Integrity in Business: Analysing ESG Issues from an Economics Perspective

Gensheng Shen, Cyril Jankoff and Seán O'Hanlon
January 2024

Introduction

Environmental, Social and Governance (ESG) is becoming a managerial topic of increasing importance for corporate executives. However, ESG issues are often discussed from legal and moral perspectives and lack a due consideration from an economics perspective. This chapter focuses on analysing some ESG issues from an economics perspective and emphasizing the implications of economics principles for ESG issues that corporate executives are now facing.

ESG in the Trend of Economic and Social Developments

Economics teaches us its Principle 1 where economic resources are scarce where their misuse or inappropriate use or abuse will incur opportunity costs (Farnham, 2021, pp. 156-157).

In her article in Forbes Magazine, Michelson, Joan (Dec. 27, 2021) predicts that the dominant economic and social trend of 2021 and beyond is ESG which is related to three key responsibilities for corporate executives as she describes as PPP (Planet with environmental responsibility, People with social responsibility and Purpose of business with corporate governance responsibility).

Michelson's prediction is based on the fundamental economics principle of scarcity and opportunity cost on the argument that 'nothing is not scarce' and therefore the employment of any scarce resources in one way will incur an opportunity cost of a forgone alternative employment. The Planet or 'the Earth' and its associated resources in air, on land and underneath are scarce environmental resources that have no easy, if any, substitutes, so much so that their opportunity costs are huge in terms of a potential risk affecting the sustainability of civilisation, if the Planet and its associated renewable and non-renewable resources are depleted; People is a scarce productive resource or human capital, so valuable so that its opportunity cost is a waste of human capital when it is unemployed or underemployed; The purpose of corporate business should be more than just maximising profits by minimising costs and/or maximising revenues, so true so that its opportunity cost will arise from a misalignment of various interests among related stakeholders in providing both private and public goods for the sustainability of social development.

The integrity issue for corporate executives is a compulsion to take the economics principle of scarcity and opportunity cost into consideration in the process of developing corporate vision, mission and values as well as business strategies, plans, policies and processes.

ESG's Implications for Corporate Decision-Making Behaviors

Economics advises us its Principle 2 where corporate executives' behaviour is assumed as being rational in 'maximising profit' and/or 'minimising costs' by equating marginal revenue with marginal cost (Farnham, 2021, pp. 160-162; pp. 90-91).

According to Perdy, K. (Feb. 22, 2023) in the Corporate Finance Institute, ESG stands for a set of standards for a company's behavior in its business operation where that companies should comply with, in addition to the profit maximisation behaviour, the broad ESG standards or corporate responsibilities: 1) the environmental responsibility considers how a company safeguards the environment in the context of business operations addressing their impact on climate change, pollution (air, water and pollutants) and using resources in a non-depleting way; 2) the social responsibility examines how a corporate manages relationships with and welfares of all stakeholders including employees, suppliers, customers and the communities at large when it operates its business operations; 3) the governance deals with what a company's leadership and management do as they say that they would do, including issues on Directors' duties, executive renumeration, audits, compliance, internal controls, and shareholder rights. Some of these issues are summarised in the table below (Expediate Group, 2022):

Actions to address these ESG issues will incur costs being defined as additional costs and may produce revenues being defined as additional revenues in economics. These ESG-related additional revenues and costs deriving from corporate's fulfilment of ESG responsibilities could be considered in the textbook-based definitions of marginal revenue and marginal cost. At present, the ESG-related costs and revenues are not considered in neither corporate decision-making equations nor in corporate accounting books in Australia. In other parts of the world such as UK, ESG issues are now beginning to be considered in law.

The integrity issue for corporate executives is a mindset change to its business goal by balancing between its profit maximisation and its corporate citizen's responsibilities for environmental protection, social wellbeing and good cooperate governance.

ESG Issues as Market Failures

Economics emphasizes its Principle 3 where markets can fail due to externalities in terms of external cost vs external benefit and agency cost vs agency benefit (Farnham, 2021).

