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Beyond ESG: Reforming Capitalism and Social Democracy

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Beyond ESG: Reforming Capitalism and Social Democracy

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ABSTRACT

Several voices are rising to demand an in-depth reform of capitalism in the wake of the increase in income and wealth inequalities of the last four decades, the climate urgency in a local global world, and the financial crisis of 2007–2010. At the forefront of this movement are different groups aiming at redefining the role of businesses around socially responsible stakeholders' governance. There is a real danger that governments will be put under pressure from misinformed constituencies and will want to play Goethe's sorcerer's apprentice: too often, good intentions are but a paved road to hell. In this document, I analyze various reform projects, I discuss the concepts of ethics and equity (environment, water, life, remuneration, inequalities, ESG) and I propose projects for in-depth reforms of capitalism and social democracy.

Keywords: collective intelligence; competition; social democracy; capitalism; value; ESG; ethics; equity; environment; water; fair and equitable remuneration; trust.

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1

Introduction

Several voices are rising to demand an in-depth reform of capitalism in the wake of the increase in income and wealth inequalities of the last four decades, the climate urgency, the perceived increase in environmental and industrial disasters, the intensification and expansion of global trade, the internationalization of cultures, the financial crisis of 2007–2010, and the emergence of the global village of Marshall McLuhan into a local global whole.

We must first understand how these phenomena came to be and what they really mean before imagining solutions if necessary. We already know two of the main sources of the crisis of 2007–2010: the economic policy of easy credit and the pressure of Congress on parastatals Fannie Mae and Freddie Mac in favor of subprime mortgages, which brought these companies not so much to underestimate the risk of the underlying financial transactions, but rather to have to turn a blind eye to these risks.

While it is necessary to make certain reforms to the functioning of capitalism, we must be careful not to throw out the baby with the bathwater, a real risk that should not be overlooked. There is a danger that governments will put themselves, under the pressure of more or less well informed groups, into wanting to play the sorcerer's apprentice of Goethe,[1] too often with good intentions on the way to hell.

The market economy, the freedom to undertake and to challenge the established economic order, and responsible capitalism remain the best guarantees of development and growth in living standards and therefore, among other things, of the development of representative diversity, the eradication of poverty, and the reduction of inequalities in consumption and inequalities of opportunity. The concept of value, of "true value" to use the expression of the World Business Council for Sustainable Development (WBCSD), is at the heart of this desire for reform.

1.1 The ESG Movement

The World Business Council for Sustainable Development (WBCSD) is an organization of over 200 large companies from all regions of the world dedicated to developing governance rules focused on the pursuit of "real value" rather than solely financial returns. Pursuing real value means promoting value creation that takes into account long-term environmental impact and both personal and social well-being; it relies on prices integrating all externalities in both costs and benefits. It is also (re)orienting capitalism towards the pursuit of this true value, focused on the protection and enhancement of natural, social and financial capital rather than towards the pursuit of financial profits and economic efficiency.

The environmental, social and governance (ESG) criteria are a set of standards that investors use to filter potential investments, qualified as sustainable investments, responsible investments, impact investments, socially responsible investments, or ethical investments.[2] ESG criteria can also, beyond any ethical concern, allow the identification of

[1] Karl Marx and Friedrich Engels (1848), Chapter 1: "Modern bourgeois society, with its relations of production, of exchange and of property, that has conjured up such gigantic means of production and of exchange, is like the sorcerer who is no longer able to control the powers of the nether world whom it has called up by his spells", a reference(?) to *The Sorcerer's Apprentice* (1797) of Johann Wolfgang von Goethe.

[2] https://www.investopedia.com/terms/e/environmental-social-and-governance-esg-criteria.asp.

companies whose practices could signal a risk factor for industrial or environmental disaster.[3]

The environmental criteria relate to energy consumption, waste management, in particular hazardous waste, pollution, preservation of natural habitats, management of industrial and environmental risks. The social criteria relate to the company's relations with its suppliers (do they have ESG policies?), the local community (charitable donations; volunteerism of its employees), its workers (total compensation; health and safety), and its customers (quality of customer service). The governance criteria relate to transparency of accounting methods, respect for shareholders, management of conflicts of interest, political contributions known as cronyism or undue or even illegal lobbying. All of these ESG criteria also refer to compliance with laws and regulations, in particular strict, shared or extended liability rules.[4] I will come back in more details to ESG approach in Section 2.7.

