rated motivation for ESG investing, with 85 percent of them expecting returns at least as high as the market average. This indicates a significant expectation among Canadian investors that ESG strategies can be financially beneficial, or at least not financially harmful, while also contributing positively to environmental and social outcomes.

Despite the uncertain empirical impact of ESG investing on financial markets and social outcomes, Canada has seen an increase in the regulatory focus on ESG investing. Since 2020, corporations under the Canada Business Corporations Act (CBCA) have been required to disclose diversity information regarding their board and senior management, including specific personal characteristics beyond gender. This has made Canada the first jurisdiction in the world to mandate such comprehensive diversity disclosures. In 2021, the Canadian Securities Administrators (CSA) proposed climate-related disclosure requirements for issuers, with further consultations planned in 2023 to align with International Sustainability

Standards Board (ISSB) standards, adapted for Canada. The federal government established the Net-Zero Advisory Body and the Sustainable Finance Action Council (SFAC) in the same year, and Canada's finance minister received the country's first sustainable finance mandate. The Investment Industry Regulatory Organization of Canada (IIROC) revised its Know Your Client (KYC) rules in November 2021 to incorporate clients' ESG preferences into investment objectives. Finally, in January 2022, the CSA provided guidance for ESG disclosures by investment funds.[6]

"Since ESG ratings are crucial information for ESG investing, they can be expected to significantly affect investment decisions to the extent that ESG considerations significantly drive such decisions."

In our study, we use data from MSCI, a leading provider of ESG ratings, to empirically examine the impact of ESG investing on equity returns for Canadian publicly traded companies. Our specific focus is how MSCI ESG rating changes influence stock returns.[7] Since ESG ratings are crucial information for ESG investing, they can be expected to significantly affect investment decisions to the extent that ESG considerations significantly drive such decisions. Our goal is to measure the effect of MSCI rating changes on company stock returns. The study encompasses 310 companies listed on the Toronto Stock Exchange from 2013 to 2022, during which 414 ESG rating changes occurred.

We follow Berg, Heeb, and Kölbel (2023) by applying a panel event study methodology to estimate the effect of ESG rating changes on stock returns. We look separately at the effects of rating upgrades and downgrades, as they might not have the same impact. In addition to assessing immediate returns, we also evaluate the effect of ESG rating changes on buy-and-hold returns over periods of up to 12 months. This approach acknowledges that investors might need time to adjust their portfolios in response to rating changes, either by selling stocks that have been downgraded or by purchasing those that have been upgraded.

Our main finding is that changes in a company's ESG rating, be they upgrades or downgrades, do not significantly affect its stock market returns, even up to 12 months following the change. This suggests that an ESG rating upgrade does not provide a noticeable financial advantage for an upgraded company in the form of a lower cost of equity capital. This finding casts doubt on the notion that public equity markets reward companies for ostensibly improved ESG performance, thereby encouraging more ESG-consistent corporate behaviour. Our study concludes that arguments touting the financial benefits of ESG investing in Canada require robust supporting empirical evidence to be credible.

2. Framework for the Analysis

The primary theoretical framework for an analysis of financial returns to ESG-themed investing rests on considerations of investors' preferences for ESG factors. For instance, investors favouring "environmentally friendly" companies might reduce their equity holdings in what they consider to be polluting firms, or even completely stop investing in those firms. Other things constant, this would lower the stock prices of "brown" companies, while "green" companies would presumably see higher stock prices. In the short term, when green companies' stock prices rise, green investors will enjoy increased returns on their investments. However, in the long term, after market prices have adjusted to new information about corporate ESG ratings, investors in green companies should realize below average financial returns. This is because the stocks of green companies they invest in will be priced higher as a reflection of their improved ESG rankings, which should result in lower yields over time.[8] In effect, new information about the ESG intensity of a company's activities should contribute to a new "equilibrium" share price for that company if the information is financially material. The length of time between the release of new information and the adjustment of the relevant company's stock price to a new equilibrium depends upon the efficiency of capital markets and is ultimately an empirical issue.

Globerman (2022) examines the empirical literature on the impact of ESG investing on financial returns and finds conflicting outcomes. Some studies identify either positive or negative correlations between ESG investing and equity returns, while many report no significant relationship. Most studies on the impact of ESG investing use US data, but our research shifts the focus to Canada. With 47 percent of its total managed publicly traded assets dedicated to sustainable investing in 2022, Canada provides an important contrast to the US, where only 13 percent of similar assets are in sustainable investing.[9]

Berk and van Binsbergen (2021) suggest that a greater presence of green investors might lead to more noticeable effects on stock market prices. This arguably makes Canada a more relevant context for studying the financial effects of ESG investing. Additionally, Canada's proactive approach to ESG investing regulation underscores the need for reliable empirical evidence concerning the impact of ESG-themed investing on financial markets.

In their meta-study, Whelan et al. (2021) note that most research linking ESG investing to financial performance concentrates on assessing risk-adjusted returns, frequently using metrics like alpha or the Sharpe Ratio.[10] These measures evaluate whether ESG-focused portfolios differ significantly in risk-adjusted returns from non-ESG focused portfolios. The methodology depends on precise alpha estimation to determine risk-adjusted returns. If not measured correctly, an observed premium (or discount) for "good" or "bad" ESG behaviour could well be attributable to an incorrect adjustment for risk (Blitz and Fabozzi, 2017). Berk and van Binsbergen (2021) critique this approach, pointing out the difficulties in reliably measuring risk-adjusted returns. Globerman (2022) suggests that the mixed results seen in

the literature regarding the relationship between ESG ratings and asset returns may be partly due to the challenges in measuring risk-adjusted returns.

This study diverges from explicitly estimating risk-adjusted returns, opting instead for a panel event study methodology as outlined in Berg, Heeb, and Kölbel (2022), Schmidheiny and Siegloch (2019), Clarke and Tapia-Schythe (2021), and Freyaldenhoven, Hansen, Pérez, and Shapiro (2021), which allows us to assess returns following ESG rating changes without needing to estimate risk-adjusted returns.

Globerman (2022) also notes that the observed variability in results linking ESG ratings to equity returns could be due to price changes during transition periods after an ESG rating change. For instance, an ESG rating upgrade could lead investors to buy more of the stock of the upgraded company, thereby boosting its price and conferring an increased return to investors until the market adjusts. Given higher prices, green stocks might subsequently yield lower returns than brown stocks in the absence of new ESG-related information. Our study addresses this by using a panel event study method to track buy-and-hold returns for up to 12 months after rating changes, enabling us to monitor return transitions over a holding period of up to one year.

In section 3 of this study, we outline the data we use for our analysis. Section 4 presents and discusses the findings from our empirical research. Concluding comments are offered in section 5. For those interested in more in-depth information about the empirical work, the appendix includes descriptions of the data, detailed information on our methodology, and a robustness analysis of the results. We have consciously kept the main body of the study straightforward and accessible, avoiding technical details to ensure it is comprehensible even for readers not well versed in statistical analysis. In contrast, the appendix delves into the more intricate aspects of the statistical framework for those seeking a deeper understanding.

3. Data

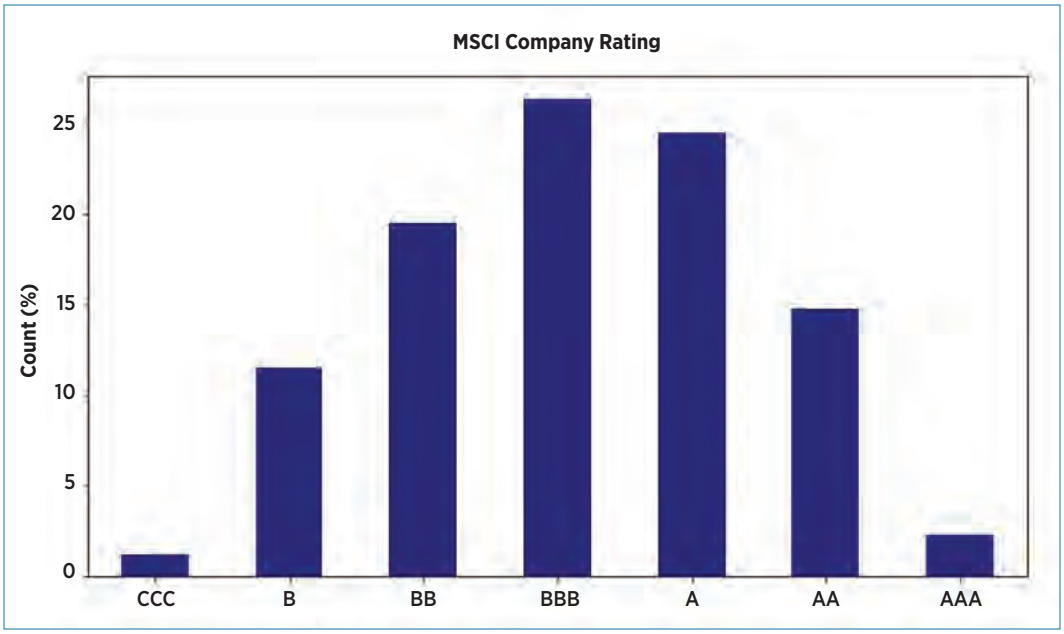
Our dataset includes MSCI ESG ratings for Canadian firms from June 2013 to December 2022. MSCI is a prominent ESG ratings provider that is recognized for its comprehensive coverage and extensive historical data. Before assembling our dataset, we considered data from various other recognized ESG providers, including Sustainalytics, Moody's, Refinitiv, and S&P Global. After thorough evaluation, we found that MSCI not only offers wide-ranging coverage of Canadian companies but also provides the most substantial historical data, a key feature for our study. This led us to select MSCI rating data for our research. Our dataset focuses on the period after June 2013, selected due to a significant increase in MSCI's coverage of Canadian companies from this date forward. This selection ensures that our analysis is based on more comprehensive and reliable data. For additional information about the extent of data coverage, please see figure A2 in the appendix.

MSCI ESG Research LLC provides ESG ratings that many investment managers use to assess and analyze the risks and opportunities associated with publicly listed companies. These ratings consider 35 key issues,[11] including factors such as carbon emissions, product safety and quality, ownership and control, and others. These factors are aggregated to create three primary "pillar scores": Environmental (E), Social (S), and Governance (G). To determine the final ESG rating for a company, the weighted average of these three pillar scores is calculated. This weighted score is then adjusted to align with industry peers. This industry-adjusted score corresponds to a rating that falls on a scale from best (AAA) to worst (CCC). It is important to note that these assessments are not absolute, but rather are designed to be interpreted in comparison to other companies within the same industry.[12]

We combined MSCI rating data with stock price data from Yahoo Finance, focusing on "adjusted close" prices, which incorporate adjustments for stock splits and dividend distributions. By incorporating that adjusted close data, we created a comprehensive dataset of 310 Canadian companies listed on the Toronto Stock Exchange, facilitating a thorough analysis of the relationship between ESG ratings and stock performance.