Standards Australia (May, 2022) lists a very broad scope of ESG requirements for companies to comply with when externalities occur. Below is the list of ESG issues where market failures occur:

Environmental
- Biodiversity loss
- Climate change
- Deforestation
- Energy use
- Environmental regulations
- Material use
- Plastics
- Pollution and waste
- Resource depletion
- Sustainable land use
- Treatment of animals
- Water stewardship

Social
- Child labour
- Conflict zones
- Diversity and inclusion
- Employee attraction and retention
- Human capital
- Human rights
- Modern slavery
- Procut liability
- Stakeholder opposition
- Social opportunities
- Volunteering
- Working conditions

Governance
- Board diversity and structure
- Bribery and corruption
- Corporate behaviour
- Corporate governance
- Cyber security
- Director nominations
- Ethical and business codes of conduct
- Executive pay
- Political lobbying and donations
- Renumeration decisions
- Tax strategy

1) Environmental issues may include corporate climate policies, energy use, waste, pollution, natural resource conservation, and treatment of animals. The compliance to ESG standards can help evaluate any environmental risks a company might face and how the company is managing

those risks such as direct and indirect greenhouse gas emissions, management of toxic waste, and compliance with environmental regulations. ‘A report from *the U.N. Intergovernmental Panel on Climate Change* sounds a death knell for coal and fossil fuels before they destroy our planet," said United Nations Secretary-General António Guterres. (The Intergovernmental Panel on Climate Change - IPCC, March 22, 2023).

For example, pollution problems caused by companies during their production incur external costs which are borne by the society (third party) and not by the pollution-producing companies, therefore companies tend to over-supply their products and services that cause more and more external costs; When government imposes pollution tax on companies according to ESG requirements, these external costs are internalised into company’s production costs, therefore companies tend to reduce products and services that cause less and less external costs.

2) Social aspects look at the company’s relationships with internal and external stakeholders. Does it hold suppliers to its own ESG standards? Does the company donate a percentage of its profits to the local community or encourage employees to perform volunteer work? Do workplace conditions reflect a high regard for employees’ health and safety? Or does the company take unethical advantage of its customers? Socially responsible companies promote ethical and socially conscious themes including diversity, inclusion, community-focus, social justice, and corporate ethics, in addition to fighting against racial, gender, and sexual discrimination.

For example, staff development or training are social responsibility to a company’s staff. Unfortunately, these activities will incur external benefits where staff who are developed and trained by one company could benefit another company when staff members change jobs, therefore companies under-provide staff development or staff training benefits to employees. When government requires companies to provide these benefits to employees by tax deduction benefits or subsidies according to ESG requirements, companies are encouraged to provide more and more staff development or training activities to internalise these external benefits for the common good of society. Many larger companies are experiencing strict ESG laws, and are getting their suppliers ready for them by asking detailed ESG questions regarding the goods they are supplying. We already have Modern Slavery laws, which forms part of the “Social responsibilities” in ESG.

3) Governance standards ensure that a company uses accurate and transparent accounting methods, pursues integrity and diversity in selecting its leadership, and is accountable to shareholders and that companies avoid conflicts of interest in their choice of board members and senior executives, don't use political contributions to obtain preferential treatment, or engage in illegal conduct.

For example, one of the common governance issues is where managers maximise benefits to themselves (unnecessary expenses) or employees maximise benefits to themselves (low productivity) at expense of shareholders’ interests. Or shareholders maximise their profits at expense of benefits due to managers or employees. All these incur agency cost to shareholders or managers or employees. To address this issue, most companies have policies on “option shares” to managers, “bonuses” to employees or “ESG requirements” on shareholders in order to align the interests of shareholder, managers and employees together for the common good of a business organisation and the society in general. These trying measures are designed to induce agency benefit. Unfortunately, companies are still focused on profits, and these monetary measures currently are seen to work contrary to this interest alignment. Thus, there does not seem to be a clear incentive for managers sitting at their desks, as these ESG initiatives will in the short-run affect their bonuses.

The integrity issue for corporate executives is a corporate commitment to address ESG-related market failures by minimising agency costs and maximising agency benefits in corporate’s decision-making equations.

Challenges for Fulfilling ESG Obligations

Economics argues for its Principle 4 where price determination mechanism is a most efficient way to allocate or reallocate scarce resources for economic efficiency according to a free (invisible hand) interaction between buyers and sellers or between consumers and producers in a marketplace according to the law of demand and the law of supply (Farnham, 2021, pp.48-49, pp. 46,48, p.228, p.64).

