

A pair of hands is shown from the bottom, cupping a realistic image of the Earth. The background is a gradient of red and pink, with a subtle pattern of clouds. The title text is overlaid on the right side of the image.

A new panacea for curing the planet?

A critical review of Environmental, Social, and Governance (ESG) investing

Abstract

In recent years, increasing attention has been paid to the concept of ESG investing in the realm of financial markets. ESG has often been presented as a promising tool for fostering the transition to a socially equitable and decarbonized economy. However, there are also increasing concerns over its actual ability to face the challenge of climate change and promote a real shift from fossil fuels to clean energy technologies and other socially sustainable practices. Drawing on recent advancements in the literature, this paper analyses the major shortcomings of ESG investing, examines the latest EU regulatory efforts in the ESG field, and discusses policy options to restore the credibility of ESG ratings and reconcile the goals of profit maximization and environmental protection.



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Table of Content

The rise of ESG investing	2
The challenges of ESG investing. A theoretical framework	3
ESG investing between regulation and voluntaristic practices	5
The impact of EU ESG regulation on companies and rating providers	7
Aligning incentives. Which policy options for ESG investing and the ecological transition?	8
Conclusions	11
References	12

The rise of ESG investing

In recent years, increasing attention has been paid to the concept of ESG investing in the realm of financial markets.

ESG stands for “Environmental,” “Social,” and “Governance.” The basic logic behind ESG investing is mobilizing a growing amount of financial resources toward companies that adopt sustainable practices and productive systems in the three ESG dimensions, with the goal of adequately funding a just transition to decarbonization of the economy and tackling the multiple challenges of climate change.

The ESG concept was first used and popularized by the United Nations in a 2004 report titled, *Who Cares Wins*, although the origins of ESG investing strategies can be traced back several decades. According to Byrne (2023)¹, “theoretically, we could look at improving basic labor conditions during the industrial revolution as efforts in the “S” and “G” categories..” Furthermore, as highlighted by Lawton (2023)², one of the first funds explicitly incorporating the issues of environmental and social responsibility in its investment strategies was created by Amy Domini in 1991, much earlier than the recent ESG hype, collecting more than \$1 billion in ten years.

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Initially, ESG investing is understood as an effective and promising tool to foster the transition to a socially equitable and decarbonized economy. However, there are increasing concerns over its ability to face the challenge of climate change and promote a genuine shift from fossil fuels to clean energy technologies and other socially sustainable practices.

Drawing on recent advancements in the literature on ESG investments, this paper is structured as follows. The first section develops a theoretical and analytical framework for exploring the major shortcomings of ESG investing,

¹ D. Byrne (2023), What is the history of ESG?, The Corporate Governance Institute, <https://www.thecorporategovernanceinstitute.com/insights/lexicon/what-is-the-history-of-esg/>

² G. Lawton (2023), A timeline and history of ESG investing, rules and practices, TechTarget, 7 April, <https://www.techtarget.com/sustainability/feature/A-timeline-and-history-of-ESG-investing-rules-and-practices>

paying special attention to relevant measurement issues that affect the assessment of corporate ESG performance. The second section deals with the emerging regulatory framework, especially at the EU level, with the aim of setting standards for both companies and ESG rating agencies, creating a more stable legal environment. The third section examines the leading market players subject to the recent ESG regulatory efforts, with a focus on the problems that arise from the interaction between rated companies and ESG rating providers. The last section considers policy options to achieve the difficult goal of aligning the incentives and interests of the various stakeholders affected by the challenges of ESG investing (firms, rating agencies, investors, policymakers, communities and citizens).

The challenges of ESG investing. A theoretical framework

What does ESG investing actually mean? More precisely, what is measured when trying to assess ESG performance and determine an ESG score?

The answer to this seemingly easy question is not as straightforward as it appears. According to a report of the European Commission staff released in 2023, “investors, companies and other stakeholders face difficulties to understand how ESG ratings are computed and what criteria and assumptions are taken into account” by rating agencies (European Commission, 2023).³ The European Commission also built a taxonomy to classify different ESG ratings that have been developed so far by the several ESG rating agencies operating in this market. Four main categories were identified: ratings based on a company’s risk assessment, mainly financial; ratings of a company’s impact from an environmental and social viewpoint; ratings that assess company compliance with international principles and guidelines; and ratings that focus on a company’s supply chain to assess its sustainability risks (*ibidem*).