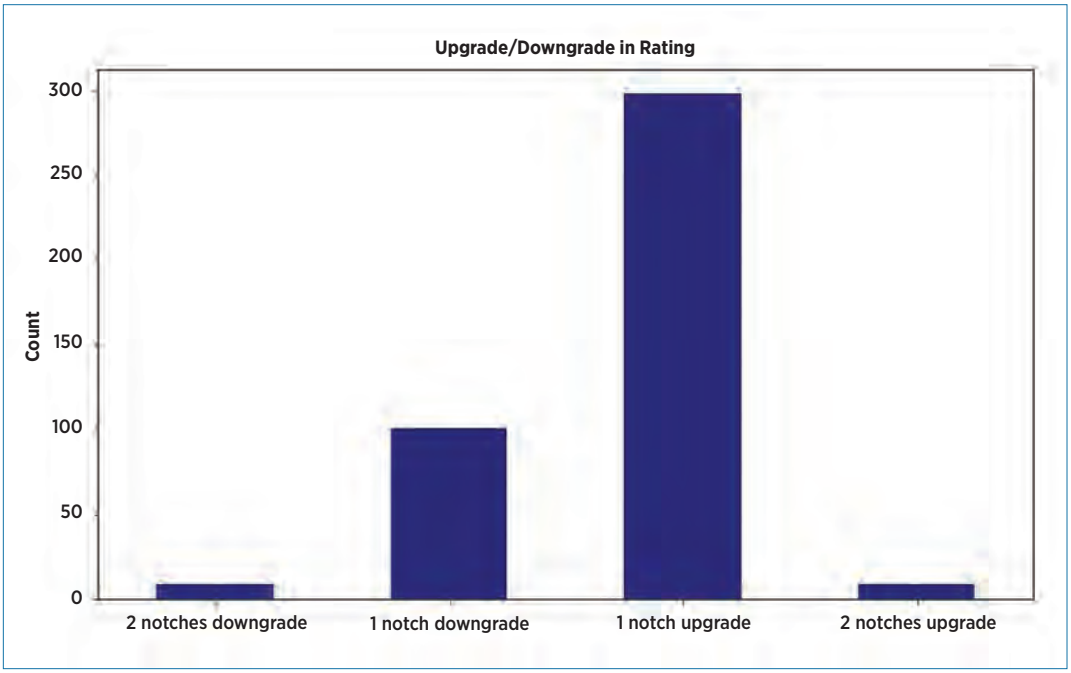
Figure 1 displays the distribution of MSCI ESG ratings across Canadian companies. This graph is derived from our monthly dataset spanning the period from June 2013 to December 2022, which includes the ESG ratings of 310 Canadian corporations tracked on a monthly basis. The rating most commonly assigned is "BBB." The distribution of ratings around this central point appears almost symmetric: the frequency of companies with higher ESG ratings decreases as we move to the right, and similarly, the frequency of companies with lower ESG ratings declines as we move to the left.

Figure 1: MSCI ESG Rating Frequency for Canadian Corporations



Source: Author's calculations from MSCI's proprietary database.

Figure 2: MSCI Rating Change Frequency for Canadian Corporations



Source: Author's calculations from MSCI's proprietary database.

MSCI conducts continuous and systematic monitoring of companies, including daily assessments of monitoring and quality-related controversies and governance events. Updates based on new information are incorporated into weekly reports, and any significant alterations in scores prompt an analyst review followed by potential re-rating.

Additionally, each company undergoes a thorough review at least once a year.

For our panel event study, we use the monthly updates in MSCI's seven ESG ratings to identify and define events that trigger upgrades and downgrades. An upgrade is defined as a change from a lower to a higher rating, for example, moving from BB to BBB, A, AA, or AAA. Conversely, a downgrade occurs when the rating shifts from a higher to a lower tier, such as from BBB to BB, B, or CCC. Figure 2 displays the distribution of these rating changes. It reveals that in our data, no rating change exceeds a two-notch shift, either upward or downward. Furthermore, the majority of the rating changes consist of one-notch upgrades or downgrades, with upgrades being the more prevalent of the two.

Our study focuses on two key variables: monthly changes in MSCI ESG ratings and buy-and-hold stock returns. Table 1 summarizes the total number of ESG rating change events, including both upgrades and downgrades. From 2013 to 2022, such changes in ESG ratings were relatively rare, accounting for about 2 percent of our dataset. This low frequency of rating changes aligns with findings from other studies, such as Berg, Heeb, and Kölbel (2023), who observed a similar incidence rate of 2 to 3 percent rating changes in their research on 3,665 US-listed companies.

Table 1: MSCI ESG Ratings Change Frequency of MSCI ESG Ratings Upgrades and Downgrades

	Number of Events
Upgrades	306
Downgrades	108

Source: Author's calculations from MSCI's proprietary database.

In our study, a crucial variable is the buy-and-hold returns over periods ranging from one to 12 months. The variable is used to assess how these returns respond to changes in MSCI ESG ratings. We derive these returns from the monthly adjusted closing prices sourced from Yahoo Finance for each of the 310 Canadian companies in our dataset. The buy-and-hold returns gauge a stock's performance across various holding periods. For instance, a one-month buy-and-hold return reflects a stock's performance if purchased in January 2017 and held until the end of February 2017. A two-month return would measure the stock's performance from January to the end of March 2017, with this trend continuing for holding periods of up to 12 months.

Table 2 presents the descriptive statistics of buy-and-hold returns for periods ranging from one to 12 months. We calculate these returns to assess how, on average, returns following a rating change differ from those of stocks that didn't experience any rating change. This range allows us to track returns over a transitional period, ensuring we capture any delayed effects of rating changes on stock prices and corresponding returns. In our sample data, which covers 313 Canadian corporations listed on the Toronto Stock Exchange between June 2013 and December 2022, the average return for a one-month holding period is 0.7 percent. This figure increases for longer holding periods, reaching 8.7 percent for a 12-month duration.

Figure 3 illustrates the distribution of one-month buy-and-hold returns within our dataset. This graph displays a near-symmetric pattern, mirroring trends seen across various holding periods. It shows a wide range of returns, with the lowest 5 percent of returns at -15.4 percent and the highest 5 percent of returns at 17.7 percent. Such a wide spread of returns is not unique to our dataset. Berg, Heeb, and Kölbel (2023) reported a comparable range in their study of monthly returns for US publicly traded companies.

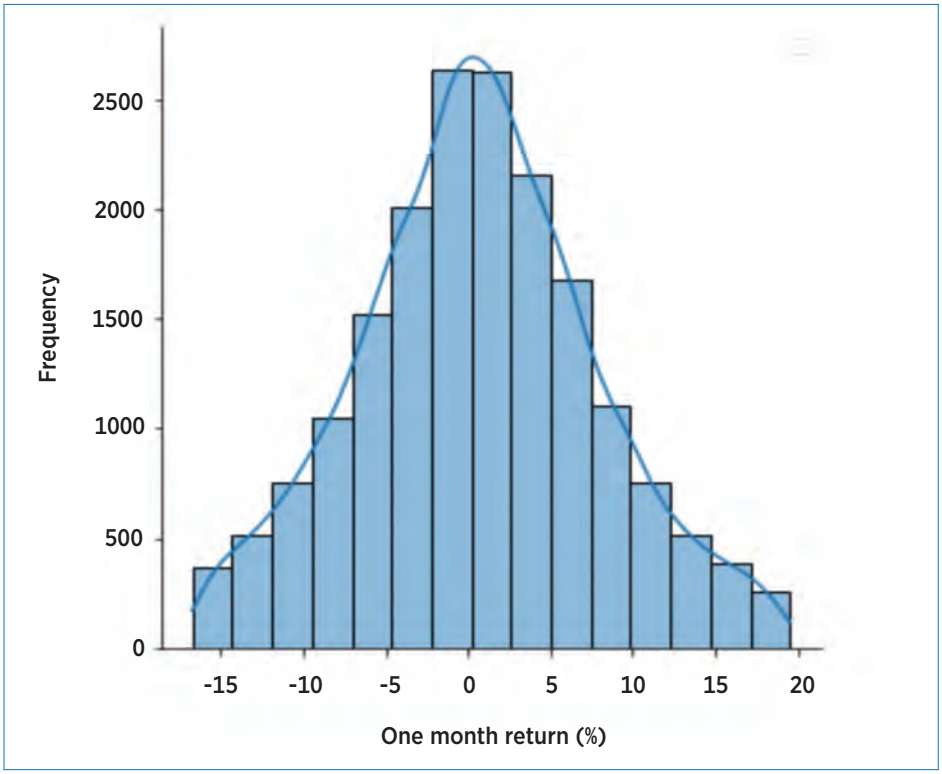
In the following section, we explain how we apply a panel event study methodology to ascertain if the average buy-and-hold returns for companies undergoing a downgrade or upgrade are significantly different from those that did not experience any rating change.

Table 2: Descriptive Statistics for Buy-and-Hold Returns

Buy-and-hold returns (%) for holding periods of	count	5%	25%	mean	50%	75%	95%	std
1 month	19950	-15.4	-4.7	0.7	0.5	5.7	17.7	9.7
2 months	19927	-21.2	-6.2	1.5	1.1	8.8	25.2	13.7
3 months	19904	-25.5	-7.4	2.3	1.9	11.3	31.5	17
4 months	19883	-29.5	-8.6	2.9	2.3	13.3	37.5	19.9
5 months	19861	-32.4	-9.9	3.6	2.6	15.1	43.4	22.6
6 months	19841	-35.1	-10.9	4.3	2.9	17.1	48.8	25.1
7 months	19822	-37.6	-11.7	5	3.4	18.7	54.2	27.6
8 months	19803	-39.6	-12.6	5.8	3.7	20.5	59.8	30.1
9 months	19789	-41.7	-13.5	6.6	3.9	22.1	64.8	32.4
10 months	19773	-43.6	-14.2	7.3	4.3	23.5	69.6	34.7
11 months	19758	-45.4	-14.9	7.9	4.4	24.7	74.2	37
12 months	19526	-47.7	-15.5	8.7	4.7	26.5	78.6	39.3

Source: Author's estimates of returns using data collected from Yahoo Finance.

Figure 3: One Month Return Distribution for Canadian Corporations



Source: Author's estimates of returns using data collected from Yahoo Finance.

4. Results

In this section, we investigate the impact of ESG rating changes on company stock returns. Our analysis reveals that companies' stock returns do not significantly respond to ESG rating changes, whether they are downgrades or upgrades.

