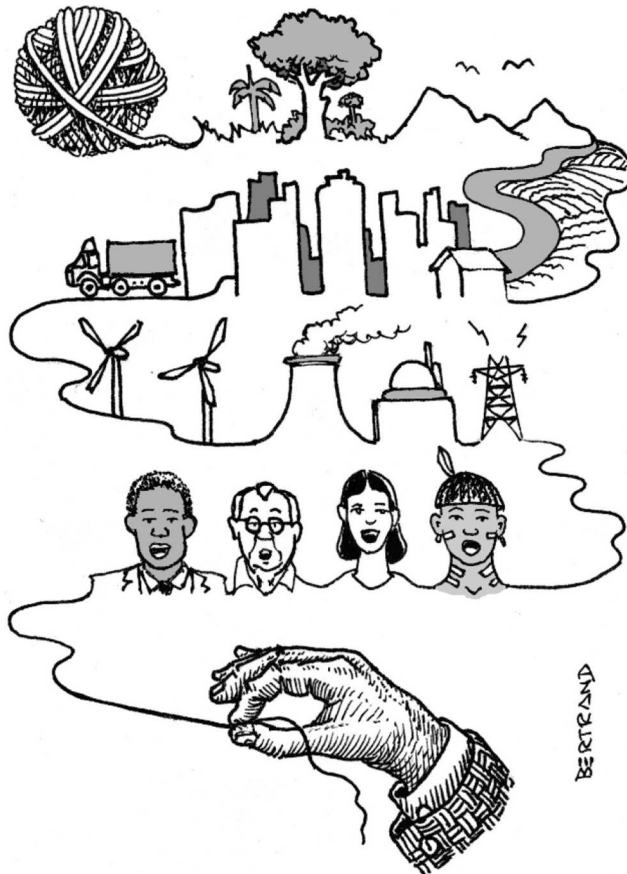


ESG: disentangling the governance pillar

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This article is a perspective paper that provides a critical assessment of ESG's governance pillar. Specifically, we reflect on the implications of considering "governance" from a broader perspective, which combines corporate governance and the analysis of the governance mechanisms used by firms in the search for greater sustainability. We argue that such an enlarged panorama generates new discussions for the transition to more sustainable production and consumption systems. We also raise the question about the potential limitations of looking exclusively at governance efficiency as the basis for an effective discussion on ESG.

Incorporating social considerations into investment decisions is not new. Its origins go back to the operation of faith-based organizations in the 19th century. The movement gained strength with the emergence of social concerns, such as the fight for women's rights, and with major events, such as the Vietnam War in the 1970s. Sometime later, opposition to the arms trade as well as to South Africa's apartheid sparked a wave of socially responsible investments (Eccles, Ioannou, & Serafeim, 2020). More recently, the inclusion of social concerns in investments has taken the form of ESG investments. The acronym ESG refers to a set of environmental, social and governance criteria that guide the way socially responsible investors evaluate a business (Pedersen, Fitzgibbons, & Pomorski, 2020). The acronym has been in the spotlight in the wake of the COVID-19 crisis (Broadstock, Chan, Cheng, & Wang, 2021; Díaz, Ibrushi, & Zhao, 2021), not only because the pandemic has deeply affected our ability to produce, distribute and consume resource-intensive goods and services but also because it has added even more complexity to the challenge of dealing with "planetary boundaries" interactions and resource scarcity. Indeed, the ESG discussion dates back to at least the beginning of the twentieth century (Caplan, Griswold, & Jarvis, 2013; Eccles, Ioannou, & Serafeim, 2020). In 2004, the World Bank's International Financial Corporation (IFC) laid a cornerstone for the debate with the publication of the report "*Who Cares Wins*", which provided principles where interpretations of the idea of ESG could stand. Since the release of IFC's report, the construction of the idea of ESG has gained momentum – and there is no sign that the movement will cool down (Cappucci, 2018; Clementino & Perkins, 2020; Eccles, Ioannou, & Serafeim, 2014; Paolone, Cucari, Wu, & Tiscini, 2021; Schoemaker & Schramade, 2019).

