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ESG en Route to Etatism

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ESG is an acronym that stands for "environmental, social, and governance." It's notoriously difficult to define because of its different applications in different contexts, but you can understand it in two ways: first, as a framework or strategy that individual corporations undertake internally; and second, as the nonfinancial standards, metrics, or factors that asset management firms, financial institutions, and institutional investors, among others, consider when they allocate capital or assess risk. The first I will call micro ESG, and the second, macro ESG. These are not the official nomenclature; they are terms that ease understanding.

Macro ESG consists of governments, central banks, NGOs, asset management firms, finance ministries, financial institutions, sovereign wealth funds, and a global consortium of institutional

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investors that collaborate to operationalize ESG at the micro level among private and publicly traded companies. The combined entities comprising macro ESG exert enormous pressure on the private sector; these entities manage assets and financial instruments from currency and loans to stocks and bonds and control capital flows throughout the world.

Every person of means and every company seeks to bank and invest. ESG involves banking and investment. Macro ESG uses finance to pressure companies at the micro level to institute ESG, and micro ESG consists of numerous corporations from all industries responding to incentives and disincentives at the macro level. Both forms of ESG—micro and macro—attempt to repurpose corporations according to alleged social obligations rather than profit maximization.

The first clear articulation of ESG occurred in 2004 at a conference called “Who Cares Wins,” sponsored by the United Nations, the International Finance Corporation (an arm of the World Bank), and Switzerland’s Federal Department of Foreign Affairs. This conference sought to mainstream ESG and integrate ESG value factors and financial market research analysis and investment. Grants from the governments of Italy, Luxembourg, the Netherlands, and Norway funded the follow-up report on the conference’s findings and recommendations. This grand genesis does not sound to me like an initiative of entrepreneurs seeking private solutions to quotidian problems.

Initially, ESG didn’t catch on. After the 2008 financial crisis, the banking crisis, and the Troubled Asset Relief Program, however, financial services institutions implemented new, immediate, and large-scale marketing and public relations. They were the “bad guys” after their risky behavior was exposed, and ordinary people were calling for financial executives to be put in jail. ESG became a convenient technique for challenging the perception that absent shareholders—owners who didn’t sufficiently engage or oversee corporate boards and management—contributed to this financial crisis, which also caused foreign governments to create stewardship regulations. The United Kingdom instituted a stewardship code in 2010 for asset managers and others who invest capital on behalf of beneficiaries, for example.

ESG constraints on investments are not moral or good. They do not accomplish the goals they purport to pursue. Their alleged benefits to society are unmeasurable, and they may not be effective at all except at excluding certain political and religious views from corporate culture. Nor do they steward money according to traditional principles regarding fiduciary duty, asset diversification, or conflict of interest. ESG makes certain CEOs feel good about themselves as they get rich, but it doesn't achieve in practice the objectives it promotes in theory.

Economics shows that the private-public distinction collapses as powerful corporations, lobbyists, and special interest groups wield the apparatus of government in the name of ESG to gain competitive advantages through laws and regulations. Because corporations seek subsidies and privileges, tax breaks and incentives, barriers to entry, and all the rest, they will continue to champion new government ESG regulations to dominate an industry or reduce competition. Meanwhile, the government picks winners and losers, favoring certain industries or companies over others.

The *E* in ESG stands for "environmental." What are we talking about here? Factors like greenhouse gas emissions, conservation, biodiversity, water consumption, solar power, and climate change disclosures. The *S* represents "social" causes: proabortion policies; LGBTQ+ activism; diversity, equity, and inclusion (DEI); transgenderism; critical race theory; and Black Lives Matter (BLM). The *G* refers to "governance," principally the shift from the shareholder model to the stakeholder model. The governance piece of ESG is not all bad. For instance, corporations should be more transparent about their finances and forthright about their financial affairs to avoid misleading investors and causing malinvestment. But the stakeholder model is highly problematic.

