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ESG: MYTHS and REALITIES

ESG Mandates and Managerial Efficiency

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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

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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

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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.

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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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