“investors, companies and other stakeholders face difficulties to understand how ESG ratings are computed and what criteria and assumptions are taken into account”

³ European Commission (2023), Impact Assessment Report Accompanying the document Proposal for a Regulation of the European Parliament and Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities, <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52023SC0204>

The lack of clear and officially recognized standards for measuring and assessing ESG performance generates confusion among investors and other market operators. As reported by Segal (2022)⁴, a survey of 1,300 executives commissioned by Workiva found that more than 70% of respondents have little confidence in the ESG reporting of their own organizations.

Furthermore, methodological problems could arise when addressing the issue of appropriately weighting the three components of ESG. Which dimension should be privileged, and why? How are the potential trade-offs between the environmental and the social components handled? As highlighted by Huang (2022)⁵, what should be done when a company has good environmental performance but “has weak labour protection or operates in a country with a controversial human rights record”?

Other measurement errors can occur when trying to quantify a company’s environmental impact. In other words, how are negative externalities computed and properly incorporated into the financial assessment of a company’s value, similar to the problem of solving “the problem of social cost” (Coase, 1960)?⁶ According to Boyce (2018)⁷, who carried out an analysis of different carbon pricing systems, “most actually existing carbon prices are well below the levels recommended by climate policy analysts,” meaning their environmental costs generated by a wide range of economic undertakings appear to be systematically underestimated. Intuitively, this can give rise to misleading ESG ratings that do not appropriately measure the impact of companies’ activities at the societal level. In this light, a particularly meaningful case is that of BlackRock U.S. Carbon Readiness Transition Fund ETF, which raised more than \$1 billion on its first day. As reported by Fintel (2023)⁸, the ETF trust includes major oil and gas companies among its top 100 holdings, such as Exxon, Chevron and ConocoPhillips. Furthermore, according to the nonprofit organization As You Sow (2021)⁹, which analyses corporate social responsibility practices, when considering “86 funds with ESG in their name – half score D or F in one or more issue areas. Of BlackRock’s 14 funds with ESG in the name, 10 get D’s or F’s.”

The challenges associated with ESG investing are not only related to the abovementioned measurement issues; they also involve the complex mechanisms in financial markets. For example, it is not always clear who is entitled to make strategic investment decisions, especially in the context of funds collecting financial resources from many different and dispersed shareholders and savers, as in the case of pension funds. Are managers of such

⁴ M. Segal (2022), Survey: Over 70% of Execs Lack Confidence in Their Own ESG Data Reported to Stakeholders, *ESGtoday*, 23 June, <https://www.esgtoday.com/survey-over-70-of-execs-lack-confidence-in-esg-data-reported-to-stakeholders/>

⁵ E. Huang (2022), Disaggregating “ESG”: a tale of two companies, Slaughter and May, 4 July, <https://sustainability.slaughterandmay.com/post/102hs79/disaggregating-esg-a-tale-of-two-concepts>

⁶ R. Coase (1960), The Problem of Social Cost, *The Journal of Law and Economics*, Vol. 3, 1-44.

⁷ J.K. Boyce (2018), Carbon Pricing: Effectiveness and Equity, *Ecological Economics*, 150, 52-61. <https://doi.org/10.1016/j.ecolecon.2018.03.030>

⁸ Fintel (2023), BlackRock ETF Trust – BlackRock U.S. Carbon Transition Readiness ETF Portfolio Holdings, <https://fintel.io/i/blackrock-etf-trust-blackrock-u-s-carbon-transition-readiness-etf>

⁹ As You Sow (2021), Why Is BlackRock’s Carbon Transition Fund Packed With Big Oil?, 21 April, <https://www.asyousow.org/press-releases/2021/4/21/blackrocks-carbon-transition-fund-packed-with-big-oil>

funds entitled to make complex decisions on behalf of the shareholders they supposedly represent, such as choosing to mobilize their resources toward ESG portfolios whose returns are not very stable?

Other problems for investors could arise when choosing the optimal strategic behavior for steering companies toward green investments. Drawing on the classical work by Hirschman (1970)¹⁰ on exit, voice, and loyalty for organizational analysis, Broccardo, Hart, and Zingales (2022)¹¹ developed economic models showing that, under specific conditions, investors' exit strategies from companies that produce negative externalities are unable to deliver socially optimal outcomes in terms of green technologies. Moreover, divesting can lead to counterintuitive effects and unexpected consequences, such as rapid asset depreciation, takeovers, and easy predation by private equity funds, which are unlikely to produce environmental benefits.

