ESG & Boundary Risks - A Social Welfare Approach

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UCL CEL-ECGI Biennial Symposium on Corporations' Boundary Risks. - November 10, 2023

Rise of ESG and Boundary Risk Practices

- **New Landscape**
  - New corporate normal
  - New regulation
    - European Directive ("CSDDD")
    - Partisan state regulation in the US
- **"Pro" View**
  - ESG as move toward a new "welfarist" corporate model
    - social welfare increase - inherent legitimacy
- **"Anti" View**
  - ESG as either managerial opportunism or excessive investor influence
    - legitimacy deficit

Overview of the Argument

- Two main claims:
  - **Social welfare theory does not support claim of inherent legitimacy**
    - several tradeoffs
    - corporate conformity
  - **Regulatory tradeoff**
    - "strong" regulation (CSDDD) adds legitimacy but may come at the expense of regulatory efficiency
    - "weak" regulation (US) may bring less legitimacy but be more efficient

Social Welfare Analysis

- ESG and boundary risks as public goods $\Longrightarrow$ can be accomodated into individuals' utility functions
  - *u_i (x, ESG)*
  - individual utility function increases in both x ("other" good) and *ESG*

- Under budget constraint, we can assume substitution effect
  - tradeoff x with *ESG* at a given MRS
  - e.g., give up 1 unit of x (e.g., profits) for 5 units of *ESG*
  - **but** individuals tend to have different MRS + tradeoffs might be more complex $\Longrightarrow$
  - **disagreement on ESG level**
    - some individuals (i) will want more; others (j) less

ESG Tradeoffs

- **Intertemporal**
  - different IMRS depending on how much individuals discount the future
    - e.g., E component: I forego emissions today for better enviroment tmw (but this comes at the cost of lower employment today)
  - also different IMRS at different life stages
    - millenials of today vs. millenials of tmw
- **Means**
  - ESG includes specific ways of realizing ESG goods
    - e.g., board gender quotas
  - individuals may agree on ESG level but disagree on means
- **Division of Labor**
  - disagreement on which institutions should be in charge of implementing ESG

Optimal Social Welfare

- Criterion cannot be Pareto efficiency:
  - would require unanimous consensus
- Kaldor-Hicks
  - Bc ESG is divisible - involves continuos choice - optimal solution is an **interior solution** (see representative consumer)

- **Question:** is current ESG agregation process likely to lead to such a solution?

ESG Corporate Aggregation

- Egalitarian vs. oligarchic view of ESG demand

- "Moral portfolios" suggest oligarchic view is more accurate
  - Increasing investor demand for ESG assets
    - Sympathetic investors include more ESG assets in their portfolios than diversification would require
  - Bubble effect: share price of ESG assets increases (and viceversa)
  - Equity reconcentration suggest pivotal role of large fund families in determining asset price effects and hence in influencing corporate ESG decisions

Corporate Conformity

- **Corporate conformity**
  - observed homogeneity in ESG practices
  - largely *i*-like stance for more ESG
  - incompatible with interior solution
- **Counterargument**
  - ESG preferences of largest investors are representative of average consumers?
  - dismissed by abduction
    - lack of pluralism
    - capitalistic principle
    - even if acting on behalf of retail investors
- **Current ESG "private" engagement might fail to increase social welfare - lack of inherent legitimacy**

Legitimacy Implications

- **Why legitimacy?**
  - ESG practices seek social changes, affecting all citizens
  - Lack of pluralism equals lack of legitimacy (consent + equal partecipation)
- **Why regulation?**
  - why not private legitimacy requirements akin to self-governance?
    - complexity of adapting political legitimacy principles (e.g., equal participation)
    - regulation already there
    - self-regulation may always fail

Regulatory Tradeoff

- CSDDD as strong regulation
  - comprehensive framework
  - adressing large number of Co.s
  - extraterritoriality
    - More legitimacy, but one-size-fits-all risk
- US state regulation as weak regulation
  - federal gap
  - 41 states
  - large variations in scope, structure and effects
    - Less legitimacy but potential for some pluralism?

Thank You!!!