1.1.1 Caveats to Keep in Mind

The U.S. Department of Labor published new regulations in late October 2020 that could limit the use of ESG criteria in pension plan investment choices.[5] The authorities say that "Protecting retirement savings is a fundamental mission of the United States Department of Labor and one of the primary public policy objectives of our country. This regulation will ensure that pension plan trustees focus on the financial interests of plan members and beneficiaries, rather than on other non-monetary or political goals. Our goal is to ensure that pension plan trustees have a clear focus on the financial interests of participants to receive secure

[3] Examples are the Deepwater Horizon (British Petroleum) disaster in 2010, the scandal of emissions (Volkswagen), and the AZT explosion in Toulouse in 2001.

[4] The World Economic Forum of Davos, in collaboration with Deloitte, EY, KPMG and PwC, has promoted an important ESG movement in 2020 with the publication of a report on measuring and consistent information reporting on ESG policies by firms: *Measuring Stakeholder Capitalism: Towards Common Metrics and Consistent Reporting of Sustainable Value Creation* (September 2020). https://www.weforum.org/reports/measuring-stakeholder-capitalism-towards-common-metrics-and-consistent-reporting-of-sustainable-value-creation.

[5] https://www.dol.gov/newsroom/releases/ebsa/ebsa20201030.

and valuable pension benefits. Plan trustees should never sacrifice the interests of participants to promote other non-financial goals."

The Department notes that the analysis of so-called ESG investments raises important and substantial questions regarding the rigor exercised and the prudence and reliability demonstrated. The regulation obliges pension plan trustees to choose investment strategies that are essentially or even entirely based on financial performance.

Boyer and Laffont (1997) show that expanding the sphere of liability for environmental disasters must also account for the existence of imperfect and incomplete information within financial markets themselves, so that environmentally hazardous but otherwise socially useful activities are adequately financed. The absence of complete information at all times and in all places may justify limiting the imposition of extended liability.

The CEO of Roviant Sciences, Vivek Ramaswamy, claims in a recent op-ed in the *Wall Street Journal* (2020) that expecting business leaders to make a stand and push for environmental and social programs (the ESG approach) gives them too much power. This authority and power should be left to governments: "My main problem with stakeholder capitalism is that it strengthens the link between democracy and capitalism at a time when we should instead disentangle one from the other. Speaking as a CEO and a citizen, I don't want American capitalists to play a larger role in defining and implementing the country's political and social values. I think the answers to these questions should be determined by the citizenry—publicly through debate and privately at the ballot box. I believe the reason many corporate executives are speaking up in favor of stakeholder capitalism is that they think they will gain popularity at a time when it is unpopular to be perceived as a pure capitalist. The crux of the populist concern about capitalism is not that companies serve only their shareholders, but rather that capitalism has begun to infect our democracy through the influence of dollars in buying political outcomes. The answer is not to force capitalism into an arranged marriage with democracy. What we really need is a clean divorce."

1.2 The Notion of Value

Determining the value of a good, a service, an investment, an hour of labor, a public good or asset, a permanent work such as a sculpture, a song or a sound recording, is one of the most important issues in economics, and also in sociology, philosophy, psychology, and numerous other fields of humanities and social sciences. The distinction between total value, average value and marginal value, as developed in the second half of the 19th century, is crucial and essential to the understanding not only of economic phenomena but also and above all of the notion of value itself.

In many ways, economists are the scientists of the value, including the value of labor, of human capital, of intellectual, physical or financial capital, of natural resources, of the environment (space, air, water), of businesses, of infrastructures, of health, of education, of life, etc.

A fair and equitable price is a competitive price, therefore a price which respects both the interests of the suppliers or producers, namely the suppliers of labor, skills, human capital, intermediate goods and services, and providers of physical, financial and intellectual capital, and the interests of demanders, buyers, users or employers of these goods and services, in a context where both the suppliers and the demanders act voluntarily or willingly, a context of "willing buyer-willing seller," therefore a context of free or competitive exchange.