In his famous September 13, 1970, *New York Times* essay "A Friedman Doctrine—the Social Responsibility of Business Is to Increase Its Profits," Milton Friedman wrote about how the purpose of corporations is, chiefly, to maximize profits for shareholders and that if corporations do that, they indirectly benefit society writ large. Profits enable corporations to do good. Firms employ workers, innovate, invent, produce needed goods and services, and generally add value to society by improving quality of life. To make

the world a better place, they need not pursue the controversial or divisive social causes favored by activist institutional investors and other proponents of ESG. In 2019, the Business Roundtable, which my friend Scott Shepard refers to as a "lunch club for CEOs," purported to redefine the purpose of corporations to align them with social good and vague concepts like "societal impact" (Business Roundtable 2019).

What does the stakeholder model of governance emphasize? Stakeholders can be anyone who is not a stockholder. It's easy to identify important stakeholders: customers, employees, suppliers. No company can succeed without satisfying these constituencies even under the shareholder model. New trends, however, reveal a broadening of "stakeholders" to include society writ large, the common good, or the public interest. These categories are so vague that they provide executives wiggle room to get away with bad behavior.

For example, if the purpose of your corporation is to maximize profits for shareholders, it is easy to measure your effectiveness at year end. That is a simple matter of accounting: "Did our revenues exceed our expenses? Yes? Great, we're doing well." But how to measure alleged contributions to social well-being? Imagine a CEO proclaiming, "Our profits were down this year and last, but we instituted and met diversity quotas on our executive board. We have new committee chairs representing different ethnic groups, so we're accomplishing our goals and succeeding." If vaguely defined stakeholders control a company, who sets the board meetings or determines what the organization's strategic plan should be? I have seen companies defining "the environment" as a stakeholder. What does that mean in practice?

Asset management firms are central to promotional narratives about ESG. About a third of the private wealth in the world is in investment management. But asset management firms have gained their wealth and power through government money. The "Big Three" asset managers—BlackRock, State Street, and Vanguard—together boast assets under management somewhere in the range of $23 trillion to $25 trillion. That figure exceeds the gross domestic product of the United States of America. Add to the Big Three the

next largest slate of asset managers, and there are over $100 trillion of assets under management across the globe.

Consider this: there are just over seven hundred billionaires in the United States, and just over three thousand in the world. There is not enough private wealth on this planet to yield the amount of assets under management that the largest asset managers invest. Where does the money come from? The answer is government: pension funds, bonds, sovereign wealth funds, and so on. As the asset management field grew over the last decade and a half, asset management firms invested in publicly traded companies that were likely to receive government subsidies. So these asset management firms were extracting wealth from taxpayers and pensioners, investing government money on the front end only to receive government subsidies on the back end.

These asset management firms influence the culture. First, they invest in exchange-traded funds that pool assets into companies favoring typically leftist political causes. Such funds exclude politically disfavored companies, fields, and industries. The second way they exert influence is by shareholder voting and proposals. Asset management firms buy shares in publicly traded companies and then engage boards and CEOs while lobbying legislatures on behalf of left-wing causes. Historically, retail or household investors rather than institutional investors were the typical stockholders, and if these owners were unhappy with the direction of the company or its management, they would simply divest, taking their money elsewhere. That's not what asset management firms do. They engage, strong-arming and bullying boards of corporations to move companies to the left.

The traditional goal of asset management is to maximize the value on investment while mitigating risk. ESG proponents have redefined risk to include unquantifiable and ambiguous goals involving climate change. The argument runs like this: "Available resources will diminish over time because of climate change. We'll have weather changes. Our supply chains will be affected by hurricanes or earthquakes or flooding or whatever." No wonder these proponents emphasize long-term risk. In two, three, or four years, when environmental circumstances haven't manifested the way alarmists predicted, these ESG proponents can claim that their

climate catastrophe remains imminent but has not yet occurred. The message: "Just wait and see. Climate change will alter your everyday reality eventually." A truly long-term vision would look not just forward to an unknown future, however, but backward to a known past.