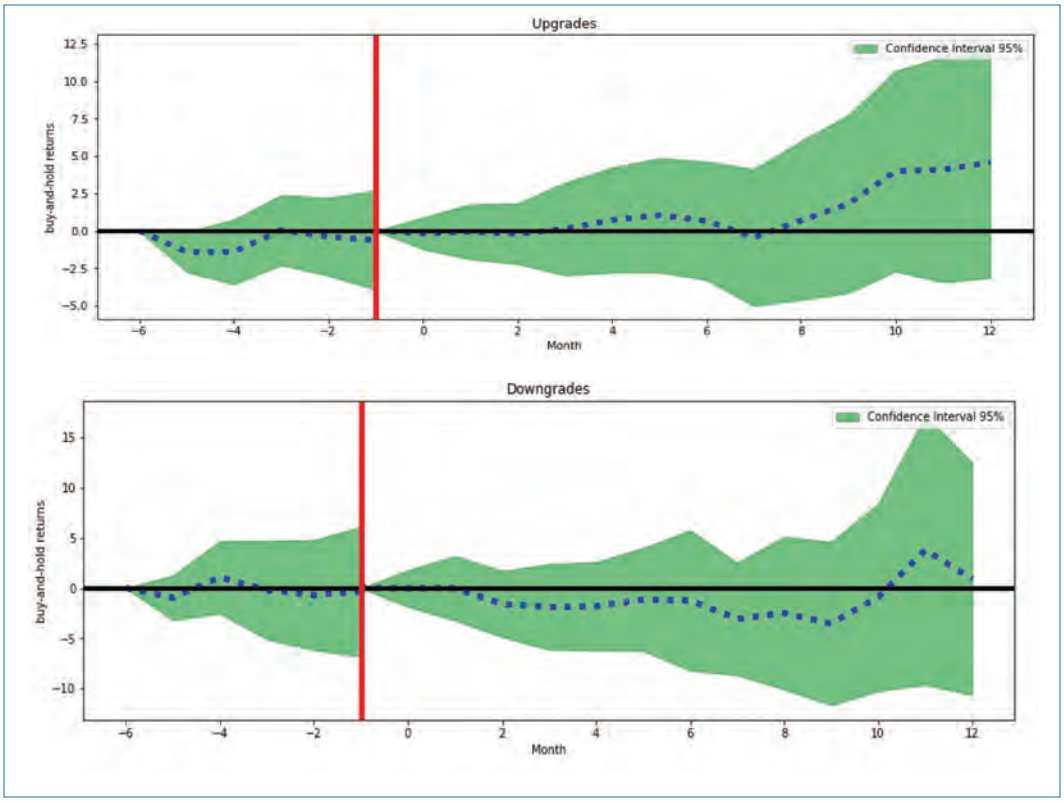
In the appendix, we outline our method for assessing how ESG rating upgrades and downgrades affect buy-and-hold returns over 12 months. Broadly speaking, we identify the average buy-and-hold returns of stocks following a rating change. This means we are comparing how the returns change on average for companies that underwent a rating change versus those that did not experience any change.

Figure 4 presents the results from a series of panel event studies analyzing the impact of MSCI ESG rating changes on companies' buy-and-hold returns, distinguishing between companies that undergo rating changes and those that do not. This comparison extends across all observed periods: for months equal to or greater than zero, the graph details the difference in buy-and-hold returns for holding periods up to 12 months, specifically comparing companies that experience a rating change to those that remain unchanged. Similarly, for months less than zero, the graph applies the same comparative analysis, demonstrating the difference in buy-and-hold returns between companies that will have a rating change and those that will not, effectively treating the period as if it included placebo events occurring 6 months before the actual rating changes, for holding periods concluding one month prior to these events.

Figure 4 categorizes the estimation for buy-and-hold returns by downgrades and upgrades. Buy-and-hold returns reflect the performance of a stock assuming it was purchased one month prior to the event date (month -1) and held for up to 12 months. For instance, if a downgrade occurs in February 2017, we consider an investor buying the stock in January 2017, marked by a vertical red line in the figure. This date represents the month before the rating change. The buy-and-hold return at month 0 illustrates the stock's one-month return from this purchase date to the event month, effectively showing the immediate return during the rating change. At month 1, the returns represent the stock's performance if held from January 2017 to the end of March 2017, continuing similarly up to 12 months.

For the months following an ESG rating change, the dotted line in each graph represents our estimation of the differential in stock returns—termed as the point-estimated buy-and-hold returns—between companies that have experienced an ESG rating change and those that have not. This estimation reflects how stock returns for companies with a rating change are likely to diverge from those without any such change, thereby capturing the anticipated impact of ESG rating adjustments on stock performance. However, since we can't be certain about this estimate's accuracy, we also calculate a range over which these returns might actually fall each month—this is what the shaded area on the graph represents. The shaded area means we're 95 percent certain the real returns will be within this range. For instance, one month after a company is upgraded (month 0), we think its stock return is about 0.17

Figure 4: The Reaction of Stock Returns to ESG Rating Changes in Canada



Notes: The vertical red line identifies when the sample stock's ESG rating changed lagged by one month. The dotted line represents the estimated differential in stock returns between companies that experienced an ESG ratings change and those that did not. The shaded area is the estimated range of stock returns using a 95 percent confidence interval. Returns are expressed in percentage terms.
Source: Author's statistical estimations as detailed in the appendix.

percent lower than stocks that weren't upgraded. And we are 95 percent confident that the real return is somewhere between a decrease of 1.2 percent and an increase of 0.9 percent compared to stocks without an upgrade.

If rating changes have a significant impact on stock returns, we expect that the estimated range of possible returns (the interval estimation) would not include a zero return. However, as figure 4 clearly demonstrates, the solid black line representing a zero return is always within the interval estimation of buy-and-hold returns for every month up to 12 months, regardless of whether the change is an upgrade or downgrade. This implies that, based on our data, there is no compelling evidence suggesting that ESG rating changes have a significant effect on stock returns.

Figure 4 includes buy-and-hold returns calculated before the rating change event. This helps us assess if any trends observed after the event are actually caused by the rating change and how they compare to the trend of the stock's performance prior to the event. Specifically, figure 4 displays the buy-and-hold returns for a stock purchased 6 months, 5 months, and

up to one month before the rating change, effectively setting a placebo event timeline from 6 months to one month prior to the actual event.

Even though our estimation results indicate that ESG rating changes don't significantly affect overall stock returns, we observe distinct patterns following both downgrades and upgrades. Specifically, after a downgrade, the differential in buy-and-hold returns between companies that have experienced a downgrade and those that have not tends to show a decrease, reaching as low as -3.5 percent within 9 months. Conversely, after an upgrade, the differential analysis reveals an increase in returns for companies receiving an upgrade compared to those without such changes, with returns going up to 4.5 percent within 12 months. This matches the theory that investors may sell off downgraded stocks and move their funds to stocks with better ESG ratings. A notable aspect of these findings is the lack of similar trends before the rating changes. This suggests that the observed shifts in return trends are directly associated with the downgrade and upgrade events. Therefore, the influence of ESG ratings on stock returns aligns with theoretical predictions. However, it is not substantial enough to conclude that ESG ratings have a statistically significant impact on stock returns.

5. Conclusion

This study explores how changes in a company's ESG (Environmental, Social, and Governance) rating affect its stock market returns. ESG ratings are key indicators that investors use to gauge a company's ESG-related performance. The theory is straightforward: when a company's ESG rating changes, investors who prioritize ESG issues are likely to sell stocks of companies with downgraded ratings and buy stocks of those with upgraded ratings. This investor behaviour could result in significant changes in stock prices and returns. Furthermore, if ESG investing has a discernible impact on stock prices, it could offer a financial edge to companies that are environmentally and socially responsible, encouraging them to enhance their ESG practices further.

In fact, our study finds no statistically significant evidence that changes in ESG ratings, whether upgrades or downgrades, affect stock returns. This leads us to conclude that ESG investing may not have the transformative effect on social outcomes through the financial markets that many suggest. In short, any benefits from being an ESG-focused company do not seem to translate into significant financial advantages in the stock market.

At least two questions arise from our conclusion. One is why investment managers pay for ESG ratings if using that information to make investment decisions does not improve investment performance. Since the costs of ESG ratings services will be passed on by investment managers to their customers, the more relevant version of the question is why customers are willing to pay higher administrative fees for ESG-themed investments when they would earn similar gross returns, and therefore higher net returns, if they invested in non-ESG themed alternatives.[13] A second and separate question is why the seeming increase in the relative

demand for more highly-rated ESG investment options in recent years has not translated into higher relative returns to those investment options.

A careful consideration of these two issues is beyond the scope of this essay. With respect to why investors are willing to pay higher fees for ESG-themed investments that are seemingly not matched by higher returns, one can appeal to the plausible argument that the investors in question enjoy non-financial (or so-called psychic) benefits from financially supporting what they believe are sustainable businesses.[14]

With respect to why returns are not related to changes in ESG ratings, we again offer only a speculative explanation. Specifically, it may be the case that investors' valuations of both green and brown companies are primarily based on fundamental information found in financial reports and other public statements, so that additional information provided by ESG ranking services by itself must be very substantive to cause shifts in demand for alternative securities. Put differently, ESG rankings may provide little reliable information about future profitability and therefore are primarily useful as a marketing tool rather than for making portfolio decisions.[15]

" ESG rankings may provide little reliable information about future profitability and therefore are primarily useful as a marketing tool rather than for making portfolio decisions."

APPENDIX

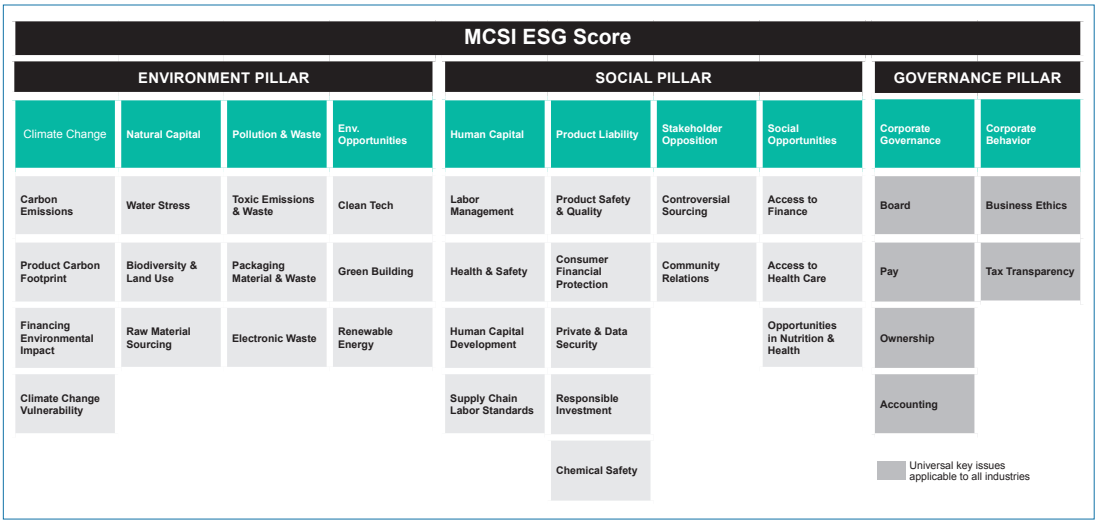
Data

In this section, we offer additional details about the data we used in our study, specifically focusing on the ESG rating data sourced from MSCI and the returns data we obtained from Yahoo Finance.

MSCI ESG Ratings Key Issue Framework

MSCI evaluates numerous data points across 35 ESG (Environmental, Social, and Governance) key issues, concentrating on the nexus between a company's primary operations and the industry-specific challenges that could pose significant risks or present opportunities. Figure A1 categorizes these 35 key issues into three pillars: Environmental, Social, and Governance.