The best guarantee that suppliers will be adequately or fairly remunerated for their goods and services, including their labor, lies in the competition between those seeking goods and services, including those seeking labor. And the best guarantee that demanders will be called upon to pay an adequate price or remuneration lies in the competition between suppliers of goods and services, including labor. Thus, a competitive price is fundamentally synonymous with a fair and equitable price because it respects the freely expressed interests of both suppliers and applicants.

At competitive equilibrium, the price of a product, good or service, is equal to its opportunity cost or value, that is, to the value, as estimated by buyers, that the product could generate in the best available and accessible alternative use, including in consumption, in leisure or in the production of other goods and services. It is also equal to its marginal cost of production which measures the value of all kinds of resources used for its production. Thus the competitive equilibrium price is both fair and equitable for the supplier/seller and the demander/buyer.

The value of the goods or services that I offer or sell is determined by my fellow citizens who freely estimate what my products bring them in terms of utility, well-being or potential and by the opportunity cost or value of resources, labor and others, incorporated into my products. The difference being the profit I can get from producing and selling an additional unit (marginal value) of goods or services. For the last unit sold, this marginal value is zero, but for all previous units (infra-marginal), it is normally positive, while for all additional units, by definition non-produced, it is negative.

In this context, the competitive prices, which measure the marginal value of things, goods and services that I produce, would only increase if I can produce goods and services of greater value for my fellow citizens.

There is nothing more stressful and demoralizing than being told or discovering that one's work and efforts do not produce anything interesting, useful or valuable for one's fellow citizens and therefore prove to be of no value, or at least that one's work and efforts do not produce anything comparable or better than what other fellow citizens produce and offer. Furthermore, in all fairness and equity, I cannot force my fellow citizens to remunerate skills and finance operations if these skills and operations do not generate anything useful or valuable for them. But at the same time it can be a source of motivation to change the skills portfolio and the basket of goods and services that one produces or helps to produce. Also, as a consumer or buyer, the other party sends a message like this when he/she decides not to buy a certain product, good or service.

Hence, competitive markets, or surrogate institutions or mechanisms including regulation that emulates competitive markets, are the essential element in bringing out the fair and equitable social value of things.

I return later (Section 2) to the notion of value, to the value of the environment, to the value of water, to the value of life, to fair and equitable remuneration, to the value of the work of children, and to the strict and/or extended corporate responsibility for environmental and industrial disasters.

1.3 The Role of Firms, Entrepreneurs, and Competition

A firm can be understood as being a transformation institution, process or mechanism that fruitfully or efficiently blends factors of production, namely human labor, materials, natural resources, technologies, borrowed capital and equity capital, to generate goods and services that are useful to its fellow citizens, end users or businesses as clients, in such a way that the total value of its products is larger or at least not smaller than the total cost of all factors used when the latter are paid or compensated at the value of their best alternative use. If that is the case, the firm is clearly generating net value and creating wealth. How to make sure that it does? Through competition and willing buyer willing seller exchanges.

Consider four types of enterprises: the capitalist enterprise, the socialist or cooperative enterprise, the labor enterprise, the idea-based enterprise. In each case, the residual decision-making power, other than those provided for by contract, will belong to the group paid last, namely financial capital (capitalist company), human capital (labor company) or intellectual capital (idea-based company). The four types considered and described below are abstract and generic. In reality, companies can depend partly on one type and partly on another.

The capitalist firm pays in priority all its factors other than equity capital, which is paid last, that is, compensated by the residual value, namely the total value of the products minus the total cost of the priority factors. This residual value is typically uncertain, may be positive or negative, and will in expected or average terms also represent the value of the best alternative use of equity financial capital. More generally, compensation of all factors and the value of their best alternative uses are done or calculated on a risk-adjusted basis.

The socialist or cooperative enterprise will generally distribute the total value of its products among all factors or partners in a more egalitarian order of priority without being completely egalitarian, making the compensation of all factors or partners uncertain or risky and variable over time. But these compensations must represent on average or in expectation the value of the factors in their best alternative use. More generally, the compensation for all factors and the value of their best alternative uses must be done or calculated on a risk-adjusted basis.