Aneesh Raghunandan and Shiva Rajgopal (2022, 824) have found that ESG-weighted portfolios consisted of companies with poor environmental track records. They also discovered problematic treatment of employees among many companies in those portfolios. Yet asset management firms assure investors that ESG portfolios include the best and most honorable companies by various measures.

Private ESG ratings agencies employ artificial intelligence and issue scores for publicly traded companies. Typically, these ratings are in quartiles: companies in the 0 to 25 range are not scoring well; those in the 50 to 75 range are performing at average; and those in the 75 to 100 range are excelling. Henry Fernandez (2020, 5:35–5:45), the CEO of MSCI, an ESG ratings agency, contends that ratings agencies are necessary to "protect" capitalism because "government intervention" and "socialism" will fill any vacuum left by private firms that fail or refuse to measure ESG commitments. In other words, if private firms do not assign ESG ratings, governments will. In fact, governments all over the world, including most recently the European Union, are introducing ESG disclosure regulations, in part because these ratings agencies lack consistency and reliability and do not have the power of government to compel private companies to prove the accuracy or traceability of their reported data. Of course, widespread accusations of "greenwashing" and "woke washing"—companies reporting false or misleading information to private ratings agencies to yield higher ESG scores—only mobilize lobbyists advocating for more and stronger ESG regulations.

Many ESG ratings seem suspect by the standard of common sense. I enjoy fast food. I drink Diet Coke every day. I love these products, but they probably contribute to diabetes, obesity, heart disease, and so forth. Do they change the world for the better? Maybe not, but they enjoy high ESG scores. Mondelēz International is a food and beverage confectionary. Its portfolio includes Oreo, Ritz, Chips Ahoy, Tang, Cadbury, and others. I'm not sure that eating a bunch

of chocolate changes the world for the better, but the Mondelēz ESG scores suggest otherwise.

The Securities and Exchange Commission (SEC) issued a review concluding what was already obvious—namely, that ESG investment metrics are inconsistent (Division of Examinations 2021). It's no surprise that the left advocates comprehensive ESG regulatory ratings standards under the direction and enforcement of the SEC.

You may have heard protestations along these lines: "Isn't ESG just private companies doing what they want to do? Shouldn't we just let them make their own choices about governance and marketing and succeed or fail on the market? If companies want to undertake DEI and other initiatives that harm their business, why not them do it and fail?" I sympathize with this reasoning, but it betrays a deep misunderstanding about how ESG operates. Consider an executive order (No. 14,030, 86 Fed. Reg. 27967 (2021)) issued by President Joe Biden and dated May 20, 2021, which commands numerous federal agencies and their heads to determine how to institute ESG within their agencies. The order states its intent to empower the government to impel private ESG activity.

Here's just a sample of some of the affected officers and agencies: the National Economic Council, the National Climate Advisor, the Secretary of the Treasury, the Department of the Treasury, the Federal Reserve Board, the Securities Exchange Commission, the Commodity Futures Trading Commission, the Federal Insurance Office, the Secretary of Labor, the Department of Labor, the Federal Retirement Thrift Investment Board, the Secretary of Agriculture, the Department of Agriculture, the Secretary of Housing and Urban Development (HUD), the Secretary of Veterans Affairs, the Federal Acquisition Regulatory Council, and the Office of Management and Budget.

Let's say you chair the Federal Reserve Board. How would you go about operationalizing ESG at the Fed? In fact, the Federal Reserve Board has partnered with six of the biggest banks—Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, and Wells Fargo—to monitor and measure climate-related risks. You could say that the Federal Reserve simply "outsourced" its tasks to comply with the executive order, establishing a strange private-public partnership.

Why would the president seek to encode these elite ESG preferences within federal administrative agencies? Under the tripartite system championed by Montesquieu and adopted by the American framers, government offsets power when it is divided into three competing branches: the executive, the legislative, and the judicial.