Figure A1: MSCI ESG Ratings Key Issue Framework

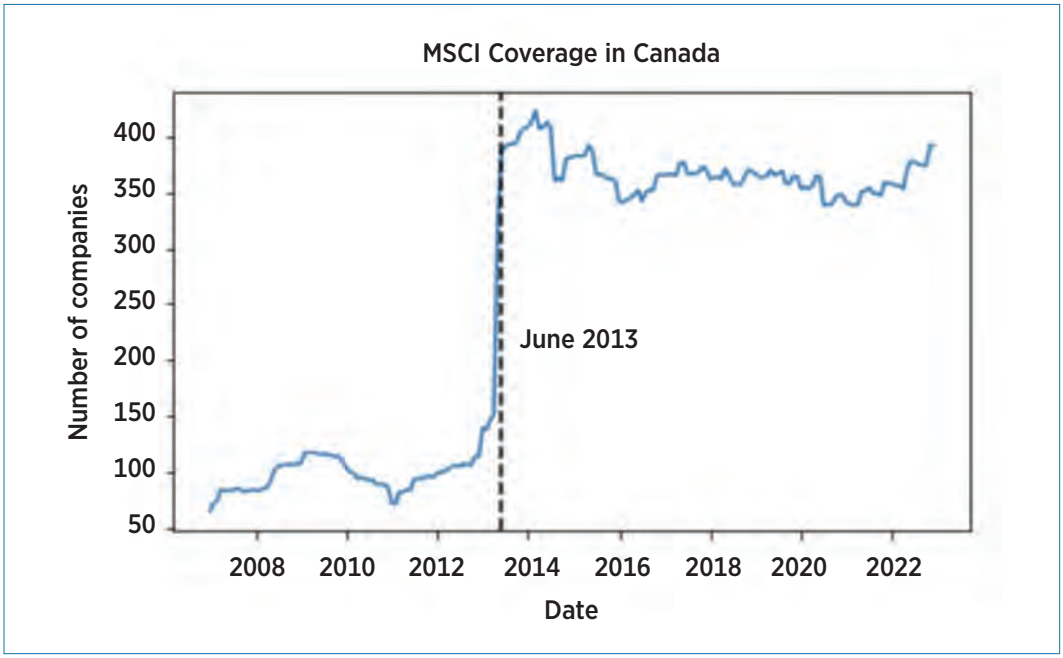


Source: MSCI, 2024.

MSCI ESG Ratings

Our data consists of MSCI ESG ratings for Canadian companies between June 2013 and December 2022. Figure A2 illustrates the MSCI coverage of Canadian companies during this period. Notably, MSCI coverage of Canadian companies significantly increased after June 2013, going from an average of 102 companies to 367 companies. To ensure the reliability of our results, we specifically focus on data from June 2013 onwards, as this approach mitigates potential biases stemming from the substantial changes in the pool of companies for which data are available.[16]

Figure A2: MSCI ESG Data Coverage for Canadian Companies



Source: MSCI, proprietary database.

Stock Returns

We obtained stock returns data from Yahoo Finance, focusing on the adjusted close prices for companies featured in our MSCI ESG rating historical data. A potential concern is whether Yahoo Finance provides adequate company coverage. While we do not have access to historical market capitalization data within our sample for a direct comparison with the Toronto Stock Exchange's market capitalization, we do have recent data on company market capitalization. As of December 29, 2023, the market capitalization of companies in our dataset was approximately CAN$3 trillion, while the market capitalization of the S&P/TSX Composite index was around CAN$3.3 trillion. This indicates that our dataset covers nearly 90 percent of the market capitalization of the S&P/TSX Composite index, which we consider to be quite comprehensive.

Furthermore, to verify the reliability of Yahoo Finance data, we replicated the study by Berg, Heeb, and Kölbel (2023). Their research used MSCI ESG rating changes for US corporations, with return data sourced from Compustat North America. In our replication, we used MSCI ESG rating data for US companies but obtained the return data from Yahoo Finance instead. We were able to closely replicate their findings regarding the impact of ESG rating changes on stock returns. This successful replication leads us to believe that Yahoo Finance data is indeed reliable for our analysis.

Methodology

In this section, we discuss our methodology for estimating the impact of changes in ESG ratings on stock returns. To analyze stock returns, we calculate the buy-and-hold returns for all stocks included in our sample as follows:

$$BHR_{\tau,it} = \left(\frac{P_{i,t+\tau}}{P_{i,t-1}} - 1\right) \times 100 \qquad (1)$$

$BHR_{\tau,it}$ refers to the percentage change in a stock's price when purchased at the end of date t-1 and held τ months from that purchase date. $P_{i,t}$ represents adjusted close, which is the closing price after adjustments for all applicable splits and dividend distributions.

We estimate the joint effect of MSCI ESG rating upgrades and downgrades on buy-and-hold returns. We follow Berg, Heeb, and Kölbel (2023) to estimate the following specification:

$$BHR_{\tau,it} = \sum_{j=-\tau}^{j=\tau} \beta_{j\tau} u_{it}^{j} + \sum_{j=-\tau}^{j=\tau} \gamma_{j\tau} d_{it}^{j} + \mu_{i\tau} + \theta_{t\tau} + \varepsilon_{it\tau} \qquad (2)$$

We perform 13 separate regressions for the timeframes $\tau \in \{0,1,...,12\}$ months to assess the immediate and subsequent effects of ESG rating changes for up to 12 months following the change. μ_i and θ_t are firm and month fixed effects, respectively. The unobserved error term is denoted by $\varepsilon_{it\tau}$. μ_{it}^{j} is a dummy variable indicating the occurrence of a ESG rating upgrade at a specific company i at a specific month $t-j$, while d_{it}^{j} indicates a rating downgrade.

The key variables in our study are $\mu_{it}^{j=0}$ and $d_{it}^{j=0}$, which indicate the occurrence of either an upgrade or a downgrade for a firm i in month t. To account for the influence of events occurring before and after the event of interest, we incorporate pre- and post-event lags, $\mu_{it}^{j\neq 0}$ and $d_{it}^{j\neq 0}$. Failing to include these controls could lead to an underestimation of our results. The coefficients of interests are $\beta_{0\tau}$ and $\gamma_{0\tau}$ that measure the estimated "abnormal" buy-and-hold returns during a τ-month holding period following a rating upgrade or downgrade. These are assessed relative to all other τ-month buy-and-hold returns for observations that occur at least months away from any rating change.

To assess potential pre-event trends in the buy-and-hold returns, we estimate the same panel regression as above. In this model, we shift all ESG rating upgrade and downgrade event dates forward by six months. This adjustment is made for holding periods ranging from τ=0 to τ=6. This modified approach yields estimates for $\beta_{j\tau}$ and $\gamma_{j\tau}$ corresponding to "placebo" events, which are essentially the hypothetical events occurring six months before the actual events. By analyzing holding periods extending up to one month before the actual events, we can effectively identify any abnormal buy-and-hold returns that might have occurred six months leading up to the real event.

Table A1 presents results from a series of panel event studies that use buy-and-hold returns for varying holding periods as the dependent variables, with MSCI ESG rating up- and

Table A1: Panel Event Study Results

	Buy-and-hold returns in months												
	0	1	2	3	4	5	6	7	8	9	10	11	12
Upgrade	-0.1691	-0.0641	-0.1961	0.1224	0.7228	1.0344	0.6729	-0.4438	0.6913	1.7894	3.9939	4.0903	4.5545
	(0.5424)	(0.9372)	(1.0333)	(1.5786)	(1.7894)	(1.9489)	(2.0172)	(2.3331)	(2.7078)	(3.0327)	(3.4166)	(3.8387)	(3.9247)
Downgrade	-0.0375	-0.0103	-1.575	-1.8659	-1.8021	-1.1261	-1.2244	-3.0590	-2.4876	-3.5297	-0.9071	3.7907	0.9133
	(0.9301)	(1.6404)	(1.6721)	(2.1790)	(2.2406)	(2.6165)	(3.5703)	(2.8622)	(3.8763)	(4.1509)	(4.7658)	(6.8422)	(5.9010)
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Month FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Pre- and post-event lags	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

downgrades serving as the event triggers. We estimate these panel regressions for holding periods of up to 12 months, as indicated by $\beta_{0\tau}$ and $\gamma_{0\tau}$ in Equation 2. The studies take into account treatment leads and lags covering the period before and after ESG rating changes, in line with the specifications of Equation 2. For each regression, we trim the buy-and-hold returns data at the 1st and 99th percentiles. The data range from July 2014 to December 2021, with a one-year trim to ensure consistency across all regressions. Each regression incorporates 13,440 monthly observations, including 196 upgrades and 71 downgrades. Firm and month fixed effects are also included in all panel regressions. The confidence intervals are based on standard errors clustered at both the firm and month levels. In the parentheses, we include the standard deviations of the estimated parameters. None of the estimated coefficients reach significance at even the 10 percent level.

Robustness analysis

In this section we briefly discuss the robustness analysis we did for this study.

In our panel event study, we do not account for firm-specific characteristics such as leverage, market capitalization, and profitability, which were included in Berg, Heeb, and Kölbel's 2023 study. The exclusion of these factors was due to our lack of access to this information. Nevertheless, we replicated Berg, Heeb, and Kölbel's 2023 results using Yahoo Finance return data, albeit without the additional controls they incorporated in their panel event study. We were able to closely match their findings. Our panel event study includes firm and month fixed effects, and we believe that incorporating further controls would not alter the study's results.

In our panel event study, we introduced dummy variables for industry and found that our results remained unaffected by this specification. Additionally, we tested for specifications that included dummies for the COVID period and the post-2016 era, similar to Berg, Heeb, and Kölbel's 2023 study. Our results were also not sensitive to these alternative specifications.

A potential concern with our panel event study is the relative rarity of rating changes. In our dataset, only 2 percent of the observations includes a rating change, which raises a concern

about whether we have sufficient historical data to accurately estimate ESG upgrades and downgrades separately. To address this, we combined upgrades and downgrades into a single "rating change" variable for use in our regression analysis. However, even with this adjustment, we found that the coefficient estimated for the rating change remains statistically insignificant.

Endnotes

1 See *Global Sustainable Investment Review* (GSIR, 2022) for a summary of policies and regulations encouraging ESG investing in Canada.
2 This document uses the terms "sustainable investing" and "ESG investing" interchangeably. ESG investing, where ESG represents Environmental (E), Social (S), and Governance (G) considerations, is a strategy that incorporates these elements into the investment decision-making process.
3 Whether greater ESG-themed investing actually results in improved environmental conditions is a matter of debate that is beyond the focus of this essay. For a discussion of that issue, see Jones (2024, February 5).
4 Globerman (2022) identifies conflicting findings for studies of US-listed public companies.
5 Institutional investors in Canada identified three primary motivations for ESG investing: minimizing risk, improving returns over time, and fulfilling fiduciary duty, in that order.
6 See *The Global Sustainable Investment Review* (GSIR) 2022 for a summary of policies and regulations related to ESG investing in Canada.
7 If stock prices at any time reflect available information about corporate ESG reputations, only new information, i.e., changes in ESG reputations, will cause stock prices to change, assuming other determinants of stock price movements are held constant.
8 For more details on the effect of ESG investing on returns in both the short term and long term, refer to "Does ESG Investing Generate Higher Returns?" published in *Kenan Insight* 2022. Please note that this source is relatively accessible and designed to provide an intuitive understanding of the topic rather than give a deep dive into the academic theory.
9 It should be explicitly acknowledged that our study, as do most empirical studies of returns to ESG investing, focuses on publicly traded companies since relevant data are more readily available for public companies. However, there is no a priori reason to believe that the return relationship would be systematically different in samples of privately held companies.
10 *Alpha* measures how an investment's return compares to a benchmark for that investment, indicating if the investment has over- or underperformed the benchmark adjusting for expected risk. A positive alpha indicates that the investment outperformed its benchmark after adjusting for risk, while a negative alpha indicates underperformance. The Sharpe Ratio calculates the return earned per unit of risk, with higher values representing superior risk-adjusted returns.
11 Figure A1 in the appendix lists the 35 key issues that MSCI uses.
12 For a discussion of the challenges to creating aggregated and standardized measures of ESG performance, see Aliakbari and Globerman (2023).
13 Pucker and King (2022, August 1) assert that ESG funds typically charge fees that are 40 percent higher than traditional funds.
14 The possibility that investors who favour sustainable companies are simply misinformed about their relative expected returns cannot be dismissed, although this explanation is at odds with the efficient market hypothesis which holds that investors use available information to maximize investment returns. The fact that ESG investing has seemingly become less popular in recent years might be supportive of the claim that initial enthusiasm for ESG-themed investing was "excessive" (see Jones, 2024, February 5).
15 Viana (2023, January 31), among others, makes this argument.
16 A larger sample is more likely to be representative of the TSX Composite Index.

