DOING WELL BY DOING GOOD

Responsible business conduct and economic performance

MABEL GABRIEL

PATRICK LENAIN

MIRNA MEHREZ

SONEJA PAYAL

OECD
BETTER POLICIES FOR BETTER LIVES

Reconciling firms' profits with responsible conduct

- **Traditional view:** Firms' responsible conduct is non-sense. Governments deal with externalities and firms focus on profit (e.g. Friedman 1970).
- **Modern view:** Firms' responsible conduct will help address externalities.
- Barrier: Firms are mandated to maximize profits.
- But investors increasingly rely on non-financial criteria to evaluate firms' performance.
- Data now collected on scores regarding Environmental, Social and Governance (ESG) performance.
- Responsible ESG conduct: private action that reduces social costs, paradoxical.
- Heal 2005's theory of corporate responsibility: Society can punish firms when it disapproves of its conducts; this potential transforms social costs—non-monetary—into private costs that reduce accounting profit (e.g. NGO opposition, reputational risk).
- Similarly, responsible conduct generates private benefits (Ambec & Lanoie 2010): Stakeholders value ESG performance (e.g. consumers willingness to pay, workers productivity, etc.).
- ESG actions are partly-excludable public goods.

Why firms do not integrate more responsible practices into their business strategies?

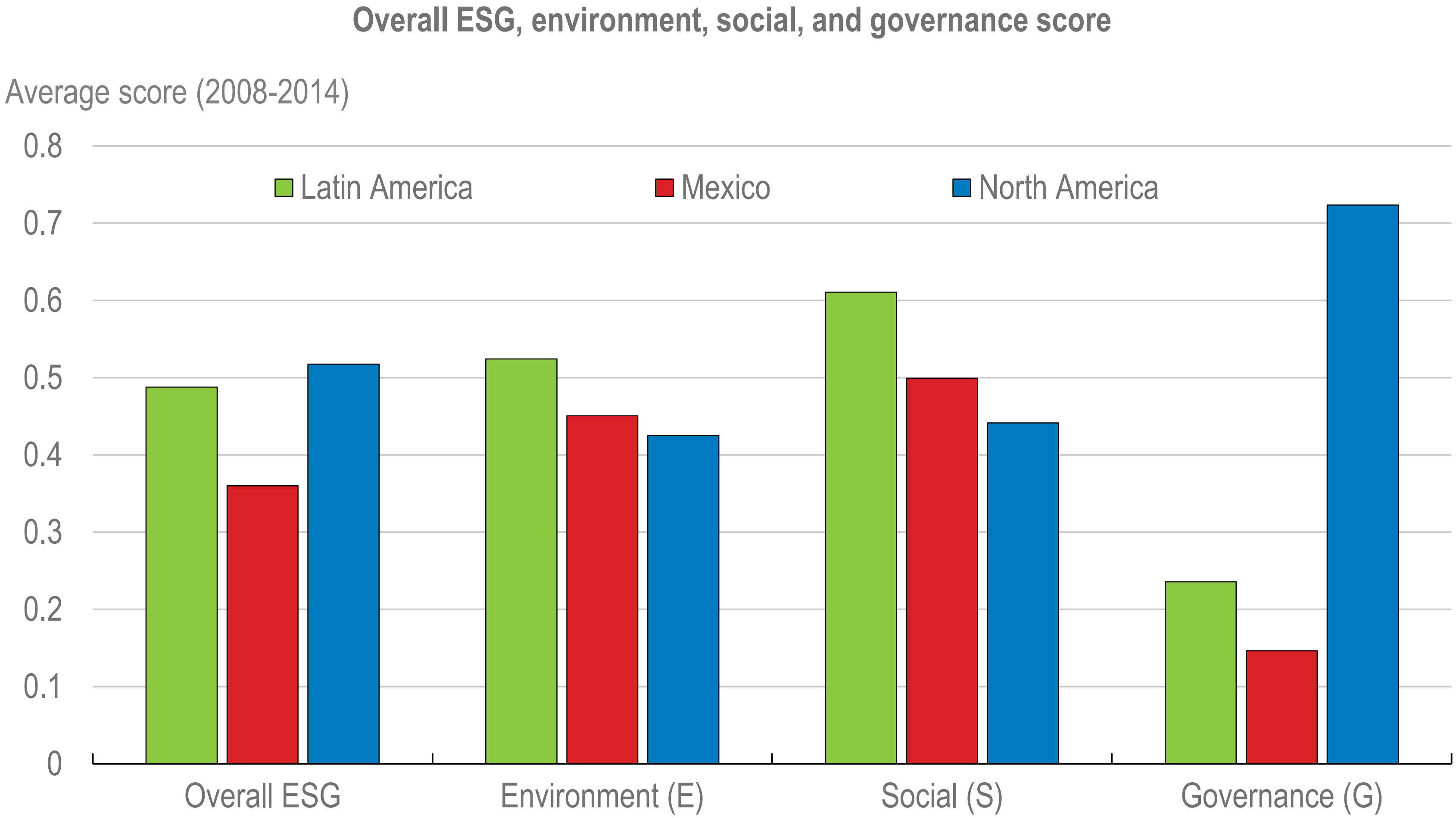
- Sustainability on the agenda at many firms but detached from core strategy
- Reactive approach: just comply with regulations or deal with incidents, rather than developing a strategic and cohesive sustainability program with a direct impact on business results.
- McKinsey (2014): corporate executives often cite challenges related to :
  - the absence of performance incentives; and
  - the presence of short-term earnings pressure that is at odds with the longer-term nature of these issues.
- Lack of conclusive studies about financial or productivity benefits attributed to responsible practices
- Empirical evidence, if positive, will encourage responsible behavior