However, although there is a growing consensus on the role of ESG principles in enabling investments in innovation for sustainable business models, the very understanding of the criteria that should compose an ESG-based corporate policy is still somewhat vague (Auer & Schuhmacher, 2016; Eccles, Ioannou, & Serafeim, 2020). In particular, the ESG "governance pillar" should be the subject of further reflection. The current interpretations suggest that an ESG-based idea of governance should prompt the adoption of transparent accounting standards, the implementation of procedures that give voice to all shareholders, the mitigation of conflicts of interest in the design of decision-making processes and, of course, the fight against illegal and unethical practices across the production chain (Khan, Serafeim, & Yoon, 2016). Yet this is only one aspect of governance – specifically, *corporate governance* (Tirole, 2001). A fully operationalizable interpretation of ESG can only live up to expectations (i.e. helping firms to become truly sustainable and, at the same time, create value) if we incorporate an analysis of both the *corporate governance* and the attributes of the *governance mechanisms* found in the organizational architecture of a firm.

Broadening the debate

The notion of governance mechanism was introduced by Williamson (1979), who teaches us that the efficiency of an organization is contingent on the design of costly contractual interfaces which tie up successive stages of the production chain. Governance mechanisms

provide incentives and determine dispute settlement procedures that help to protect the value created from investments in assets specialized to a cooperative relationship (Williamson, 1991). It goes without saying that embedding the principles of ESG into the production chain of a firm might require not only the adoption of new technologies but also the negotiation and enforcement of an innovative set of contractual interfaces that will protect the value derived from multiple transactions with employees, suppliers and buyers. Moreover, it is expected that these contractual interfaces will establish clear procedures for the voicing of concerns and the renegotiation of the terms of the relationship over time. In this sense, the efficient structuring of an ESG-based strategy depends on the design of appropriate governance mechanisms.

Think about social criteria. In the ESG scope, they refer to the relationships that the company establishes with relevant stakeholders – e.g. workers, suppliers, local communities, and actors from the political environment. If we want to understand how the corporation positions itself in the tangle of interests of such diverse pool of stakeholders, the corporate governance matters. In other words, we should pay attention to the way a company translates heterogeneous preferences into a coherent positioning. Yet this is just the first step. Once priorities are defined, companies must design governance mechanisms that properly define property rights, i.e. provide a fair access to dispute settlement procedures, protect the value created by weaker partners in cooperative relationships, and minimize the negative impacts of corporate activities on the livelihoods of stakeholders.

Think, now, about ESG environmental criteria. If we want to understand why companies decide to use and transform natural resources in a particular way, or the extent to which environmental risks are fully considered in the decision-making process, again the corporate governance matters. However, the implementation of “green” policies relies on the design of governance mechanisms that translate the priorities defined at the corporate governance level into specific organizational choices. Take as an example the treatment of waste along the production chain. It can be done internally or be outsourced to an external partner. And this choice is nothing more than the selection of a specific way in which this contractual interface will be managed – which, of course, will depend on how the preferences of relevant stakeholders are gathered and articulated into specific strategies.

Therefore, our message is straightforward: the idea of governance within the ESG cannot be reduced to the notion of corporate governance. While the notion of corporate governance is important and raises central issues for the implementation of an ESG-based agenda, it is only part of the problem. Effective ESG-based governance policies should provide an answer to two related challenges:

- (1) the existence of decision-making costs, which affect the participation of stakeholders and may impair the definition of priorities that reflect the preferences of stakeholders at the *corporate governance* level; and
- (2) the existence of contractual costs, which limit our ability to design efficient *governance mechanisms* in a competitive environment (Hansmann, 1996).

In other words, the materialization of any set of ESG governance criteria reflects a process in which the “green” preferences of a broader pool of stakeholders are not only effectively collected but also translated into policies that influence the choice of the governance mechanisms that will tie the multiple stages of a production chain (Figure 1).

Is it all?

The broadening of ESG’s “governance pillar” can certainly facilitate the operationalization of innovative strategies that meet environmental and social criteria. However, that is *not* all.