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It's Time to Move on from ESG

Steven Globerman

Executive Summary

The ESG movement calls for public companies and investors in public companies to identify and voluntarily implement environmental, social, and governance initiatives—ostensibly in the public interest.

There are two schools of thought as to why corporate managers and professional and retail investors should adopt ESG-intensive business and investment strategies. The first is that doing so will make companies more profitable and thereby increase the wealth of their shareholders. However, to date, academic research has failed to identify a consistent and statistically significant positive relationship between corporate ESG ratings and the stock market performance of companies. On the other hand, research does suggest that adopting an ESG-intensive or "stakeholder" governance model might compromise the efficient production and distribution of goods and services and thereby slow the overall rate of real economic growth. Slower real economic growth means societies will be less able to afford investments to address environmental and other ESG-related priorities.

The second is that companies, their senior managers, and their boards have an ethical obligation to implement ESG initiatives that go beyond simply complying with existing laws and regulations, even if it means reduced profitability. However, corporate managers and board members cannot and should not be expected to determine public policy priorities. The latter should be identified by democratic means and not by unelected private sector managers or investors.

Given that there are indications that investor support for ESG is waning, it is apparent that the time has come for corporate leaders and politicians to acknowledge that it's time to move on from ESG.

Introduction

The ESG movement, which arguably overlaps with schools of thought variously known as stakeholder capitalism, socially responsible corporate behaviour, or "New Capitalism," is the most significant intellectual challenge to the traditional shareholder model of capitalism since Berle and Mean's (1932) argument that the separation of ownership from management in large corporations undermined corporate efficiency and facilitated management enriching itself at the expense of shareholders.[1] The ESG acronym stands for a range of environmental, social, and governance actions that critics of shareholder capitalism suggest public companies should voluntarily initiate to improve the well-being of society. Such initiatives include, among other things, reducing greenhouse gas emissions, conserving on the use of water and other natural resources, reducing income inequality, implementing diversity in employment hiring and executive leadership, treating workers, consumers, and suppliers "well," and providing amenities such as green spaces and charitable donations to communities in which the companies operate.

A companion development is the ongoing call for ESG-themed investing by securities regulators and professional investment managers. ESG (or sustainable) investing is meant to provide incentives to companies to be more socially responsible. Specifically, to the extent that investors favour "green" companies relative to "brown" companies, financial capital will flow to the former and away from the latter in a world where ESG-themed investment becomes widespread. This, in turn, will contribute to lower costs of financial capital for green companies and higher costs of capital for brown companies, which will encourage the growth of ESG-intensive companies relative to their less intensive peers.[2]

There are two broad schools of thought on why companies and their investors should adopt ESG-intensive corporate and investment strategies. One maintains that doing so will make companies more profitable and thereby increase the net worth of their shareholders. The second asserts that companies have a social responsibility to implement ESG initiatives that go beyond simply complying with existing laws and regulations directly or indirectly governing corporate behaviour, such as pollution emissions regulations, carbon taxes, water use restrictions, reporting requirements for carbon emissions, laws prohibiting discrimination on the basis of gender, race, or religion, and so forth, even if doing so reduces long-run profitability.[3]

The purpose of this essay is to summarize and synthesize a set of studies that the Fraser Institute has published in its ESG: Myths and Realities series.[4] The studies directly and indirectly address these two schools of thought, as well as government- and activist-led efforts more broadly to promote ESG-themed investing.

Is ESG a profit-enhancing strategy?

> "If implementing ESG-related initiatives promised to increase long-run profitability, companies presumably would implement them without prodding from regulators or activist organizations."

On the surface, an argument that companies and their shareholders would be financially better off if companies more actively pursued ESG-related initiatives seems illogical. If implementing ESG-related initiatives promised to increase long-run profitability, companies presumably would implement them without prodding from regulators or activist organizations. As such, the claim that companies focused on maximizing the wealth of their shareholders will ignore the interests of other important stakeholders, including customers, employees, and suppliers, seems oxymoronic.

Proponents of ESG investing who maintain that it will increase risk-adjusted corporate profitability argue that flawed corporate governance results in publicly traded companies failing to implement many if not most profit-maximizing ESG strategies. In particular, they argue that the management incentive systems that public companies use, such as profit-based compensation, encourage "short-termism" in managerial decision-making which biases management against sustainable business strategies that would increase profits in the long-run.[5]

One empirical test of whether companies are foregoing profit-enhancing ESG-related strategies looks at whether there is any relationship between the ESG rankings of companies (or portfolios of companies) and the stock market performance of those companies or portfolios. Globerman (2022b) summarizes a range of empirical studies that examine whether returns to assets, mostly stocks but also bonds, are related to the ESG rankings of the companies (or portfolios of companies) in the sample of observations. ESG rankings are typically summary measures produced by consulting firms that rate companies based on available information about those companies' environmental, social, and governance practices. Globerman concludes that there is no consistent relationship between the ESG rankings of companies and risk-adjusted returns to equity or bond investments. Some studies find a positive relationship, while others find either a negative relationship or no relationship at all.

Most of the studies reviewed in Globerman (2022b) are focused on US public companies. A more recent study by Globerman (2024) in the ESG: Myths and Realities series examines the relationship between stock market returns and changes in ESG ratings for a sample of 310 companies listed on the Toronto Stock Exchange between 2013 and 2022. The study uses proprietary data from MSCI, a leading ESG ratings provider, to identify changes in the ESG ratings of companies in the sample. The study finds that neither upgrades nor downgrades in ESG ratings significantly affect stock market returns. This Canadian study is particularly relevant as it addresses a potential weakness in studies that examine the relationship between

ESG rankings and equity returns. Namely, if capital markets are efficient and ESG performance rankings remain constant, a company's ESG performance should be fully capitalized into its stock price. Hence, one would not expect to find a statistical relationship between ESG rankings and equity returns going forward. However, changes in ESG ratings should be new information for investors, and if higher (or lower) ratings are related to increased (or decreased) equity returns, one should expect to see a statistically significant relationship between ESG rating changes and equity returns over the period of time that includes the ratings change.

Many proponents of ESG-themed investing argue that the failure to identify a consistent and statistically significant relationship between ESG ratings and equity returns reflects incomplete or misleading ESG ratings. They thus advocate for greater mandatory disclosure of ESG-related information by companies, as well as for increased standardization of the information reported to facilitate comparisons across companies and to reduce misleading corporate ESG claims (known as "greenwashing").

Mandating more ESG-related corporate disclosures obviously imposes additional costs on public companies and diverts productive resources away from productivity-enhancing investments in order to satisfy regulatory-related disclosure requirements. Cumming's (2023) contribution to the ESG: Myths and Realities series warns that the available evidence he reviews indicates that the costs associated with mandatory ESG disclosures cause some privately owned firms to delay or forego listing on public stock exchanges, which adversely affects the efficiency of capital markets, as well as the overall performance of domestic economies. Such mandates also increase costs for public companies thereby contributing to a decline in the number of publicly traded companies in Canada and the US over the past decade.

Nor is standardizing mandatory ESG reporting likely to improve the information content of such reporting. In another essay in the ESG: Myths and Realities series, Aliakbari and Globerman (2023) evaluate the feasibility and potential consequences of mandating standardized ESG disclosures. In particular, they highlight the implementation and enforcement challenges that would arise from mandating a uniform set of ESG reporting standards that apply to all public companies. They conclude that any specific set of ESG-related requirements mandated by regulators for uniform reporting by public companies will inevitably be arbitrary and difficult to verify given the heterogeneity in business conditions and practices across industries and companies, as well as differences across "stakeholders" in the information that they would find materially relevant.

In short, even if the absence of a statistically significant positive relationship between ESG ratings and stock market performance in part reflects the poor information quality of ESG ratings, it is unlikely that mandating increased ESG-related disclosures or standardizing such disclosures would materially affect the financial benefits of ESG-themed investing or boost corporate profitability given the variety of ESG ratings measures used in existing studies, as well as the theoretical reasons against the existence of a relationship.

ESG as an ethical imperative

To be sure, many supporters of the ESG or sustainable capitalism model base their support on moral or ethical grounds rather than on grounds of improving economic efficiency and investors' wealth. Specifically, they argue that senior executives and board members have a social obligation to align corporate strategy and actions to support ESG-related objectives. As Mintz and Tingle (2024) explain in their contribution to the ESG: Myths and Realities series, many advocates of ESG are demanding that companies do things that benefit some group or purpose (including the environment) when doing something else would be more profitable for the firm and its shareholders.

Those who support the position that managers and board members should forego maximizing the wealth of shareholders in order to promote broad social goals such as mitigating climate change often point to a failure of governments and regulators to ensure that those social goals are realized.[6] For example, Savitt and Kovvali (2022) assert that government regulation of business has been a failure, as evidenced by a worsening climate crisis and a burgeoning crisis of income inequality among other social ills. They further argue that the public is increasingly exasperated by public officials who seem unable or unwilling to "step in," and so citizens are demanding "better performance" from the corporations they interact with. For some analysts, legislative and regulatory failure reflects limited public sector financial resources. For others, the problem lies in inadequate expertise on the part of politicians and regulators, perhaps abetted by the lobbying efforts of companies that bias the political process in favour of supporting the interests of shareholders.

Whether governments and regulators are doing too much or too little to address broad social interests such as climate change, income and wealth inequality, and racial and gender discrimination is a contentious issue that is well beyond the scope of this essay to address. What can be legitimately questioned is whether private sector executives should be expected to pursue goals other than the efficient production and distribution of goods and services in order to maximize the long-run wealth of their shareholders. Put more directly, there is no reason to believe that private sector executives and institutional investors are capable of making the inevitable tradeoffs between different broad social goals or between broad social goals and corporate profitability. For example, given limited productive resources, pursuing a goal such as investing in the reduction of carbon emissions implies reduced investment to promote increased organizational efficiency with attending higher costs for

> “ [T]here is no reason to believe that private sector managers are competent to adjudicate among social priorities and corporate initiatives that make some broad groups in society better off and others worse off.”

consumers, lower wages for employees, and perhaps reduced spending on stakeholders outside the organization such as local charities.[7] In the absence of clear direction from a democratically elected and accountable government, there is no reason to believe that private sector managers are competent to adjudicate among social priorities and corporate initiatives that make some broad groups in society better off and others worse off.[8]

ESG and corporate governance

To be sure, some have argued that executives and institutional investors are accustomed to making tradeoffs within their own organizations, and therefore are competent to make tradeoffs involving the well-being of all stakeholders affected by their decisions.[9] Others argue that allowing executives and institutional investors to pursue a broad stakeholder welfare mandate invites those executives and institutional investors to pursue their own pecuniary interests at the expense of all stakeholders, including shareholders. Put simply, when decision-makers have a responsibility to a virtually unlimited number of stakeholders, they are likely to be responsible to no individual set of stakeholders. The expected consequence of the absence of managerial accountability is an overall reduction in private sector efficiency with an accompanying slowdown in real economic growth.