Standards Australia (May, 2022) pointed out four main challenges to address ESG issues:

1. Environmental degradation and social inequity continue to grow despite massive growth in ESG investment, products and services.
2. Lack of harmonisation - numerous voluntary frameworks and standards e.g. CDP, CDSB, GRI, SASB, IIRC, TCFD exist which can confuse the market.
3. Companies - particularly small businesses - may struggle to identify and implement best practices for various ESG indicators.
4. Shareholders and investors may not know where to access accurate and trustworthy information when assessing ESG-aligned investments. Too much misinformation about, as certain vested interests appose ESG-type sustainability issues being raised - as it affects their profits, thus the share price and indeed the value of the business (which is part of the share price).

The source of four challenges is a missing market where a demand-supply mechanism is established. Prices to compensate companies to address environmental degradation and social inequity are very difficult to be set or measured without a market where demand or supply can interact and operate for an equilibrium outcome. Carbon credits are an attempt to establish a market where companies or countries can sell or buy carbon credits in order to control the world total of carbon emissions. The income tax system is also an attempt or a mechanism to transfer some payments from rich to poor and from companies with wind-fall profits to their disadvantaged people to address inequality issues.

The integrity issue in business for corporate executives is a need for a global cooperative effort to develop a world-wide market mechanism where the demand and supply law is operational to induce visible costs and benefits for corporate commitments and actions to ESG.

ESG for Future Sustainability

Economics points out its Principle 5 where an economic decision is no more than a trade-off between various alternative options, for example a choice between short term and long term interests, short-run and long-run production possibility curves (Farnham, 2021).

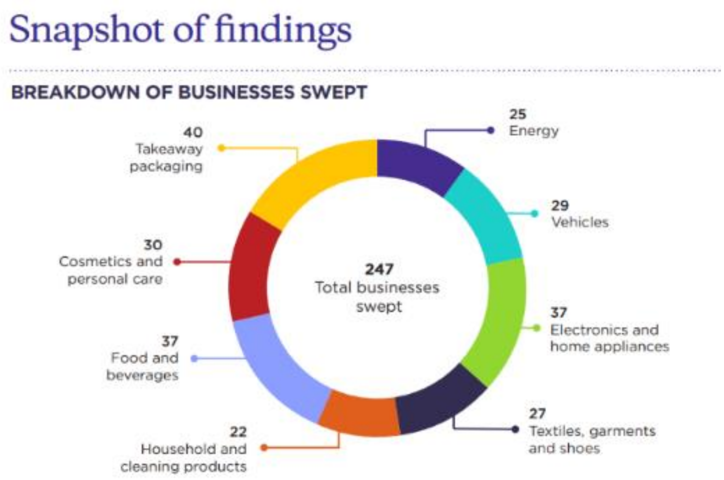
James, Chalmers, etc, (Oct 28, 2021) in their PwC Report argued that ESG and sustainability are closely related. ESG screens companies based on criteria related to being pro-social, environmentally friendly, and with good corporate governance. ESG, looks at how a company's management and stakeholders make decisions on the short run while sustainability considers the impact of those decisions on the run. Paying costs for these ESG measures in the short run can lead to sustainability benefits in the long run.

The integrity issue for corporate executives is a strong need to practise as a corporate citizen by well balancing between a corporate short-run interest and a social long-run interest.

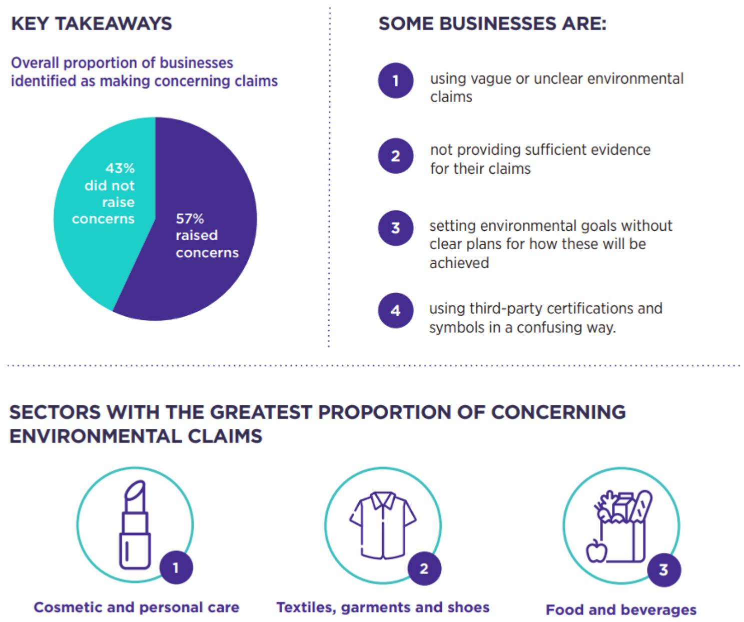
ESG-Related Imperfect Information or Market Inefficiency

Economics assumes its Principle 6 where market is efficient because information is perfect. In ESG area, markets often fail to provide perfect information or sometimes do provide false information (Farnham, 2021).

