COMPETITIVE ENTERPRISE INSTITUTE

WEBmemo

May 5, 2021 No. 61

Frequently Asked Questions on ESG Theory

Adapted from the study
Environmental, Social, and Governance Theory: Defusing a Major Threat to Shareholder Rights

By Richard Morrison[*]

Q: **What does "ESG" stand for?**
A: ESG is short for "environmental, social, and governance." It is a theory of investing that calls for corporations to elevate the interests of other "stakeholder" groups to the same status as shareholders, and to actively engage in environmental and social activism in addition to producing products and services.

Q: **Where did ESG theory come from?**
A: The term "ESG" was first used in a report published by the United Nations Global Compact in 2004, but has a long history of similar, predecessor concepts both in academic literature and in the business world. Similar concepts include "corporate social responsibility," "corporate social performance," "socially responsible investing," "stakeholder capitalism," "shared value creation," the "triple bottom line," and "impact investing," among others.

Q: **Is there a history of corporate leaders embracing "social responsibility" policies?**
A: Modern capitalists like Ben Cohen and Jerry Greenfield of Ben & Jerry's are far from the first corporate founders to profess a public commitment to socially enlightened management. The last two centuries of Anglo-American business history are filled with quirky free thinkers and high-minded theorizers who were driven by their own vision of business virtue, though many of their expectations would clash with modern standards.

Q: **How does ESG as a system of ethics for business differ from more traditional expectations?**
A: Individual business owners or corporate officers may be under any number of ethical obligations, depending on their status—for example, as a citizen, parent, Christian, environmentalist, Freemason, or volunteer leader—but those roles and responsibilities are independent of the firm. The traditional understanding of the corporation allows it to focus on the purpose for which it was constituted—profitably producing goods and services—

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while allowing its shareholders and employees to use their own resources of time and capital to advance whatever personal objectives they value. ESG calls on the firm, as an entity, to assume and discharge communal ethical duties beyond its scope as a business enterprise.

Q: **Who are the advocates of ESG theory?**
A: ESG means very different things to different people. Some advocates want to advance specific environmental or labor policy outcomes. Some are individual investors who want a competitive rate of return but want to minimize their carbon footprint. Others are professionals looking to sell ESG-themed financial products and consulting services or to carve out a lucrative career niche for themselves in a burgeoning field.

Q: **How rigorous are the ESG scores and ranks that analysts assign to companies?**
A: The scores assigned by different ratings firms often diverge significantly. That suggests that the firms involved are either measuring different things or measuring the same things in such an imprecise manner that their numerical and letter-based scores do not correspond to any objective standard.

Q: **What happens one separates performance in the three categories of environmental, social, and governance?**
A: Research that breaks out E, S, and G components finds that positive correlations with returns is associated mostly with sound governance policies, while high scores on environmental and social components are unrelated or even inversely related with performance. This suggests that the most traditional or "conservative" elements of ESG—internal oversight, transparency, and anti-conflict of interest measures—are the only elements of the bundle that yield actual returns. The newer, more progressive-inspired elements of ESG theory—climate disclosures, diversity mandates, and "fair trade" commitments—do not generate the "win/win" advantages to firms that their proponents frequently claim.

Q: **How are political and government officials involved with ESG?**
A: Recent legislation proposed by members of Congress, including Sen. Elizabeth Warren (D-MA), and regulatory proposals advanced by the current leadership of the Securities and Exchange Commission (SEC), would move U.S. corporations away from the longstanding legal presumption of shareholder primacy to one in which government agencies manage the priorities of business entities. Requirements to disclosure additional corporate information and comply with new standards of conduct may be forthcoming from the SEC.

Q: **Is there an alternative to having government agencies manage ESG priorities?**
A: Federal policy makers could restrain themselves and allow progressive-minded corporations to embrace a voluntary system of "benefit corporation" charters, augmented by private certification standards. Legally binding corporate charters that elevate other stakeholders to the status of shareholders are available to founders and board members who want to embrace them. Non-profit organizations also offer private, voluntary standards that certify compliance with ESG-style priorities.

Q: **What will happen if government officials decide to issue mandatory ESG regulations?**
A: A binding regulatory framework would likely be expensive, time-consuming, and afflicted by the same problems that beset most regulatory policy. Regulatory capture, privileging of incumbent firms, and negative effects on growth and innovation would all likely result. Moreover, flawed rules would become quickly entrenched and become extremely difficult to change once regulated entities start spending money to comply with them. This would likely leave currently dominant firms even more powerful than before.