Bebchuk and Tallarita (2020a, 2020b) make a case for why the stakeholder model of corporate governance is inferior to the shareholder model from the perspective of a society’s overall economic and social welfare. The main reason they cite is that senior executives and corporate board members are more likely to implement strategies and take actions that benefit themselves at the expense of shareholders and other stakeholders when operating under the stakeholder (or ESG-centric) model of governance.[10] This outcome can be expected because it is more difficult for stakeholders—including shareholders—to monitor the performance of executives and board members when the latter operate with broad, possibly conflicting and difficult-to-measure objectives, as well as because incentives to monitor performance are weakened as the number of principals whose interests are at stake increases.

Some proponents of the stakeholder model of corporate governance, such as Savitt and Kovvali (2022) dismiss concerns about corporate directors acting opportunistically, even in situations where they can do so successfully. They characterize Bebchuk and Tallarita as imagining that directors, freed from the shackles of share-price maximization, will engage in a frenzy of self-interested behaviour, ordering corporate affairs to their own benefit without

regard to corporate purpose or corporate value. Such proponents of the stakeholder model assert that the majority of directors are "decent and careful" and that norms matter to them. Moreover, if directors fail to perform their oversight function effectively, they can be voted out of their positions by shareholders—and even sued.

A more nuanced rejection of Bebchuk and Tallarita's argument is that the shareholder model encourages a focus by management on short-run profit maximization at the expense of long-run wealth maximization. This short-term focus allegedly benefits administrators at the expense of shareholders who, for reasons that are not made clear by proponents of this argument, are supposedly unable or unwilling to hold administrators to account for sacrificing long-run wealth maximization in order to drive up share prices in the short-run and thereby boost executive compensation tied to stock options and the like.[11] Conversely, the stakeholder model supposedly encourages or compels managers to pursue long-run profit-maximization with an implication that organizations will be run more efficiently as a consequence.

In this context, it is ironic that companies such as Alphabet and Meta have been criticized by investment analysts for investing in initiatives such as autonomous cars and augmented reality, given the length of the expected time period for those initiatives to pay off.[12] Moreover, Holmstrom (2017) and Edmans (2023) identify the fundamental challenges in tying executive compensation to performance when organizations are pursuing a stakeholder model. Specifically, they identify and discuss the difficulties in designing and implementing efficient administrative compensation schemes when decision-making spans a portfolio of activities and engages an array of policy instruments as will be the case for ESG-focused organizations. Edmans (2023) asserts that when stakeholder objectives are in direct conflict, it is impossible as a practical matter to link the compensation of administrators to overall stakeholder performance. Moreover, if some stakeholder objectives are easily measurable, while others are not, administrators will have incentives to promote the measurable objectives, even if the organization as a whole would be better off if the difficult-to-measure objectives were prioritized.

It is certainly legitimate to raise concerns about government legislative and regulatory failure in the context of broad environmental and social policy issues. However, shifting what is arguably the government's responsibility onto private sector organizations will reduce the efficiency and wealth-creating potential of those organizations without fixing any government failure. Indeed, by reducing the economic and technological assets available to society to tackle environmental and related social issues, imposing ESG imperatives on private sector organizations will arguably make it harder to address those issues effectively.[13]

Concluding comments

Growing calls for publicly traded companies and portfolio investors to prioritize ESG-intensive investment opportunities, which overlap closely with arguments for operating companies and portfolio managers to adopt a broad stakeholder framework rather than a shareholder (or investor) framework, presume that this change in focus will enhance overall social welfare, even if it comes at the expense of reduced wealth creation by the private sector. While most defenders of the shareholder wealth maximization governance model acknowledge the relevance of environmental concerns and the importance of raising living standards of the poorest members of society, among other ESG-related priorities, they reject the claim that the widespread adoption of a vaguely defined stakeholder governance model by private sector managers and investors will convey net social benefits.[14]

> **"… consumer behaviour is a powerful force to express societal preferences regarding environmental and social issues…. by responding to consumers' preferences, firms operating in competitive markets provide solutions to many environmental and social problems."**

The Nobel laureate Eugene Fama (2024) makes the argument in the ESG: Myths and Realities essay series that, while imperfect, competitive market forces are likely to be more effective and efficient at addressing environmental and social concerns than top-down, externally imposed ESG programs or stakeholder capitalism. In particular, consumer behaviour is a powerful force to express societal preferences regarding environmental and social issues. Fama argues that by responding to consumers' preferences, firms operating in competitive markets provide solutions to many environmental and social problems.

Fama and many other economists believe that pursuing shareholder wealth maximization promotes maximum private sector efficiency which, in turn, creates the financial and technological wherewithal for societies to address relevant ESG priorities.[15] They also believe that identifying ESG priorities and determining how to resolve inevitable tradeoffs across different groups in society given any chosen set of priorities is best done through the democratic political process, including the market preferences expressed by consumers and investors in their roles as private sector decision-makers.

In summary, dissatisfaction with how the political process has dealt with the ESG-related concerns of different interest groups does not equate to a defence of ESG or its related stakeholder model. There is no reason to believe that managers of operating and investment companies enjoy any comparative advantage in identifying and implementing broad environmental and social policies compared to politicians and regulators. Indeed, as Friedman

(1970) prominently argued, to the extent that private sector executives promote their commitment to stakeholder governance principles, they inadvertently weaken the case for private sector capitalism, particularly if their commitment is in pursuit of competitive advantages at the expense of rivals.[16]

It was beyond the mandate of the various studies in the ESG: Myths and Realities series reviewed in this essay to discuss whether and how political and regulatory processes might be reformed so as to reduce the incidence and impact of government failure in areas such as environmental and minority group employment policies that many ESG proponents advocate. However, the studies referenced above fairly question whether effectively transferring governance responsibilities for ESG-related policies to private sector executives and portfolio managers is the appropriate response to government failure, if such policies indeed reflect the preferences of society. The broad conclusion of the studies reviewed in this essay is that the private sector best serves the interests of society when it focuses on maximizing shareholder wealth within the confines of the established laws, as Friedman explained more than five decades ago. As such, the time has long passed to move on from top-down ESG mandates.

Endnotes

1 See Globerman (2022a) for a discussion of these various critiques of shareholder capitalism. *The New Capitalism* study was part of the Fraser Institute's ESG: Myths and Realities series.
2 For a discussion of how investing behaviour can indirectly promote corporate ESG initiatives, see Globerman (2022b), a study that is part of the ESG: Myths and Realities series.
3 This latter school of thought has been developed in the literature arguably in response to Friedman's (1970) iconic defense of profit maximization as the sole responsibility of business.
4 All studies published as part of the ESG: Myths and Realities series are explicitly identified as such.
5 See Globerman (2022a) for a discussion and critique of governance-related arguments against the shareholder-focused corporate model.
6 Lau (2023) argues that the ESG movement has been primarily championed by elites in non-governmental institutions such as the World Economic Forum rather than by individual investors, consumers, and workers. Pardy (2023) highlights statements of some business leaders to the effect that the role of business is to channel resources to tackle contemporary social and environmental issues. Pardy echoes Friedman's (1970) warning that public commitments to ESG by business leaders is effectively a call for socialism. Both the Lau and Pardy essays are part of the ESG: Myths and Realities series.
7 Friedman (1970) argued that corporations should not directly engage in charitable giving. Rather, employees and shareholders should donate a portion of their compensation and investment returns to charities of their choice if they are so inclined. In the ESG: Myths and Realities series, Olasky (2022) summarizes empirical studies showing that individuals choose to give less money to non-profits with corporate sponsorship than to those without such sponsorship. Hence, the overall effect of corporate philanthropy could actually be a net loss for non-profits.
8 Friedman (1970) cautioned against giving private sector executives a mandate to make public policy because doing so conflicts with the democratic process. Mintz and Tingle (2024) similarly argue that it is the role of elected legislatures to achieve social goals. It is not securities regulators or investment fund managers' responsibility to take on the role of a democratically elected government.
9 See, for example, Savitt and Kovvali (2022) and Mayer (2022).
10 Whether the resulting loss of efficiency is the result of deliberate opportunism or the difficulties that executives face in trying to satisfy a broad set of constituents with conflicting and ill-defined objectives is not material to this argument. For an analysis of corporate governance issues related to ESG mandates, see Globerman (2023) in the ESG: Myths and Realities series.
11 See Globerman (2023) for a critical discussion and analysis of this indirect argument for the stakeholder governance model.
12 See Globerman (2023) for a discussion of these criticisms.
13 For example, slower economic growth implies a more slowly growing tax base to fund government programs in areas such as education, health care, and income transfers that, in turn, particularly help lower-income households. Lower corporate profits imply less internal funding available for firms to undertake R&D and related initiatives that help reduce carbon emissions and mitigate the adverse health effects of environmental contaminants.
14 Shifflett (2023), among others, documents a recent decline in investors' support for ESG investing.
15 Certainly, many critics of stakeholder capitalism reject some, if not all, of the ESG initiatives that have been proposed by activist groups and even by government regulators. A prominent example is the legal challenge brought by the attorneys general of several US states against securities regulators mandating that state-run pension funds incorporate ESG-related considerations into their investment decision-making.
16 For example, environmental regulations are more costly per dollar of sales for small and medium-sized companies than for large companies. In this regard, Cumming (2023) discusses the likelihood that mandated ESG reporting requirements imposed on public companies might discourage small and medium-sized companies from going public. For a discussion and evaluation of the arguments against Friedman's defence of shareholder capitalism, see Globerman (2022c).

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Putting Economics Back into ESG

Jack Mintz, QM and Bryce Tingle, KC

One of the great statements about corporate law was penned in 1883 by Lord Bowen with reference to a corporate picnic for employees, "The law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company" (Hutton v. West Cork Railway Co., 1883). The issue captured in Lord Bowen's remark concerns the legitimate aims of the corporation and stretches as far back as the corporate form itself.

While the current debate revolves around the phrase "environmental, social, and governance" or "ESG," the term has been at other times discussed as "corporate social responsibility (CSR)" "sustainability," "triple bottom-line," concern for "stakeholders," or non-shareholder "constituencies," and when applied to investors, "stewardship," "socially responsible investing (SRI)," or just "responsible investment." One should always be suspicious when an idea keeps changing its name.[1]

The debate about corporate purpose is old, but it is not founded on a fundamental error. There are significant conflicts of interest between the various constituencies of the corporation and it matters whose interests are paramount. The economic way of describing this conflict is whether companies ought to make investments with a net present value (or rate of return on capital) that is lower than the alternatives. Note that we are not framing the question as whether corporations should make investments with a negative rate of return. Obviously, a company that regularly made these sorts of decisions would rather quickly run out of money, go bankrupt, and thus remove itself as a vehicle for social and environmental justice. Rather, the question is whether a company should do things that benefit some group or purpose (including the environment) when doing something else would be more profitable. This is what advocates of ESG are really demanding.

An Interminable Debate without Economics

The fact that the argument about the proper purpose of the corporation has gone on for as long as business corporations have existed should tell us something about the argument. On one side, it is clear why the notions behind ESG keep popping up: corporations impact many people, and we would generally like those impacts to be positive. It is unlikely that a critical mass of our society will ever look at how a corporation treats its employees and say, "I hope the company is a bit harsher in the future." We care about a lot of things more than profitability (and unthinking people do not care about profitability at all). The temptation to ask more from business will always be with us.