Measuring firms' responsible conduct: What are ESG scores?

Firms' business practices are scored based on environmental, social and governance (ESG) criteria. Thomson Reuters ASSET4 provides data for each company on:

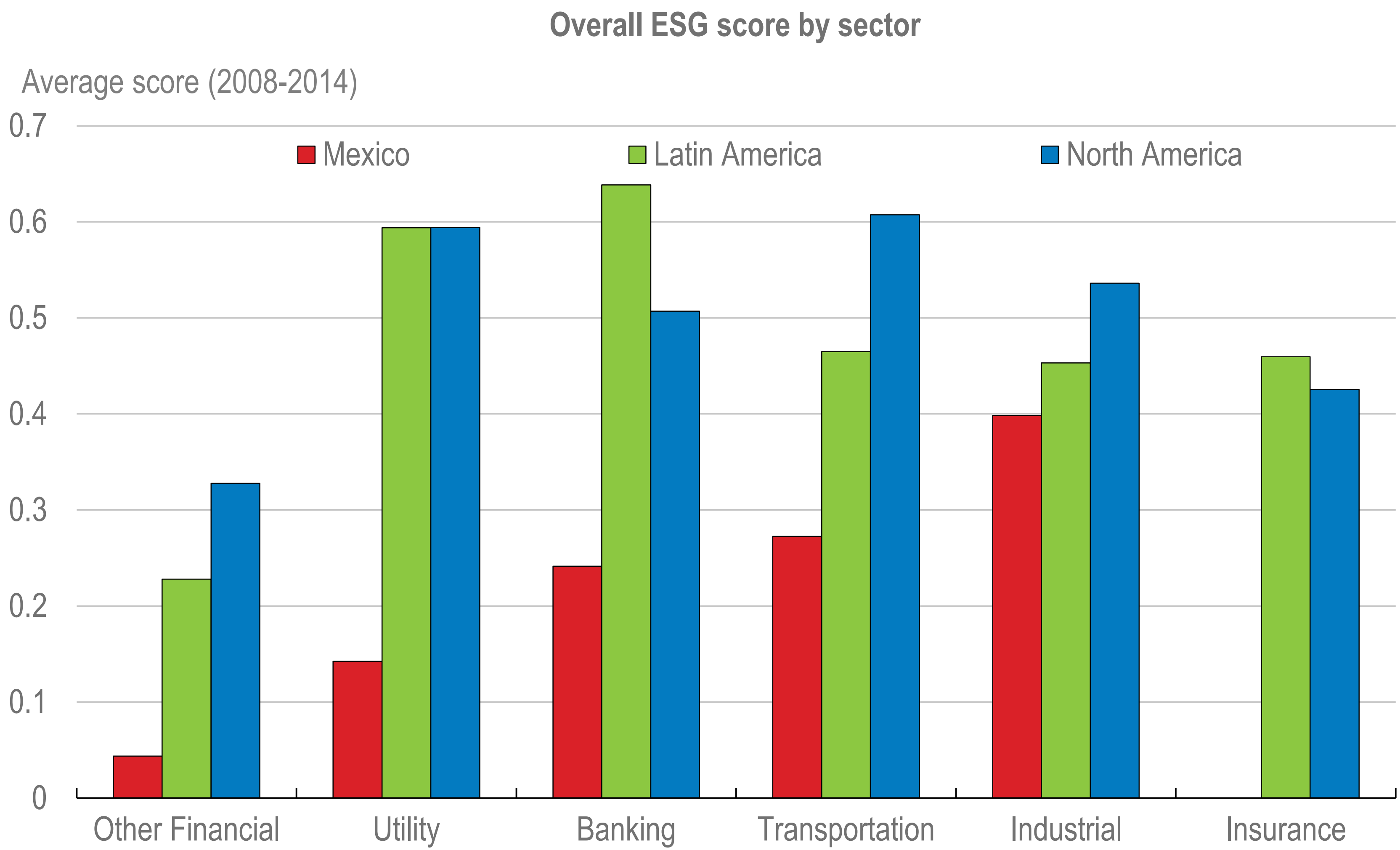
- **Environmental (E) score:** How well a company avoids environmental risks and capitalize on environmental opportunities (e.g. resource reduction, emissions reduction, and product innovation).
- **Social (S) score:** A company's capacity to generate trust and loyalty with its workforce, customers and society, through its use of best management practices; a reflection of the company's reputation (e.g. employment quality, health and safety, training and development, diversity, human rights, community and product responsibility).
- **Corporate governance (G) score:** Measures a company's capacity to ensure that its board members and executives act in the best interests of its long-term shareholders, through the creation of incentives, as well as checks and balances (e.g. board structure, compensation policy, board functions, shareholders rights, vision and strategy).

