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ESG: MYTHS and REALITIES

It's Time to Move on from ESG

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FRASER INSTITUTE

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?

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.

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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, forthcoming) 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, forthcoming) 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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