The labor company will pay in priority all its factors other than labor, which will be paid last, that is to say compensated by the residual value, i.e., the total value of the products less the total cost of the priority factors, including suppliers and borrowed capital (the Labor company is financed by assumption at 100 per cent by borrowing at market conditions). This residual value will generally be uncertain, can be positive or negative, variable over time, but must represent on average or in expectation the value of the work in its best alternative uses. More generally, the compensation of all factors, including borrowed capital and labor, and the value of their best alternative uses should be done or calculated on a risk-adjusted basis.

The idea-based company will pay in priority all its factors other than the idea-owners (holders of intellectual property), which will be paid last, that is to say compensated by the residual value, which is the total value of the products minus the total cost of priority factors, including suppliers and borrowed capital (the idea-based company will hypothetically finance itself 100 per cent by borrowing at market terms). This residual value will generally be uncertain, can be positive or negative, variable over time, but must represent, on average or in expectation, the value of ideas or of the intellectual property (or of the efforts that have generated this intellectual property) in their best alternative use. More generally, the compensation for all factors and the value of their best alternative uses must be done or calculated on a risk-adjusted basis.

The entrepreneur is in each case the innovator by excellence, the master cook who blends the ingredients to raise social wellbeing. In modern businesses, this entrepreneur is personified by the CEO as the leader ultimately responsible for the success and growth of the firm or organization. The Corporate Finance Institute states that the roles and responsibilities of a CEO vary from one company to another, depending in part on the organizational structure and/or size of the company but the typical duties, responsibilities, and job description of a CEO include, among others: leading the development of the company's short- and long-term strategy; maintaining awareness of the competitive market landscape, expansion opportunities, and industry developments; assessing risks to the company and ensuring they are monitored and minimized; and setting strategic goals and making sure they are measurable and describable.

In other words, the CEO personifies first and foremost the design, development, and management of the firm's real options (Boyer, 2021a): the recognition that uncertainty creates opportunities and value; the recognition that such value requires adequate decisions in order to materialize, including the determination of the scale and scope of the firm; the identification of the sources of uncertainty and the collection of information; the identification of the decisions (options) that promote exposition to favorable developments and/or reduce exposure to unfavorable ones; the design of optimal decision rules and their delegation throughout the firm. The real options approach is mostly a way of thinking and adjusting one's behavior accordingly. Its application throughout the firm is a responsibility of the CEO.

Of course, there is no reason preventing the CEO from playing, as a concerned citizen, an active role in his/her community, but the role as citizen and the role as CEO must be properly differentiated.

Moreover, how can we make sure that firms generate net social value and create wealth? By subjecting them to competition. Competitive intensity will favor the emergence of efficient firms and the closing of inefficient ones. Competitive markets for factors of production and for end products, goods and services, favor the proper value accounting, making sure that firms compensate their factors at their best alternative use and commercialize valuable goods and services for end consumers and businesses. When all factors of production are directly or indirectly priced at their competitive value, and all end products are sold directly or indirectly at competitive prices, the firms, competing with each other including forthcoming new innovative firms, will be forced either to use the optimal blend of factors properly compensated at their best alternative value (opportunity cost) to produce an appropriate set of end products thereby generating a net social value and creating wealth, or go out of business or go bankrupt.

This is the gist of Friedman's assertion that the social responsibility of corporations is to maximize profits. Profit maximization is an efficiency measure that serves all of the firm's stakeholders. Competition prevents a company in a competitive situation and surrounded by competitive markets, from exploiting its workers, cheating its suppliers, and/or deceiving its customers. Competition prevents the company from generating durably supra-competitive profits and therefore prevent it from compensating equity holders beyond the best alternative value of capital.

Competition, properly understood, measured and regulated, is the cornerstone of this socio-economic organization model.

1.4 Collective Intelligence and Trust

People may disagree on the appropriate goals and objectives for a society. They may differ in their views on how efforts should be allocated between creating and redistributing wealth. They may even argue about the relative efficiency of different ways and means available for pursuing shared goals and objectives.

But when there is confusion between goals and objectives, on the one hand, and the ways and means available for achieving them, on the other, the debate becomes spurious. Thus, while debates about goals and objectives are societal in nature, debates about ways and means are technical—or at least they should be.

In extreme cases, there is no confusion. To a large extent, a goal must be socially shared, in that we all agree on it or at least have a way to build a consensus around it. This could involve an open and transparent electoral process, for instance.