The reason why the debate is not quickly resolved in favour of the moral intuitions behind ESG requires a bit more digging. Economics tells us that business corporations find themselves enmeshed in a variety of competitive markets. These markets include not only the markets for the various products sold by the corporation, but also the labour markets in which it hires its employees and executives, the financial markets in which it raises debt and equity capital, the markets made up of its suppliers, and often a market for control of the corporation itself. The existence of these competitive markets is almost totally ignored in most discussions of ESG. Partly this is because the existence of these markets is almost totally ignored in discussions of corporate governance generally, and partly because a lot of the people who are interested in ESG do not know much about business.

According to one poll, a random selection of American adults thought corporations make an average 36 percent profit, defined as a percentage of sales after taxes (Reason-Rupe, 2013). In fairness to ESG advocates, if this were true, one could safely ignore markets and immediately start instructing businesspeople on how they should spend company money. Unfortunately, it is not even close to being true. In a typical year, the profit margin of American businesses is just three percent (Bhattacharjee and Dana, 2024). Out of this margin, the average company needs to still pay taxes and cover the cost of its capital.[2]

How much do corporations make once all their expenses are paid? This is not an easy question to answer because the cost of capital is difficult to calculate, especially the cost of equity finance including risk and inflation (Witmer and Zorn, 2007; Olson and Pagano, 2023). Bazel and Mintz (2021) estimate the nominal cost of capital without risk and taxes to be 4.9 percent for multinationals operating in North America, consistent with integrated international capital markets. Risk, the most difficult component to measure, would result in a cost of capital of 7.9 percent for Canada and 8.5 percent for the United States.[3] Add in corporate income and other capital-related taxes, the minimum nominal return to compensate capital owners is 8.4 percent in Canada and 9.1 percent in the United States. In other words, the average corporation does not make very much at all over its costs including the imputed cost of equity (Fama and French, 1999; Alderson and Betker, 2009).

As economics makes clear, a corporation in a reasonably competitive market cannot make investments that will raise the cost of its products above those of its competitors. If there were a company that decided not to automate its factories solely out of a charitable concern to maximize the number of people it employs, that company would eventually be driven out of business by competitors that have embraced automation, in a process familiar to everyone who reads the business section of a newspaper.

ESG will also prove practically impossible for those rare businesses in Canada that earn above-normal profits (economic rents) due to the ownership of land or resources, regulatory protection, or barriers to entry in an industry. The value of these rents will be reflected in the company's share price because the share price will rise to take into account the future expected cash flows from these rents. Basic economic theory suggests that higher costs associated with ESG will result in a reduction of output, a rise in market prices, a fall in economic rents, and lower share prices. In other words, the firm will be unable to cover its cost of capital. This is not saying anything controversial: ESG is a transfer of wealth from shareholders to other parties. In general, shareholders do not like declining share prices and they tend to punish managers who are responsible.

"Basic economic theory suggests that higher costs associated with ESG will result in a reduction of output, a rise in market prices, a fall in economic rents, and lower share prices."

The impact of competitive markets is why employees do not toddle off every day stuffed with "cakes and ale." It is also why, when we look at the large body of empirical literature on corporate ESG activities, we find so much evidence that they are merely window-dressing unless they are secretly related to improving profitability (Tingle, 2024: 235-49).[4] Finally, it is why the idea behind ESG has never managed to gain much traction in the real world of economic actors, though it has gone in and out of favour with regulators.

Why Care about ESG?

Why should we worry about ESG if there is, in fact, no way for ESG to materially influence corporate behaviour without conflicting with their essential profit-making activities?

The problems with our current infatuation with ESG can be easily summarized:

i) To the extent that the expensive ideas that make up ESG are accepted by Canadian securities regulators and investors, it will render our public markets less attractive to new entrants (Cumming, 2023). New Canadian businesses take money from outsiders and eventually have to give that money back. Historically, this was done by taking the company public; increasingly, it is done by selling the business. In many

industries, especially high-tech industries, there are few Canadian purchasers, so selling the business often means it moves to the United States. Unattractive public markets (where ESG lives) are bad for Canada.

ii) To the extent regulation or shareholder pressure imposes some ESG obligations on Canadian companies, they will grow less competitive relative to their international peers (Pardy, 2023). For example, when Canada introduced its Extractive Sector Transparency Measures Act in 2014, it led to a transfer of assets from Canadian firms to their American competitors (Rauter, 2020).

iii) To the extent some ESG behaviours are imposed on Canadian corporations only, individual investors will be harmed as the competitive position of those corporations declines (Globerman, 2022a). This is already visible in the relatively poor financial performance of Canada's energy industry as a result of ESG pressures in this country (Mejia and Aliakbari, 2024).

iv) Much of our progress in improving the welfare of non-shareholder constituencies has come from business as usual. Focusing on ESG rather than the health of our markets and fostering innovation, reflects a major misunderstanding of where progress arises (Fama, 2022).

v) To these concerns, we would like to add one other. As we have seen, it is impossible in the presence of competitive markets for companies to make material, voluntary, unilateral ESG investments. In reality, advocates of ESG are not asking merely for more cake. They are trying to solve big problems, not the quality of breakroom snacks. A company that trumpets its commitment to employee welfare symbolized by its cake-filled picnics will cause irreparable harm to the social fabric of Canada if it finds itself compelled to off-shore its factories to Mexico or Asia. If ESG promises by investors and companies can only ever be honoured in the breach, trust in corporations and elites will decline.

What Can Be Done?

There is evidence that the current ESG movement is fading (Larcker et al., 2024). For now, how do we minimize the harms?

1. Expand what counts as ESG

As our main theme, ESG should be expanded to include economics. Shareholders will not be happy earning a poor return on capital. Neither will workers, who will be laid off or unable to gain wage increments from companies in financial trouble. And if Canada pushes ineffective but expensive ESG mandates, capital will move to those countries with a framework that includes economics in evaluating corporate success.

Security concerns could also be included in ESG (Mintz, 2022). When the unprovoked invasion of Ukraine occurred, it was discovered that investment funds with ESG mandates had been preferentially investing in Russian oil and gas operations (the principal source of funding for the Putin regime) because of their lower per barrel carbon emissions (Vandaelle, 2022). When Europe came to Canada looking for energy to make up for the imports lost from Russia, we were unable to contribute anything to the energy security of our allies and fellow democracies. We have some of the largest energy reserves in the world, but an embarrassingly narrow version of ESG has kept us from exploiting them.

"[Canada has] some of the largest energy reserves in the world, but an embarrassingly narrow version of ESG has kept us from exploiting them."

2. Stop regulating in the name of ESG

The securities commissions in Canada (and elsewhere in the world) have been pulled into regulating purely political matters unrelated to facilitating price discovery and ensuring market integrity. In Canada, they are currently in the midst of a high-profile effort to revise corporate disclosure around carbon and diversity (CSA, 2023).

Securities commissions lack the experience, skills, processes, and oversight to regulate broad political matters. For example, there are reasons why corporations have tended to resist wholesale adoption of diversity targets and publicly tracking the results. These sorts of diversity, equity and inclusion, or "DEI" initiatives increase the salience of racial and other differences, discount merit in hiring and promotion decisions, reward those who can most credibly claim the status of victim (setting off a competition towards the bottom), ignore other types of diversity (such as differences in experience or viewpoint), and retrospectively call into question the merits of those minorities who are hired or promoted. No one seriously interested in managing and building an organization wants to import this dynamic.

Securities regulators in Canada need to seriously rethink their remit. They are not general regulators of corporate governance; they exist only to ensure Canada's capital markets are fair and efficient, not to advance other goals. Responsibility for broader social goals lies with the legislature, which is subject to much more oversight and which enjoys the legitimacy provided by being elected.

There is another problem with ESG regulations: rules about disclosure and measurement must be standardized. ESG, with its variety of stakeholders and the harms it attempts to address, is poorly suited to standardization (Aliakbari and Globerman, 2023; Tingle, 2023). Some of the information is unquantifiable, some is incommensurate, some involve trade-offs between vulnerable parties, some requires subjective or value-laden judgment calls, and some requires an understanding of the company's alternatives that no third party possesses. In

aggregate, this means that regulations will (perversely) encourage companies to ignore some problems and, at the same time, they will provide companies with ample opportunities to game the required metrics. ESG reporting is far more complex, expensive, and problematic than the financial reporting to which it is often compared.

3. Prosecute ESG-related fraud

Companies and investment funds that make ESG claims should be held liable in the normal course if those claims are untrue. Claiming to be an ESG fund has been a winning marketing strategy for investment funds over the last decade. There is considerable evidence, however, that ESG-branded funds do not, on average, hold more environmentally and socially responsible companies (Liang et al., 2021; Raghunandan and Rajgopal, 2020; Kim and Yoon, 2023). Some studies find ESG funds hold companies with worse track records for compliance with labour and environmental laws. A typical finding is that companies in ESG-branded funds "exhibit worse performance with respect to carbon emissions, in terms of both raw emissions output and emissions intensity" (Bolton and Kacperczyk, 2021). These studies demonstrate the presence of fraud in the securities market. We do not allow false representations on other subjects, so why would we permit it for representations about ESG?

4. Impose liability for the use of ESG ratings

Much of the current ferment about ESG in capital markets is underwritten by an industry comprised of somewhere between 80 and 125 firms that purport to measure, rate, rank, and provide a simple score about each company's ESG performance (Tingle, 2023: 215). Institutional investors require these third-party ESG ratings because they lack the resources, competence, and incentives to carefully investigate and compare the relative ESG performance of companies.

Over the last several years, over a dozen research teams have investigated ESG ratings, and all of them found that they are invalid (Tingle, 2023: 216). This research is easy to do: simply compare how rating firms score the same company. Viewed in its entirety, the empirical literature suggests that rating firms agree about the ESG credentials of a firm less than half the time.[5] This means that ESG ratings tell you nothing useful about a company (Chatterji et al., 2016: 1598).

Research that looks at how well ESG ratings predict actual corporate behaviour, finds that these ratings do a poor job of predicting future pollution and environmental compliance violations, as well as predicting future labour-related issues and enforcement actions (Chatterji et al., 2009; Raghunandan and Rajgopal, 2022). The invalidity of ESG ratings virtually guarantees that they will be a poor guide to what a company does. As investment managers are fiduciaries, they owe a legal duty to their funds' beneficial holders not to make decisions using deeply flawed ESG ratings data.

5. Regulate proxy advisors

Third-party proxy advisory firms have also played a major role in the rise of ESG. For almost two decades, these firms have been the de facto standard setters for corporate governance. Their influence over the voting decisions of institutional shareholders means that companies generally attempt to follow proxy advisors' corporate governance rules. Proxy advisors' work is often flawed and the assumptions behind their governance decisions are frequently contradicted by the empirical literature (Tingle, 2014, 2016).

Proxy advisors routinely undercut the careful decisions of securities regulators in this country. For example, Canadian securities regulators recently considered how companies should report on their diversity performance (CSA, 2023). However, in their Request for Comment, the securities commissions at least were alert to questions of what format for reporting was most likely to protect all minorities, what reporting was least likely to be "gamed" or reduced to a check-the-box exercise, and what sort of reporting was least likely to interfere with the exercise of directors' legal fiduciary duties. While the Canadian regulators engaged in discussions about these issues, the largest proxy advisor in the country, Institutional Shareholder Services, simply ignored the nuanced discussion and mandated a check-the-box diversity quota rule (ISS, 2024: 16–17).