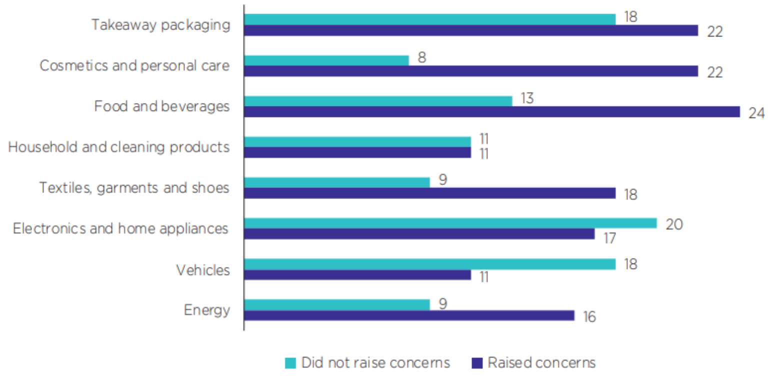
The ACCC published its report ACCC (ACCC, March 2 2023) on the internet sweep of 247 businesses. The ACCC internet sweep identified misleading environmental and sustainability marketing claims in October/November 2022. Under the Competition and Consumer Act (CCA), the ACCC can use powers under s155 of the Act to obtain information, documents and evidence in relation to matters which may constitute a contravention of the CCA. The ACCC can also issue substantiation notices requiring a person or business to give information and/or produce documents that could be capable of substantiating or supporting a claim or representation made by the person or business.



The report found more than half of the businesses reviewed made concerning claims about their environmental or sustainability practices. Of the 247 businesses reviewed during the sweep, 57 per cent were identified as having made concerning claims about their environmental credentials. The cosmetic, clothing and footwear and food and drink sectors were found to have the highest proportion of concerning claims among the industries targeted in the operation. Other sectors examined also had a significant proportion of concerning claims.



NUMBER OF BUSINESSES MAKING CONCERNING CLAIMS BY SECTOR



Businesses using broad claims like ‘environmentally friendly’, ‘green’, or ‘sustainable’ are obliged to back up these claims through reliable scientific reports, transparent supply chain information, reputable third-party certification or other forms of evidence. To do otherwise is ‘greenwashing’:

Sustainability claims may be made in a variety of ways:

- **Product specific claims**: These may appear on packaging, websites, advertisements or social media posts by influencers.
- **Company-wide claims**: These will generally appear on websites or in corporate social responsibility statements and reporting documents.
- **Claims using logos and symbols (including certification trademarks)**: These can appear on product packaging, websites, or advertisements.

The report found 8 issues in internet false claims that demonstrate many significant issues in imperfect information and market inefficiency:

1. Vague and unqualified claims
2. A lack of substantiating information
3. Use of absolute claims
4. Use of inequivalent comparisons
5. Exaggerating benefits or omitting relevant important information
6. The use of aspirational claims, with little information on how these goals will be achieved
7. Use of irrelevant third-party certifications
8. Use of images which appear to be trademarks

The integrity issue for corporate executives is to uphold the business ethics and corporate code of act in operating and managing business in an honest and transparent manner.

ESG-Driven Demand for CSOs for the Future

Economics predicts in line with its Principle 7 where a shortage in association with a price rise occurs where supply is less than demand or demand is greater than supply in terms of moving towards market equilibrium (Farnham, 2021, pp.64-65).