Finally, the road to environmentally and socially responsible investments are further complicated by investor time-discounting preferences, particularly when the goal of immediate and short-term returns prevails over longer term approaches. In a paper titled *Profit Maximization and the Extinction of Animal Species*, Clark (1973)¹² drew on economic models that showed when the discount rate is sufficiently high, profit maximization leads to the paradoxical result of exterminating animal populations and depleting natural resources, with consequences from the viewpoint of the tools needed to cope with the inherent tension between short- and long-term investing approaches.

ESG investing between regulation and voluntaristic practices

As already mentioned in the introduction, ESG investing has its origins to several centuries ago. According to Lawton (2023)¹³, the "religious codes banning investments in slave labour" can be considered a pioneering form of ESG investment decision. Similarly, Moushey (2021)¹⁴ mentioned practices adopted in the United States in the 18th century by Methodists who urged boycotting activities related to the production of goods and services, such as tobacco, liquors and gambling. Another instance of ESG investment behavior was when

¹⁰ A.O. Hirschman (1970), *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (Cambridge, MA: Harvard University Press)

¹¹ E. Broccardo, O. Hart, L. Zingales (2022), *Exit versus Voice*, *Journal of Political Economy*, 130(12), <https://doi.org/10.1086/720516>

¹² C.W. Clark (1973), *Profit Maximization and the Extinction of Animal Species*, *Journal of Political Economy*, 181(4), 950-961

¹³ G. Lawton (2023), *A timeline and history of ESG investing, rules and practices*

¹⁴ W. Moushey (2021), *A Short History of ESG*, *The Sustainable Blog*, 30 August, <https://blog.sustainablehq.com/a-short-history-of-esg-bc82bac830c>

anti-Vietnam War protestors in the sixties (*ibidem*) boycotted companies involved in war-related efforts and activities.

In recent years, following the UN report which contributed to popularizing ESG, there was an increasing formalization of ESG investment practices, with international initiatives clarifying the meaning of ESG investing and how it can be pursued.

In an attempt to go beyond the voluntaristic approach of the abovementioned practices, efforts have been made to create a legally binding regulatory framework applied to ESG investing. At the end of 2022, the European Union officially adopted the Corporate Sustainability Reporting Directive (CSRD), which updates the reporting requirements set by the pre-existing Non-Financial Reporting Directive (NFRD), expands the number of companies subject to the new regulation, and introduces an information audit system. Furthermore, to address the lack of transparency frequently expressed by investors and other stakeholders regarding the ESG rating criteria used by providers in their assessments, in July 2023, the European Commission adopted the European Sustainability Reporting Standards (ESRS), comprising 12 broad thematic fields associated with “hundreds of metrics and targets” (KPMG, 2023). Companies now must disclose the data, paying special attention to indicators on their impact on climate, pollution, water and marine resources, biodiversity, workforce, consumers and other issues.

While the EU is trying to move to a more definite and harmonized legal environment, the situation in the US appears quite scattered. Behbin et al. (2023)¹⁵ recently reported that a ESG disclosure rules for funds proposed last year by the US Security and Exchange Commission is still under review. Their analysis also indicates that ESG policies are highly fragmented, with 20 states having enacted “anti-ESG rules,” while “pro-ESG rules” (particularly related to investment prohibitions in specific activities) have been adopted in eight states.

According to Yu (2022)¹⁶, 29 countries worldwide have recently introduced regulations with mandatory ESG disclosure systems, including Malaysia, Singapore, the Philippines, and Hong Kong. In the case of the UK, companies with more than 500 employees are required to consider climate-related aspects and other social issues, such as impacts on employees and local communities, in their annual strategic reports.

Overall, the EU is particularly active and interested in developing a regulatory framework aimed at alleviating the confusion on the ESG issue perceived by many market players. The next section will examine the potential impacts of recent EU legal advancements in the ESG field, analyzing the different interests at stake and how they interact.

¹⁵ M. Behbin, E.S. Goldberg, R. Mann, A.C. McDonald, (2023), ESG investing regulations across the 50 states, Morgan Lewis, 21 July, <https://www.morganlewis.com/pubs/2023/07/esg-investing-regulations-across-the-50-states>

¹⁶ A. Yu (2022), The Global State of Mandatory ESG Disclosures, Convene, 28 July, <https://www.azeusconvene.com/articles/the-global-state-of-mandatory-esg-disclosures>

The impact of EU ESG regulation on companies and rating providers

According to KPMG (2023) estimates¹⁷, “starting from 2024, almost 50,000 companies are subject to mandatory sustainability reporting” and will have to comply with the new EU Corporate Sustainability Reporting Directive. As highlighted by Worldfavor (2023)¹⁸, the number of companies targeted by the EU CSRD represents 75% of the total EU companies’ turnover and is much larger than the number of legal entities (11,000) previously subject to the NFRD, amended by the CSRD.