Latin American firms perform well, except for corporate governance



Note: ESG scores in North America refer to a simple average of firms from the United States and Canada and scores for Latin America refer to a simple average of firms from Brazil and Chile. Data for Mexico does not include the financial sector given that data for only one firm in 2014 is available. The number of firms reporting ESG scores varies per year.
Source: ASSET4 Thomson Reuters data.

ESG differences between sectors are large



Note: ESG scores in North America refer to a simple average of firms from the United States and Canada and scores for Latin America refer to a simple average of firms from Brazil and Chile. ESG data is not available for any Mexican firm in the insurance sector and data in the financial sector is only available in 2014 for one firm. The number of firms reporting ESG scores varies per year.
Source: ASSET4 Thomson Reuters data.

Do ESG-friendly firms perform better?

- **Theoretical predictions:** ESG-friendly conduct improves economic performance.
  - Communities may respond positively to ESG-friendly firms, valuing their practices and additional expenditures, willing to pay more for products from such firms improving their sales and revenues.
  - A company that offers its employees trainings, bonuses, compensation, good health insurance and leaves might be rewarded with higher labour productivity as result of higher motivation.
- Large literature examined empirical relationship between ESG and economic performance: E.g. Friede, Busch & Bassen 2015's; Mehrez 2016's review.
- Largely unsettled debate.
- Accordingly, an empirical analysis was conducted to better understand this relationship.
- **Hypothesis:**
  1. ESG-friendly firm is rewarded with better financial performance; and
  2. Employees in ESG-friendly firms are more productive
- **Data:** Panel data on the environmental, social, and governance behavior as well as financial indicators of 35 Mexican firms, 1457 North American firms, and 111 Latin American firms spanning over 2008 to 2015 (Thomson Reuters ASSET 4 dataset).

Do ESG-friendly firms perform better?

