# Why we must simplify our approach to ES(G)

*Achieving our environmental and social goals will be crucial to our survival as a species and to our democracies.* ***Sergio Scandizzo*** *analyses the "environmental, social, and governance" (ESG) criteria and the difficulty in identifying what each component is supposed to measure. He suggests focussing on the alignment to the EU taxonomy and the amount of taxes paid, and removing "governance" from ES(G).*

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The fundamental problem of modern societies is how to limit our impact on the planet's finite resources while keeping social inequality at an acceptable level. In fact, it appears reasonable to posit that we are unlikely to survive as a species beyond a certain increase in average temperature and as a democratic society beyond a certain level of inequality. What those two levels are and how to measure them could prove controversial, as we do not know to what extent the former is attainable and the latter desirable.

Indeed, while most people would agree that the depletion of scarce natural resources (which include a liveable climate) should be contained, there is widespread disagreement on what level of environmental impact is feasible to attain given the present state of technology and current and desired levels of economic development across the world. On the other hand, while almost everybody would concur that excessive social inequality – especially if it means many people living in squalor – is undesirable, only a small minority is likely to advocate a perfectly uniform distribution of wealth and income.

Since it is the scale and nature of our economic activities that drive both the degradation of our natural environment and the increase in inequality, only substantial changes in such activities can reduce and possibly reverse those trends. Furthermore, as governments cannot mobilise, let alone provide by themselves the full amount of the gigantic resources needed, it is reasonable to expect that only a substantial redirection of investments across countries, sectors and firms can hope to achieve tangible results. While there are signs that governments are trying to foster such a redirection through policy changes – the EU taxonomy being the most articulated example – the role of the private enterprise in this collective endeavour remains ambiguous. It is therefore time to look at how business firms contribute to the solution of those problems.

The industry response to this challenge has been the birth of ESG rating agencies that are supposed to fulfil a similar role to the one performed by credit rating agencies: provide an independent assessment of the performance of a company along the environmental, social and governance dimensions. It appears, however that the methodologies developed by such agencies are still in the process of evolving towards a common standard and they are far from being able to capture all the relevant interactions between economic activities and environmental and social factors. While there is evidence that ESG ratings produced by different agencies for the same companies can diverge substantially, such methodologies being proprietary and largely undisclosed, it is also difficult to establish to what extent they are theoretically sound and empirically robust.

However, the fundamental problem with ESG ratings is that it is far from clear what they are supposed to measure. Not only attempts at explaining such ratings strongly suggest a fallacy of ambiguity, whereby a hypothetical construct is treated as real, but it is also debatable what such hypothetical construct might be. Unlike credit risk ratings that aim to estimate an unobservable, but well-defined quantity (the probability of default), ESG ratings purport to measure companies' "ESG performance" or "ESG risks", without providing any ontological grounding for such concepts. The whole approach is strongly suggestive of an IQ test, whose ultimate aim is the estimation of … an IQ.

I believe that companies are allowed to operate not just insofar as they do no harm or at least keep such harm in check and pay for it. They are granted their charter, to use the original XVI century language, because they contribute to the common good *through* their profit seeking activities, not in spite of it. Milton Friedman, in a now famous New York Times editorial, maintained that this is the case by definition, but we now find that claim at best dogmatic and at worst manifestly contradicted by evidence. Consequently, we need to assess, maintaining both objectivity and comparability of results, the quality and quantity of the impact from the different types of economic activities on those objectives. In other words, rather than look at how well a company follows environmental or labour laws or the instances of affirmative actions in its hiring practices, measure its environmental footprint or its charitable donations, we should focus on its direct contribution to the stock of our environmental resources and to the fairness of our society.

I propose to rate companies' contributions according to two environmental and social metrics: percentage of activities' turnover aligned to the EU Taxonomy and taxes paid as a percentage of corporate profits, the latter metric being an admittedly crude shortcut in the hopefully temporary absence of an EU social taxonomy. In addition, by focussing on firms' direct contribution to environmental and social goals, we will leave aside the governance dimension. Without discounting the importance of governance for a sound economic system, a ranking of companies based on how well they are governed may be of great interest to regulators and stakeholders in general but would likely pollute a quantification of how much they contribute to our environmental and social goals. In fact, a company may be a model of internal governance while being entirely misaligned with the EU taxonomy and paying little or no corporate taxes.

More than sixty years ago, in a now famous article, The Problem of Social Cost, Nobel Prize winner Ronald Coase addressed "those actions of business firms which have harmful effects on others". The time has come to focus on those actions that are beneficial to society as a whole.

***Author's disclaimer****: The views expressed in this article are those of the author and do not necessarily represent those of the European Investment Bank.*

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*Notes:*

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