RealClear Policy

ESG Does Not Measure a Firm’s Social Impact

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Advocates of investing based on environmental, social, and governance factors, or ESG, promised that it would transform how business performance is measured, to society’s benefit. Yet, far from being revolutionary, ESG is just the most recent manifestation of an old fallacy—that businesses create wealth for their owners but little else of value for society.

When a business makes a profit, its trading partners or stakeholders, including customers, employees, and suppliers, also gain. Yet these gains are ignored by ESG and other rating schemes that claim to measure the firm’s impact on society.

A business’ stakeholders freely choose whether to trade with it or not. A customer buys a product if the product’s value to the customer exceeds the product’s price. An employee works for a firm because what the employee receives in exchange exceeds what any other available job would offer. A supplier agrees to sell the firm its goods or services if the selling price creates a profit for the supplier. All these stakeholder gains reflect profit-making businesses making positive contributions to society.

A recent National Bureau of Economic Research paper considers all this and estimates a firm’s social impact by measuring the benefits accruing to its shareholders and various stakeholders. It also accounts for negative externalities—harmful side effects a business may produce—including CO2 emissions.

Which of the firms included in the study had the largest positive social impact? Walmart.

Yes, Walmart scored highest because it is large, so its business impacts many people. It sells products at low prices primarily to lower-income consumers, who reported that they would find it difficult to buy the same products at higher prices.

Yet Walmart has only an average ESG rating, according to Sustainalytics, a major ESG rating firm. The study found this discordance was common, concluding, “Existing ESG and social impact ratings are essentially unrelated to our economically grounded measures.”

What do ESG scores measure? ESG is a subjective rating scheme. It reflects the beliefs of the persons who issue the ratings. ESG was created by United Nations (UN) bureaucrats working in concert with executives from the finance industry. Its purpose is to use corporate assets to promote ideological causes that progressives favor.

In practice, ESG has proven to be incoherent. A 2022 study by MIT researchers examined six different ESG scores from six rating firms and found that their methodologies varied greatly. For example, one rating firm used 282 inputs, whereas another used only 38. The study also reports that the six ESG ratings are not highly correlated. As one of the study's authors put it, "the six never all agreed on a company's ESG rating, and in most cases there was little agreement among them."

Before ESG came on the scene, the same global institutions now at the forefront of promoting it, including the UN, World Bank, and World Economic Forum, were busy promoting another economic fallacy—that the world had too many people and was rapidly running out of natural resources. They argued that limiting population growth was the only way to reduce poverty and avoid societal collapse.

The population fallacy was responsible for China's infamous one-child policy, which led to millions of forced abortions and sterilizations. It also resulted in millions of forced sterilizations in India, financed by lending from the World Bank and the United Nations Population Fund.

And for what? The human toll aside, macroeconomic data clearly show population control's ineffectiveness as a means of poverty reduction.

India and China have more people and greater prosperity today than in the 1970s, when population control efforts were at their peak. More generally, in 1970, 45 percent of the world's population lived in extreme poverty, whereas today it is only 8 percent. Yet the world's population more than doubled during this same period.

What caused the reduction in poverty? It was primarily market reforms in China and India that limited the government's role in the economy and encouraged more market activity. Profit-seeking businesses then created wealth, goods, services, and jobs, just as they do in the United States and Western Europe.

We can see such effects across countries as well: rich countries have an abundance of profit-seeking firms, while poor countries do not.

ESG and other subjective rating schemes do not reflect how business improves the state of humanity. What ESG does is divert corporate resources from profit-seeking, which benefits all of society, toward ideological causes that progressives and some global institutions favor.

China and India did not pull millions out of poverty by embracing ESG, stakeholder capitalism, or any of the other monikers popular in today's business lingo, but by freeing their people's entrepreneurial spirits. What better evidence is there that profit-seeking firms benefit all of humanity?

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