Conclusion

We argue that—most importantly—economics needs to be put into ESG. Any conception of corporate governance that ignores economics (or markets) will prove irrelevant and harmful to corporations. We can draw considerable confidence from the fact that caring about corporate constituencies is usually good economics. Of course, companies pursuing their long-term interests may not be sufficient to achieve society's objectives. Instead, it is the role of elected legislatures to achieve these social objectives. It is not the securities regulators' or investment fund managers' responsibility to take on the role of a democratically elected government (which, in any event, is impossible). Pretending that we can solve our serious social and economic problems by adopting the version of ESG circulating in this country will do considerable harm to Canada without securing much of a valuable benefit in return.

"Pretending that we can solve our serious social and economic problems by adopting the version of ESG circulating in this country will do considerable harm to Canada without securing much of a valuable benefit in return."

Endnotes

1 There has been an evolution of academic justifications for what now goes under the name ESG (Globerman, 2022b).
2 The cost of capital is measured here as the weighted average of paying interest on corporate debt and providing a return to equity owners to compensate them for supplying and holding the riskiest financial claims on the corporation, net of the inflation rate.
3 Based on a long-run equity risk premium of five percent in Canada and six percent in the United States (Booth, 2019) and a market value of debt to assets equal to 0.4 for non-financial corporations (Bazel and Mintz, 2021).
4 Some voices claim that ESG activities increase firm profitability. The problem with these arguments is explaining what ESG brings to the business strategy. If market pressures are driving companies to make certain investment decisions, why do we need ESG regulation or pressure? These sorts of claims that companies can satisfy constituencies with conflicting interests were described by Nobel-prize-winning economist Robert Merton as "escap[ing] the dilemma by swift flight from it" (Merton, 1976: 88).
5 In contrast, credit rating agencies agree about 99 percent of the time (Berg et al., 2022).

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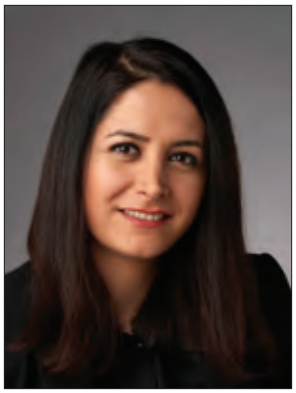
About the Authors

Series Editor, Steven Globerman

Steven Globerman is a senior fellow and Addington Chair in Measurement at the Fraser Institute. Previously, he held tenured appointments at Simon Fraser University and York University and has been a visiting professor at the University of California, University of British Columbia, Stockholm School of Economics, Copenhagen School of Business, and the Helsinki School of Economics. He has written more than 200 academic articles and monographs and is the author of the book *The Impacts of 9/11 on Canada-U.S. Trade* as well as a textbook on international business management. He served as a researcher for two Canadian Royal Commissions on the economy as well as a research advisor to Investment Canada on the subject of foreign direct investment. He earned his B.A. in economics from Brooklyn College, his M.A. from the University of California, Los Angeles, and his Ph.D. from New York University.



Elmira Aliakbari is director of the Centre for Natural Resource Studies at the Fraser Institute. She received a Ph.D. in Economics from the University of Guelph, and M.A. and B.S. degrees in Economics, both from the University of Tehran in Iran. She has studied public policy involving energy and the environment for nearly eight years. Prior to joining the Fraser Institute, Ms. Aliakbari was Director of Research, Energy, Ecology and Prosperity with the Frontier Center for Public Policy. She has presented her work at many academic conferences and has been published in the prestigious academic journal *Energy Economics*. Ms. Aliakbari's research has been discussed in prominent media outlets including the Wall Street Journal, and her commentaries have appeared in major Canadian and American newspapers such as the *Globe and Mail, Washington Times, National Post,* and *Financial Post*.

Terry L. Anderson is the John and Jean DeNault Senior Fellow at the Hoover Institution, Stanford University; past president of the Property and Environment Research Center, Bozeman, MT; and Professor Emeritus at Montana State. Much of his career focused on developing the idea of *Free Market Environmentalism,* the title of one of his 43 books. More recently he has focused his research on the evolution of Native American property rights institutions. His most recent book with Kathy Ratte is *Renewing Indigenous Economies.* He lives in Montana with his wife, Monica, where they enjoy fishing, hunting, horseback riding, and skiing.

Derek H. Burney, OC, is Chairman of Burney Investment Group as well as Enablence Technology Inc. and a member of the Advisory Board of Paradigm Capital Inc. He has a long and successful career in both the private and public sectors. He was the chief of staff for Prime Minister Brian Mulroney (1987 to 1989), Ambassador to the United States (1989-1993), Chairman and CEO of Bell Canada International (1993 to 1999), and President and CEO of CAE Inc. (1999 to 2004). He has taught at Carleton University's Norman Paterson School of International Affairs and was Chancellor for Lakehead University from 2013 to 2017. He serves on a number of corporate boards including Quebecor World Inc., Shell Canada, TransCanada Corp. and New Brunswick Power.

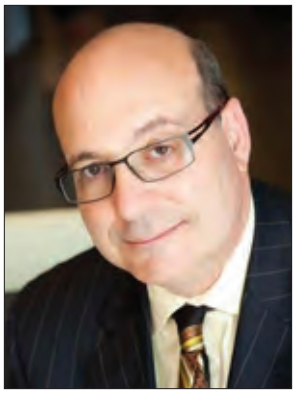
Douglas Cumming is the DeSantis Distinguished Professor of Finance and Entrepreneurship at the College of Business, Florida Atlantic University as well as a Visiting Professor of Finance at Birmingham Business School, University of Birmingham, UK. Previously, he was a Professor and the Ontario Research Chair at the Schulich School of Business, York University. Professor Cumming received his B.Com (Hons.) in economics and finance from McGill University, his masters from Queen's University and a Ph.D. in economics as well as a J.D. in law from the University of Toronto. Professor Cumming is also a Certified Financial Analyst.

He has published over 200 articles in leading refereed academic journals in finance, management, and law and economics, and his work has been cited over 25,000 times according to Google Scholar. His is the Founding Managing Editor-in-Chief of the *Review of Corporate Finance* (2021–). He is a former Managing Editor-in-Chief of the *British Journal of Management* (2020–2022) and the *Journal of Corporate Finance* (2018–2020). Professor Cumming has published 20 academic books with Oxford, Wiley, Elsevier, and other publishers.

Pierre Desrochers, Fraser Institute Senior Fellow, is an Associate Professor of Geography at the University of Toronto, Mississauga. His main research interests include economic development, energy, environmental and urban policy and food policy. He holds a Ph.D. in geography from the University of Montreal. He spent two years at Johns Hopkins University (Baltimore, Maryland) as a post-doctoral fellow and in 2017 was awarded the Julian L. Simon Memorial Award by the Competitive Enterprise Institute in Washington, DC. He has published more than 50 academic articles and over 200 economic columns in various outlets. Prior to joining the University of Toronto, Mr. Desrochers was the Montreal Economic Institute's Research Director, where he remains an associate researcher.

Eugene F. Fama is the Robert R. McCormick Distinguished Professor of Finance at the University of Chicago, Booth School of Business. Professor Fama completed his undergraduate degree at Tufts University and both his Masters and Doctoral degrees at the Booth School, then know as the Graduate School of Business, University of Chicago. He was awarded the Nobel Prize in Economics in 2013.

Sofia Johan is Associate Professor of Finance at Florida Atlantic University, USA, and Visiting Professor at InnoLab, University of Vaasa, Finland. She is co-editor of *Venture Capital: An International Journal of Entrepreneurial Finance* and associate editor of the *British Journal of Management,* the *International Journal of Finance and Economics,* and the *British Accounting Review*. She is on the editorial boards of *Entrepreneurship Theory and Practice*, *Small Business Economics: An Entrepreneurship Journal, Emerging Markets Review,* and *Finance Research Letters*, among others. Her research focuses on corporate finance, corporate governance, alternative investments (hedge funds, venture capital, private equity, real estate investment trusts, and IPOs) and alternative finance (crowdfunding, peer-to-peer lending, and cryptocurrencies).



Dr. Jack M. Mintz, CM is the President's Fellow of the School of Public Policy at the University of Calgary after serving as the Palmer Chair and founding Director from January 1, 2008, to June 30, 2015.

He is a board member of Mackenzie Health, York Region, Ontario and the Aristotle Foundation for Public Policy. He is a Distinguished Fellow at the MacDonald-Laurier Institute, a Senior Fellow at the C.D. Howe Institute, and research fellow at International Tax and Investment Centre in Washington DC, CESIfo Germany, and Oxford's Centre of Business Taxation. He is a member of the editorial board of *International Tax and Public Finance*. He is also a weekly contributor to the *Financial Post* of Canada.

Dr. Mintz became a member of the Order of Canada in 2015 as well as receiving the Queen Elizabeth Diamond Jubilee Medal in 2012 for service to the Canadian tax policy community and Queen Elizabeth Platinum Medal in 2023 for serving as chair of the Alberta Premier's Economic Recovery Council from 2020 to 2022.

Marvin Olasky is a former academic, now retired, but still active across a number of interests. He earned a B.A. in American Studies from Yale University and a Ph.D. from the University of Michigan in American Culture. He was a professor at the University of Texas at Austin from 1983 to 2007 before becoming the provost at King's College in New York (2007 to 2011). From 2011 to 2019 he was the distinguished chair in journalism and public policy at Patrick Henry College. He is also an Affiliate Scholar of the Acton Institute. He was a long-standing contributor to World Magazine, becoming editor in 1994 and editor-in-chief in 2001. He is the author of 28 books including the highly acclaimed *Tragedy of American Compassion,* and writes a weekly column on aspects of homelessness for the Discovery Institute, where he is a senior fellow.

Bruce Pardy is professor of law at Queen's University, senior fellow with the Fraser Institute, and executive director of Rights Probe (rightsprobe.org). A critic of legal progressivism and the discretionary managerial state, he has written on a range of subjects at the front lines of the culture war inside the law, including environmental governance, climate change, energy policy, human rights and freedoms, professional and university governance, property and tort theory, free markets, and the rule of law. He has taught at law schools in Canada, the United States, and New Zealand, practiced civil litigation at Borden Ladner Gervais LLP in Toronto, served as adjudicator and mediator on the Ontario Environmental Review Tribunal, and has published and commented widely in traditional and online media. He is one of the co-creators of the Free North Declaration, a public petition and movement to protect civil liberties in Canada from COVID-19 irrationality and overreach.

Bryce C. Tingle, KC holds the N. Murray Edwards Chair in Business Law at the University of Calgary. He is the author of many academic publications. His new book, *Hard Lessons in Corporate Governance*, was published in May 2024 by Cambridge University Press.

Mr. Tingle serves as a Member of the Alberta Securities Commission (ASC). He is also a Member of the National Special Advisory Group to the RCMP's Integrated Market Enforcement Team.

Mr. Tingle previously served on the Exempt Markets Committee of the Ontario Securities Commission (OSC), on the Securities Advisory Committee of the ASC, as Director of the Financial Regulation Programme of the School of Public Policy, as past Chair of the Business Law (Alberta) subsection of the Canadian Bar Association, and as a member of the Conduct Committee of the Law Society of Alberta.

Mr. Tingle is a member of the founding teams for several companies active in the technology, energy and financial industries. He has also served as a director and board chair of many private and public companies.

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