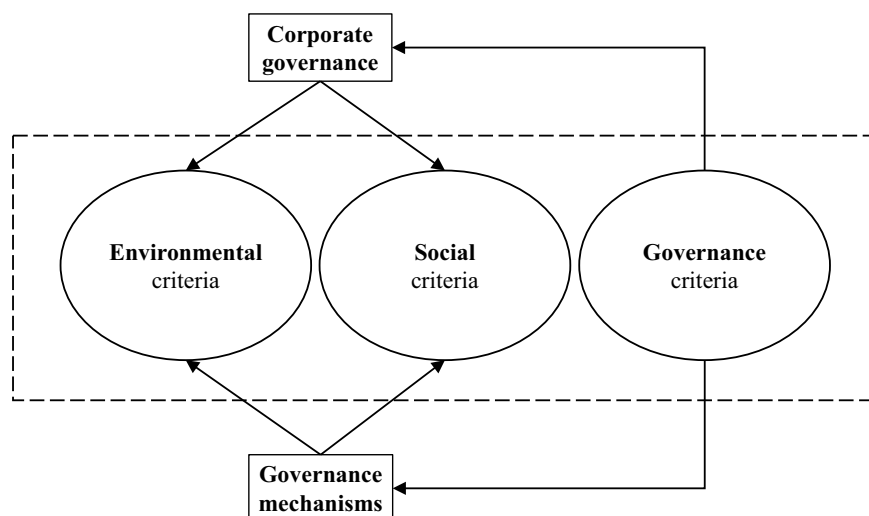


Figure 1.
Expanded view of
governance within
ESG

ESG-based policies must address environmental and social issues beyond the current focus of most managers and analysts.

Current interpretations of ESG principles have often been accompanied by the defense of self-regulation [see Hart (2010) for a discussion]. A widely heard “mantra” in the ESG movement is that companies know better than anyone else how to design policies that tackle environmental and social issues. The reason would be what we call a “naïve view” of ESG. This view could be described as follows. In response to economic incentives, managers and shareholders are being pushed to implement an ESG agenda based on voluntary measures. It is not a problem, the reasoning goes, because potential costs derived from environmental and social measures would be more than offset by the economic benefits, thus shaping the idea that adopting ESG-based policies is “good for business”. The reproduction of this “mantra” has implied the use of a rationale that emphasizes the maximization of the returns to shareholders as the ultimate goal of an ESG-based strategy.

However, focusing on efficiency and the maximization of the returns to shareholders says nothing about the way the value created along the supply chain is distributed. For instance, analyzing the performance of highly efficient organizational architectures may reveal a pattern of value appropriation that concentrates gains in the hands of firms that have more access to relevant information (e.g. consumer preferences) or have an enhanced ability to set the terms of the agreement with business partners, as the case of the coffee industry shows (Daviron & Ponte, 2005). Information asymmetry and the use of bargaining power can thus lead to an uneven distribution of value between partners in a business relationship – with the word “uneven” meaning that the individual contribution that each partner gives to the process of value creation within the relationship is not fully aligned with the distribution of the resulting rewards (Miranda & Saes, 2011).

Accordingly, the effective implementation of a coherent set of ESG-based policies must be embedded in a rationale that acknowledges the impact of information asymmetry or differences in the relative bargaining power on the distribution of the value created along a production chain. To be more specific, an effective ESG-based policy includes organizational remedies that correct potential distortions in the distribution of value among the participants of

a production chain. And this implies a full recognition of the role of a broader pool of stakeholders in value creation processes. As Barney (2018) contends, attracting unique resources that may help a firm to generate profits in competitive markets depends on policies that distribute profits not only to residual claimants (i.e. shareholders) but also to the stakeholders that helped to materialize the outcome. In this sense, ESG-based policies may be “good for business” if the adoption of enhanced social and environmental criteria means a concern not only with efficiency but also with the fairness in economic relationships – a move that may ultimately enhance the ability to attract resources and create value in the long run.

This move, however, may lead to higher production and governance costs, potentially exacerbating horizon problems within the organization. That is why ESG-based policies should not be seen as a natural consequence of a “win-win” process, but as the consequence of a conscious decision whose implementation may lead to lower profits in the short run. The consolidation of a more ambitious ESG-based agenda should come with the acknowledgment that there is nothing wrong with accepting to bear higher production and governance costs if this means tackling complex environmental and social issues. Indeed, owners and managers should not be concerned with the mere short-term maximization of profits, but with the materialization of priorities – which may reflect the pursuit of a broader set of goals – into effective policies. After all, profit is an outcome that results from the complex interplay of both decisions made at the firm level and exogenous conditions (Grandori, 2019). The design of corporate governance policies and governance mechanisms is an important part of this equation, and we still need to think about how they can serve not only as levers of efficiency but also as foundations for greater fairness. This is the real challenge that currently presents itself.

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