Market Forces Already Address ESG and “Stakeholder Capitalism” Concerns

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There is currently much discussion of stakeholder capitalism, the proposition that firms should be run in the interests of all their stakeholders, including workers, various types of securityholders, and perhaps customers, and not just shareholders. My theme is that contract structures—the contracts negotiated among a firm’s stakeholders—address stakeholder interests.

Contracts play a vital role in directing economic activity, but contracts can be costly to write and enforce, and the broader the set of stakeholders included in the contracting process, the more difficult it is for firms to operate efficiently. If all relevant stakeholders have the right to influence a firm’s decisions regarding production and the distribution of profits, agreement about how these activities are to be carried out is unlikely to be achieved at reasonable cost.

A solution in this context is to structure relatively simple contracts whereby almost all stakeholders receive “fixed payoffs” or payment amounts. In return, the firm’s shareholders get to make most of the decisions and enjoy (or suffer) the financial gains (or losses) resulting from the firm’s behaviour. For most firms, the efficient contracting structure involves fixed promised payoffs for most stakeholders, with financial risks largely borne by the shareholders who have most decision rights.

In a competitive environment, fixed payoffs should reflect the risk of shareholders acting in an opportunistic way towards other stakeholders, e.g., failing to live up to the mutually agreed terms of contracts. Contracts that embody more risk of opportunism will require higher fixed payoffs. And as with any contract, the prospect of contract renegotiation limits
potential bad faith or opportunistic behaviour by firms who will likely be penalized by higher fixed payoffs in future contracts.

Properly structured contracts between firms and stakeholders allow firms to deliver products demanded by consumers at the lowest possible cost, and competition among contract structures pushes toward this outcome. This competitive process is likely to be more effective and efficient than externally imposed “top-down” governance structures with catchy names like stakeholder capitalism, which are likely rife with unintended consequences.

ESG (environmental, social, and governance)

If you follow the news, you’ve also likely heard of something called ESG, an acronym meant to spell out a set of behavioural standards for firms.

The G (governance) is easy to address. In a competitive market environment, the firm has incentives to choose a governance structure that allows it to deliver products to customers at the lowest cost. Constraints on governance choices (for example, laws that specify the racial or gender mix of boards of directors) likely introduce inefficiencies that consumers ultimately pay for in higher prices.

E&S (environmental and social) issues are more complicated. If environmental and social goals become a goal in consumer decision-making—for example, if consumers opt for free-range chicken and beef, which is more expensive to produce than would be true using alternative production techniques—firms will provide free-range poultry and meat without direct or indirect government regulations. Consumers vote at the checkout line and the economy produces the “right” amount of free-range poultry and meat. By responding to consumers’ preferences, firms operating in competitive markets provide solutions to many E&S problems.

Asset markets (real estate, stocks, bonds) can also address E&S issues. Most asset-pricing models assume investors are only concerned with the expected risk-adjusted returns generated by their investments. In fact, investors might also care about the environmental and social actions of firms. As early as 2007, E&S considerations, (known as socially responsible investing) started showing up in the asset management industry. Today, there’s a wide range of E&S investment products.

So what are the costs and benefits to firms who choose products and production techniques oriented toward E&S goals?
If some investors value the E&S actions of firms, a switch from E&S indifference to E&S virtue will reward firms with higher share prices, which imply lower costs of capital for virtuous firms. But higher share prices imply lower expected returns to shareholders. Moreover, even if all of a firm’s investors agree that more E&S is better than less (or vice-versa), they are unlikely to agree on which specific E&S actions and in what amounts are preferable. This creates a decision quagmire for managers seeking to satisfy the divergent E&S interests of different shareholders.

For example, an E&S virtuous firm may transfer half of its annual profits (that would otherwise accrue to shareholders) to outside groups that fight for E&S issues (an environmental organization, for example). But for some investors, 50 percent may be too much; for others, too little. There will also likely be disagreement about how the 50 percent is split among different E&S actions.

How to resolve this problem? Hart and Zingales (2017) argue that since shareholders hold the decision rights, a shareholder vote is a possibility. But choosing the specifics of a question may itself prove difficult. A vote also implies winners and losers, and the possibility of unexpected actions that may offend the E&S tastes of some investors will likely make investors less willing to bear the costs of E&S commitments by firms.

Some ESG proponents argue that firms should prioritize shareholder welfare, not shareholder wealth. But again, shareholders have divergent tastes and interests. Firms that prioritize shareholder wealth rather than shareholder welfare will likely incur lower contract costs.

**ESG and externalities**

ESG proponents make many assumptions including that firms that prioritize shareholder wealth ignore the side effects or unintended consequences of their actions.

But is this true?

Consider this example. Suppose there are two ways to produce a product—the cheap way produces pollution that costs the firm nothing; the expensive way controls pollution but at some cost to the firm. If consumers are indifferent to pollution, dirty producers will drive out clean producers (Shleifer 2004). But if some consumers value less pollution or can be convinced by E&S arguments to value less pollution, they can vote for less by paying more for the version of the product produced cleanly (but at higher cost). The end result is a mix
of clean and dirty products that consumers vote for with their purchases. It seems that the market solves this ESG problem—but not necessarily and probably only partially.

Now suppose all consumers care about pollution, and dirty producers offer the same products as clean producers but at lower prices. Despite their distaste for pollution, some consumers will likely choose the products of dirty producers because they perceive that their individual choices have little effect on the total amount of pollution. In other words, there is a free-rider problem. Everybody would pay more for the products of clean producers if they could be convinced that other consumers would not cheat and buy dirty products.

A potential solution is to control dirty production with government regulation. But even with the government-imposed solution, there are tradeoffs of costs for benefits that change with the amount of pollution—and these tradeoffs change with the evolution of production technology that can better control pollution. In the end, imperfect though it may be, E&S activism to shape the tastes of consumers and investors may be more effective than regulation to address environmental externalities.

This is not to say that E&S consumer activism is a perfect remedy to environmental externalities. For example, suppose all consumers value (and are willing to pay for) less pollution, but all consumers don’t buy all products (e.g., most men don’t buy lipstick). In deciding whether or not to produce with less pollution, firms weigh the benefits to them of selling environmentally favourable products at higher prices versus the associated higher costs of producing those products. But this likely means they will ignore the benefits of less pollution to consumers who don’t buy their products and will therefore pollute more than society ideally desires.

Indeed, it’s difficult to find activities free of side effects and unintended consequences. For example, candy bars and sugared drinks are potentially toxic for consumers with a tendency towards diabetes. One might argue that personal freedom demands that such consumers eat and drink what they please since they bear the costs and benefits. But they don’t bear all the costs if other people help pay for their health care through higher premiums for health insurance or socialized health care. Smoking and hard drugs are similar examples.

When pressured, the political process might address these problems but the solution will likely be clumsy at best. Given the inefficiencies of government regulation, activism that induces consumers and investors to value E&S-friendly products may be a better (though imperfect) alternative because it's essentially a market-oriented approach that better adjusts to unpredicted negative outcomes than political solutions.
Finally, ESG activism is likely to accomplish more by working through consumer tastes rather than investor tastes. Each consumer can react to each ESG action with respect to a specific product according to their tastes. But an investor is committed to the firm’s set of ESG actions. As previously noted, given the divergent tastes of investors, the somewhat unpredictable ESG actions of firms will likely produce equally uncertain payoffs. The result is likely to be limited participation in ESG investment, even by investors committed to ESG action.

Conclusions

Generally, bottom-up market forces, while imperfect, especially in the presence of externalities, better address the issues raised by proponents of stakeholder capitalism and ESG than top-down government initiatives.

Endnotes


References


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