Weinreb Group (2021) published a report which predicts the recruitment trend for CSOs (Chief Sustainability Office) and this trend is determined by the following six major requirements on companies (Michelson, Joan , Dec. 27, 2021)**:**

1. Being CEO now requires ESG values, expertise, communication skills and accountability;
2. The ACCC and ASIC are developing rules for mandatory ESG reporting;

3. Money talks: A dramatic rise in ESG-focused investing, including from the world's largest asset manager:
4. Talent rules: the pandemic has obviously shined a spotlight on employee wellbeing, on workplace safety, and on how valuable talent is, even as it redefined the "workplace."
1. ASX now requires diversity on boards of listed companies to publicly disclose…information on the voluntary self-identified gender and racial characteristics and LGBTQ+ status… of the company's board of directors";
2. Exponential increase in Chief Sustainability Officer (CSO) and Chief Diversity Officer (CDO): There has been at least a 228% increase in the number of Chief Sustainability Officers (and similar titles) over the past 10 years, 54% of whom are women, with a particular spike in 2020, according to a June Report from the Weinreb Group.

Integrity issue for corporate executives is a plan to act quickly to equip companies or business organisations with professionals in ESG.

Conclusion

Seven economics principles have been applied to analyse seven groups of ESG-related issues. The analysis from an economics perspective has provided corporate executives with a reference guidance to consider and address seven groups of ESG-related integrity issues:

1. Compulsion to take the economics principle of scarcity and opportunity cost into consideration in the process of developing corporate vision, mission and values as well as business strategies, plans, policies and processes;
2. Mindset change to its business goal by balancing between its profit maximisation and corporate citizen's responsibilities for environmental protection, social wellbeing and good corporate governance;
3. Corporate commitment to address ESG-related market failures by minimising agency costs and maximising agency benefits in corporate's decision-making equations;
4. Need for a global cooperative effort to develop a world-wide market mechanism where the demand and supply law is operational to induce visible costs and benefits of ESG for corporate commitments and actions;
5. Strong need to practise as a corporate citizen by well balancing between a short-run corporate interest and a long-run social interest;
6. Requirement to uphold the business ethics and corporate code of act in operating and managing business in an honest and transparent manner;
7. Plan to act quickly to equip companies or business organisations with professionals in ESG.

It is strongly considered that ESG issues are not only legal and moral issues but also significant issues from an economics perspective for corporate executives to consider and resolve for the long-term benefits of environmental, social and governance responsibilities in years to come.

References

ACCC (March 2 2023) "ACCC Report: Greenwashing by Businesses in Australia: findings of the ACCC's internet sweep of environmental claims", (weblink: Greenwashing by businesses in Australia - findings of the ACCC's internet sweep of environmental claims | ACCC)

Chalmers, James, Cox, Emma, and Picard, Nadja (Oct 28, 2021) *PwC Report: The economic realities of ESG* (weblink: The economic realities of ESG (pwc.com)

Farnham P. (2021) *Economics for Managers, Global Edition, 3rd edition,* Pearson.

Jankoff, C. (2023) *How to use economic theory to make your business really take off.*

Michelson, Joan (2021) *The Biggest Economic Trend Of 2021 Is ESG: People, Planet and Purpose, Forbes, (weblink:* The Biggest Economic Trend Of 2021 Is ESG: People, Planet, Purpose (forbes.com)

Peterdy, Kyle (Feb. 22, 2023) *ESG (Environmental, Social and Governance)**:** A management and analysis framework to understand and measure how sustainably an organization is operating,* Corporate Finance Institute (weblink: What is ESG (Environmental, Social & Governance)? (corporatefinanceinstitute.com)

Standards Australia (May, 2022) *Research Paper: The building blocks of trust for Australia's ESG investing landscape* (weblink: Environmental Social and Governance (ESG) | Standards Australia)

The Intergovernmental Panel on Climate Change (IPCC) (March 22, 2023) The Sixth IPCC Report on Climate Change (weblink: IPCC — Intergovernmental Panel on Climate Change)

Weinreb Group (2021) *The Chief Sustainability Officer 10 Years Later The rise of ESG in the C-suite* (weblink: Weinreb-Group-Sustainability-and-ESG-Recruiting-The-Chief-Sustainability-Officer-10-years-Later-The-Rise-of-ESG-in-the-C-Suite-2021-Report.pdf (weinrebgroup.com)

Dr Gensheng Shen is a Professor and Facilitator at UBSS.
Dr Cyril Jankoff is an Associate Professor at UBSS and Associate Dean, Scholarship – he is also a Fellow of the Centre for Scholarship and Research.
Seán O'Hanlon is an Associate Professor at UBSS and Campus Director, Melbourne CBD Campus.