But the administrative state has arisen as a fourth branch of government that, although created by the legislature and superintended by the executive, operates in some respects outside the boundaries and the scope of the other three branches. It contains within it three branches of its own. Federal agencies have administrative law judges and courts that make up the judicial branch; they promulgate rules and regulations, thereby exercising the legislative function; and they have executive heads that enforce those rules and regulations while managing the agency. The power of this fourth branch of government arguably exceeds that of the other branches because of the unaccountability that has grown with it. If the president can encode elite ESG preferences within the administrative state, they become embedded in the system and entrenched in the bureaucracy. Then they are here to stay.

Several federal laws already address the underlying concerns of ESG: the Clean Air Act, the Clean Water Act, Title VII and Title IX of the Civil Rights Act, the Sarbanes-Oxley Act, the Dodd-Frank Wall Street Reform and Consumer Protection Act, and so on. Embedding ESG into the administrative state would seem unnecessary but for the likelihood that it will concentrate power in a few administrative agencies that oversee capital flows and work closely with big banks and institutional investors. Recall how BlackRock executives (e.g., Mike Pyle, Eric Van Nostrand, Brian Deese, Adewale Adeyemo, Thomas Donilon, etc.) have jumped in and out of government roles. To operationalize ESG for the long term, asset managers must learn the inside workings of the relevant federal agencies, and the relevant federal agencies must learn the inside workings of their closest corporate partners.

Another nefarious manifestation of ESG is debanking. Perhaps you've been warned that small business owners may one day walk into their local or community bank requesting a loan, only to be asked, "What's your ESG rating?" To which the small business owners say, "I don't have an ESG rating; I'm a private,

family-owned company." "Well, sorry," the bank associate replies, "your ESG rating doesn't qualify you for a loan with us; you have to go elsewhere." Yet there's nowhere else to go.

This scenario may seem hyperbolic. Certainly, we are not so far gone just yet. But the anecdote is not just a "scare tactic." Ask a Canadian trucker. And don't forget Operation Choke Point, which, under the Obama Administration, weaponized the Department of Justice, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (FDIC) against lawful small businesses by threatening banks with punitive regulation if they did not debank legitimate clients.

Examples of debanking in the United States abound. JPMorgan Chase closed the account of the National Committee for Religious Freedom. It canceled Michael Flynn's credit cards. Chase Bank terminated the accounts of conservative activists and Proud Boys members. Bank of America refuses to fund some oil and gas companies. It debanked a Christian charity called Indigenous Advance that partnered with ministries in Uganda to aid impoverished children and orphans. Citibank has restricted credit for gun manufacturers. JPMorgan Chase, Citigroup, Bank of America, and Wells Fargo have taken measures to undermine the firearms industry, which, of course, is fiscally responsible and creditworthy—and heavily regulated. Nevertheless, Visa, Mastercard, and American Express created new merchant category codes for firearms and gun shop sales. Such purchases no longer fall in the "general merchant" category. PayPal has closed the accounts of individuals associated with the January 6 Capitol riot, as well as of groups that the Southern Poverty Law Center deems hateful—for example, the Alliance Defending Freedom.

The trend is to characterize debanking as eliminating risk, as financial institutions purport to disassociate from groups or ideas that could harm their reputation. On the free market, banks could refuse to do business with anyone without violating libertarian principles. But banks in our regulatory, managerial, and bureaucratic government system enjoy federal deposit insurance and numerous subsidies. Their debanking moves are a result of ESG pressures from above. They do not involve sound or prudential business decisions and practices.

Why would big businesses support ESG government mandates? For instance, why would they support the proposed ESG disclosure mandates of the SEC or the European Union's Corporate Sustainability Due Diligence Directive? The first reason is that small businesses cannot afford to comply with complex and costly ESG regulations. Large firms can absorb the cost of ESG regulations while gaining advantages over smaller competitors and local businesses that cannot afford regulatory compliance. The wealthier the business, the more it can lobby politicians, capturing rents and legalizing anticompetitive measures. In this way, corporate executives reap gains for their companies at the expense of wider society.

Second, the threat of government coercion incentivizes businesses to support positions that are otherwise against their interests. Although ESG would not make them better off, businesses might embrace or pursue it if the consequences of noncompliance with government mandates or regulations would make them even worse off. In other words, the government distorts incentives for businesses that anticipate future regulations or compliance with current regulations.