How to achieve goals and objectives? This is where the discussion about ways and means comes in. This discussion should be more technical. What resources and technologies are available? How can they further the objective? And how much do they cost?

Any discussion about ways and means is essentially concerned with relative efficiency and relative costs. Achieving a consensus on goals and objectives requires an efficient, competitive political process with candidates vying for electoral support (basically democratic election rules and institutions). Achieving a consensus on ways and means requires an efficient, competitive economic process (basically competitive markets, competitive processes, and competitive prices).

The New Competition-based Capitalism (NCC) and the new Competition-based Social Democracy (CSD) models described and advocated in Sections 4 and 5 are offshoots of a conception of economics as the study of mechanisms of coordination, motivation, specialization, regulation, and management of exchanges that condition and entrench developments of collective intelligence in human society.[6]

Humanity can thus be compared to a social organism constantly evolving, thanks to increasingly efficient and effective resources allocation mechanisms, to ever increasing levels of collective intelligence. The cerebral cortex of this organism, essentially consisting of institutions, markets, and competitive prices, is itself evolving into more complex, sophisticated, and resilient forms. This organism and its cerebral cortex is vulnerable to a variety of illnesses, of greater or lesser severity and duration, which are, however, curable with a better understanding of human behavior, at both the individual and the social, or interactive, level.[7]

In this broad program, Economics prides itself in forging enriching interactive links with Mathematics and Computer Science as well as other Humanities and Social Sciences, especially Experimental Psychology, Sociology, Political Science, Business Administration, and Law.

At the World Economic Forum in Davos in January 2003, to which I was invited as a guest speaker, one of the main topics of discussion was the restoration and fostering of trust, both within the business community and in society at large.

The reason for this interest at that time was twofold: First, a wave of large-scale bankruptcies and financial scandals had shaken confidence within and towards the business world and, second, "trust" is the most

[6] Here I am taking inspiration from Ridley (2011).

[7] To quote Matt Ridley: "Human civilization is a collaborative achievement, not a product of individual intelligence or innate capacity. It came about because we networked our brains, not because we improved them. We had very primitive lives for a quarter of a million years despite having modern IQs. There may be a lesson here for artificial intelligence". http://www.rationaloptimist.com/blog/collective-intelligence-on-the-edge.aspx.

important social capital because it can significantly reduce transaction costs of all kinds within a society. The 2007–2010 crisis in financial markets, which is fundamentally a crisis of confidence within the banking sector in general, brings the issue of trust to the forefront.

Trust is both private and social capital and, as such, developing and maintaining it poses difficult problems of organization and therefore coordination and incentives. It is private capital because a company will benefit from the confidence of its partners. But the trust thus privately created has a positive impact on trust across all firms. This social effect is sufficiently important for public authorities to have a particular responsibility to ensure that trust capital is fostered and sustained.

Trust is a capital that is built up with difficulty over the medium and long term and easily destroyed in the short term—in the private, public, and social spheres. The manipulation and falsification of information transmitted by organizations, particularly with regard to risk measurement, is a first pernicious factor in the destruction of social capital. A second comes from the complacency of watchdogs responsible for regulated companies—the cases of Fannie Mae (Federal National Mortgage Association—FNMA) and Freddie Mac (Federal Home Loan Mortgage Corporation—FHLMC) come to mind as being particularly egregious. A third comes from flaws in performance incentive mechanisms, which too often neglect to correct for reckless risk-taking.[8] A fourth one revolves around formulaic application of the mark-to-market accounting rule in a setting in which evaporating confidence makes the relevant markets disappear and exacerbates the contagion of non-confidence completes the picture.[9]

Trust is an especially important type of social capital. Consequently, the *loss of confidence* in the financial system in 2007–2010, and particularly in interbank financial relations, helped precipitate the financial

[8] Rajan (2010) claims that private institutions, assuming that Freddie and Fannie's involvement in the subprime market would significantly reduce the risk of high-risk loans, ended up taking too much risk by extending cheap credit. The problem is not with the economics and financials of the banking sector per se, but with the faulty incentive schemes promoted by government interventions in favor of cheap credit.