The Model

- Different models were estimated to test the associations between financial performance and labour productivity with each of the ESG scores separately.

$$\begin{pmatrix} Financial\ indicator \\ Labour\ productivity \end{pmatrix}_{it} = \alpha + \beta(E, S, G, ESG\ score)_{it} + \gamma Firm\ controls_{it} + \epsilon_{it}$$

- Three different financial indicators are used:
  1. Return on assets (ROA, ratio of EBIT over total assets)
  2. Return on equity (ROE)
  3. Asset turnover, measured as revenues over total assets
- Labour productivity is measured as the logarithm of the ratio of value added (revenues-intermediate inputs) over number of employees.
- Firm characteristics are included as controls: firm size, firm value (logarithm of total assets), market value to equity and price to book ratio, firm age, leverage, liquidity ratio and risk.
- Country and sector fixed effects are also included as needed.

Do ESG-friendly firms perform better?

Estimated coefficients on the association between ESG scores and firms' performance

Sample: Mexican firms reporting ESG scores[1]

Variables of interest	Proxies	ESG score	Social score	Environment score	Governance score
Financial performance	Return on assets (ROA)	0.00101 (0.0216)	0.0211 (0.017)	0.000895 (0.0206)	0.00301 (0.051)
	Return on equity (ROE)	0.800** (0.134)	0.863** (0.122)	0.921** (0.128)	0.681 (0.349)
	Asset turnover	0.282* (0.126)	0.442*** (0.105)	0.507*** (0.122)	0.733*** (0.315)
Labor productivity	Value based labour productivity	0.534*** (0.235)	0.699*** (0.189)	0.492* (0.224)	0.602 (0.559)

Sample: Mexican, Latin American and North American firms reporting ESG scores[2]

Variables of interest	Proxies	ESG score	Social score	Environment score	Governance score
Financial performance	Return on assets (ROA)	0.0392*** (0.0041)	0.0127 (0.010)	-0.0013 (0.0056)	0.0134 (0.014)
	Asset turnover	0.405*** (0.0302)	0.379** (0.066)	0.251*** (0.018)	0.282 (0.123)
Labor productivity[3]	Value based labour productivity	0.0063 (0.005)	0.0035 (0.0051)	0.0078* (0.0046)	0.0011 (0.0074)

1. Estimations for ROA and asset turnover were estimated also for the whole sample of Mexican firms, i.e. those with and without an ESG score (260 firms). Results are similar and therefore not reported. Sector fixed effects are included. Sample: Mexican firms reporting ESG scores including all sectors.
2. Country fixed effects are included.
3. An alternative specification was estimated including other determinants of labour productivity as control variables such as expenditure on R&D, training hours of employees, physical capital and salaries; results do not show a significant relationship of ESG scores and labour productivity.
Note: *** p<0.01, ** p<0.05, * p<0.1. Return on assets (ROA) = EBIT/total assets. Return on equity (ROE). Asset turnover = Revenues/total assets. Value based labour productivity = log(value added/employees).
Source: OECD calculations based on ASSET 4 Thomson Reuters data.

Do ESG-friendly firms perform better?

Main findings

- Overall, the main findings for Mexican firms suggest that:
  1. Revenues (asset turnover) are positively associated with all the three scores;
  2. Return on equity (ROE) and labour productivity are positively associated with the overall ESG score as well as the social and environmental score; and
  3. There is no statistically significant association between firms' return on assets (ROA) and none of the environment, social, and governance scores
- The positive association of the overall ESG score with an improvement on firms' financial performance (ROA and asset turnover) holds when including Latin American and North American firms to the analysis. However, the association with labour productivity becomes weak.

Limitations

- This empirical approach faces limitations and constraints. For instance:
  - The small size of Mexican sample (35 firms) limits the robustness of results;
  - Cross-section analysis might be invalid when there is high firm heterogeneity;
  - Endogeneity might be caused by omitted variables or reverse causality, implying that only association can be determined, neither the direction nor the mechanism of causation.

What can policymakers do to encourage ESG-friendly behaviour?

Environmental sustainability

- Environmental taxes and traded emission permits
- Footprint transparency including supply chain.

Social sustainability

- Flexible hours, teleworking, paternity leave, childcare
- Non-discriminatory hiring

Responsible governance

- Remuneration transparency
- Diversity of board members, mandatory or voluntary gender quotas