Third, ESG has empowered special interest groups, most obviously the accountants and lawyers who have developed a veritable cottage industry regarding compliance with new or potential ESG regulatory regimes. An entire industry of high-powered consultants, some of whom own stock in the very companies they're advising, get rich off ESG, so of course they hope to perpetuate it.

In a competitive market, private companies that self-imposed ESG would fall behind their competitors that remain apolitical and seek purely to maximize profits for shareholders. No company can succeed by alienating a large swath of its customer base. Let's say, *arguendo*, that half the country is socially conservative while the other half is on the left. A company would fail if it regularly offended the conservative half. But what if you have systemic regulation requiring every company to participate in the kind of ESG investing that promotes and proliferates left-wing ideas? If ESG *becomes* "the system," then those who do not play within the rules of the game lose access to capital.

It is mathematically impossible for ESG-weighted portfolios to outperform the market, all things being equal. A chief principle of

investment holds that investors mitigate risk by diversifying assets across different fields, companies, and industries to ensure returns in one area of the economy if there are unexpected deficiencies in another area. Yet ESG takes entire sectors of the economy out of play, sectors that historically performed well in capital markets. Only by enshrining ESG restrictions into law, forcing all investors to play by a new set of rules, can ESG investing succeed in the long run.

ESG index funds that performed well during 2020 and 2021 turned out to include several companies that were not associated with ESG (for more information, see Fisch and Robertson 2023; and Pastor, Stambaugh, and Taylor 2023). According to a recently enacted SEC rule, if a fund advertises an ESG portfolio, then 80 percent of the portfolio's assets must match ESG criteria. That this rule seemed necessary at all suggests that certain ESG funds performed well by greenwashing or woke washing—that is, by including in their portfolios companies that fell outside the scope of ESG.

One last grievance about these asset management firms concerns their probable breach of fiduciary duties in their pension investments. When they invest state pension money in underperforming funds based on nonfinancial factors, they harm pensioners. State pension funds exist for one reason: to maximize financial value. Investing pension funds for any other purpose undermines the interests of the beneficiaries. If a retail or household investor wants to invest his money in an ESG-weighted fund, he has the right to sacrifice value for psychic benefits or his belief in social or environmental impact. But no state treasurer or comptroller should hire an asset management firm that invests in ESG funds on a nonpecuniary basis. Imagine a Christian conservative public school teacher discovering that her pension money indirectly funds companies working with Planned Parenthood to pay for out-of-state abortions.

Asset management firms often own shares in competitor companies and therefore possess proprietary information that could be used to manipulate the market. Asset management firms can exercise their proxy voting powers to push one competitor or another in a certain direction based on insider knowledge about the internal workings of different companies. That is a flagrant conflict of interest implicating serious legal problems.

One of my favorite poems is Robert Frost's "Stopping by Woods on a Snowy Evening." Picture the narrator of this poem: an old man, an avuncular figure, surrounded by ominous trees on a cold and dark evening in New England. The poem goes like this:

> Whose woods these are I think I know.
> His house is in the village though;
> He will not see me stopping here
> To watch his woods fill up with snow.
> My little horse must think it queer
> To stop without a farmhouse near
> Between the woods and frozen lake
> The darkest evening of the year.
> He gives his harness bells a shake
> To ask if there is some mistake.
> The only other sound's the sweep
> Of easy wind and downy flake.
> The woods are lovely, dark and deep,
> But I have promises to keep,
> And miles to go before I sleep,
> And miles to go before I sleep.

How beautiful and profound. The poem reminds me that, however easy it is to despair at the overwhelming power of ESG and etatism, we must not yield to angst. Don't let the darkness tempt you. It seems appealing to give up and withdraw from the fray, but we have miles to go before we sleep. And miles to go before we sleep. *Tu ne cede malis, sed contra audentior ito*![1]

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[1] Do not give in to evil, but proceed ever more boldly against it! (Ludwig von Mises's motto).

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