[9] During the financial crisis and recession of 2007–2010 these factors were dominant.

crisis and then the economic recession. After an interim period of quasi-stability in financial markets, we may be heading back toward chaos in the financial markets with a resurgent risk of *loss of confidence* in sovereign debt of important countries and its impact on bank liquidity and solvability, a sign of this being the increasing role of central banks as lenders of last resort for governments.

To re-establish and/or maintain confidence, four issues must again be addressed now:

- First, refocus the role of governments. Governments should focus their efforts on rebuilding and maintaining confidence in addition to developing conditions favorable to creative destruction, as job losses are a necessary component of job creation and growth. To do so, governments must accept a new role and redefined means of intervention, tailored toward taking the economy out of a bad but stable equilibrium. This requires a concerted effort by all agents, mainly private and public corporations, but also including governments.

- Second, governments need to favor the development of new institutions and instruments, mainly finance and insurance based, aimed to facilitate adjustments by firms and individuals to endogenous and exogenous shocks in their socio-economic environment. Governments should also favor the inclusion of clauses in mortgage or other contracts to allow for continuous adjustments to economic conditions in case of recession or crisis, thereby avoiding sudden, cascading adjustments that only aggravate poor economic conditions needlessly.

- Third, various micro prudential and macro prudential regulatory rules should be implemented over the coming years. I develop elsewhere[10] some of the rules that could make the regulation of the financial system more efficient and allow for somewhat automatic adjustments and reorganizations for a better control of systemic risks.

[10] See Chapter 24 in Boyer (2017a). For an insider view of the crisis see Bernanke *et al.* (2019).

- Finally, governments must resist the temptation of resorting to protectionist “buy local” measures intended to artificially spur demand for local products and services to the detriment of living standards and the general well-being of the population. This raises a problem of coordination among governments. There exists a real danger of seeing a vicious circle crop up during crises and recessions with protectionism responding to protectionism, plunging economies into a more serious slump. Thus, contrary to pursuing protectionist policies, governments should seek to protect the movement toward globalization and the liberalization of markets. The substantial growth of international trade in the last half-century has been a major factor in enhancing collective economic well-being as well as cultural and social development. This increase in trade has led to important gains with regards to wealth creation, economic growth, social progress, with above all a significant eradication of poverty.

Growing out of recessions and spurring innovation and growth would benefit in the longer run also from fiscal reforms and new roles for the government sector and the competitive sector, as well as from reformed relationships between those sectors.

Regarding fiscal reforms, a general switch from awkward hybrid taxation system toward a system centered on consumption taxes, hence toward abolishing income taxes on individuals and corporations, would contribute significantly to a more efficient economy.

The core roles (and competencies) of the *public/governmental sector* should be first, the identification of citizens’ needs in terms of public and social goods and services, both in quantity and quality; second, the design of proper mechanisms through which conflicts between different baskets of such goods and services and between different coalitions of citizens will be arbitrated; and third, the management of contracts and partnerships with private/competitive sector organizations for the production, distribution and delivery of the chosen basket of public and social goods and services. The core competencies of the *private/competitive sector* should be to produce, distribute and deliver the public and social goods and services as well as private ones by making use of the best forms of organization and the most efficient combinations of factors, human resources and technologies.

More fundamentally, the emergence and omnipresence of competitive prices and processes throughout the economy, in the public and social goods and services sectors in particular, would represent significant forces aimed at avoiding waste while generating and implementing innovative solutions to social problems and challenges. In that regard, the emergence and omnipresence of competitive prices and processes must be understood as significant factors in achieving long term economic growth and increases in individual and social well-being.

The renewed relationships between the public and private or competitive sectors cover not only the contractual arrangements for the production, distribution and delivery of public and social goods and services but also the development of a New Competition-based Capitalism NCC (see Section 4). This NCC calls for implementing ESG-type programs based on the promotion/development/maintenance of competitive prices and markets by inducing firms to include in the formulation of their mission their desire to avoid doing business with "heavily" subsidized firms, whether suppliers or clients, or at least voice their hesitation/opposition to doing so, and for implementing strict constraints on the power of business to intervene in politics and the power of politicians to intervene directly in businesses in order to separate/dissociate business and politics as well as separate/dissociate capitalism and the process of electoral expression in democracy.

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