It is reasonable to expect that the CSRD will also impact ESG rating providers that operate in EU territory. According to the European Commission (2023)¹⁹, 59 ESG rating provider companies currently operate in the EU, generating a turnover of EUR 300 million. However, the number of ESG data markets are expected to grow in the next years, “driven by the changing nature of risks to companies, by growing investor awareness of the financial implications of those risks and by the growth in investments products that explicitly seek to meet certain sustainability standards (*ibidem*).”

It is difficult to predict whether the CSRD will be effective at mobilizing resources toward green investments and setting widely shared standards and objective measurement tools, thereby providing investors and companies with greater clarity, transparency, confidence, and trust in how rating agencies calculate ESG scores.

A quite optimistic view is that companies with higher ESG ratings are already able perceived as more financially attractive: for example, a study conducted by Deloitte (2022)²⁰ found that “a 10-point higher ESG score is associated with an approximate 1.2x higher EV/EBITDA,” leading to the conclusion that “investing to deliver better ESG performance can drive value upside for a business beyond the associated net financial costs.” However, this kind of result could also be affected by what econometrics scholars label *endogeneity* or *reverse causality*, meaning that the observed relationship between ESG performance and market value can also be interpreted the other way around. According to the inverse view, a company has a good ESG rating because its market capitalization is

¹⁷ KPMG (2023), Get ready for the next wave of ESG reporting, <https://kpmg.com/xx/en/home/insights/2023/01/get-ready-for-the-next-wave-of-esg-reporting.html>

¹⁸ Worldfavor (2023), What is the EU’s Corporate Sustainability Reporting Directive?, <https://blog.worldfavor.com/what-is-the-eus-corporate-sustainability-reporting-directive-csrd>

¹⁹ European Commission (2023), Impact Assessment Report Accompanying the document Proposal for a Regulation of the European Parliament and Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities

²⁰ Deloitte (2022), [Does a company’s ESG score have a measurable impact on its market value?](#)

high. Indeed, this is the vision expressed by the manager of a UK government pension scheme as quoted in a recent article by Bryan (2023)²¹, clarifying that larger companies are more likely to interact with ESG rating providers and meet their data demands, thereby achieving higher ESG scores.

Against this backdrop, greater attention should be paid to creating more objective measurement standards and to the potential conflicts of interest that may arise from the relationship between rated companies and ESG rating providers. The European Commission (2023)²² also recognized this problem, highlighting that when “ESG rating providers rate companies and simultaneously offer paid advisory/consulting services to the same companies to improve ratings” significant distortions directly affecting the outcome of a company’s ESG performance assessment could result.

Overall, it is critical to monitor how the new EU CSRD will be implemented and the evolution of the interactions between rated firms and rating providers to avoid the risk of misleading ESG scores. Despite improvements in the ESG measurement tools, it is necessary to pay attention to structural factors, such as company size, market power, and financial resources, to create a business environment in which the ESG premium signals a company’s ability to produce environmental benefits rather than the outcome of an opportunistic relationship between rated entities and raters.

Aligning incentives. Which policy options for ESG investing and the ecological transition?

Notwithstanding recent regulatory efforts, especially in Europe, there appears to be increasing skepticism about the effectiveness of ESG investing to foster the transition from a fossil fuel to a decarbonized economy. The main reasons for concern involve the abovementioned measurement issues that make it difficult to accurately assess environmental and social performance and the mechanisms that are concretely at work in the context of financial markets. Increasing attention is also being paid to the inherent tension between the search for profits and sustainable management, conservation, and reproduction of natural resources, in line with the theoretical findings of Clark (1973).²³

²¹ K. Bryan (2023), ESG ratings: whose interests do they serve?, Financial Times, 3 October, <https://www.ft.com/content/fbe10867-fea1-4887-b404-9f9e301e102e>

²² European Commission (2023), Impact Assessment Report Accompanying the document Proposal for a Regulation of the European Parliament and Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities

²³ C.W. Clark (1973), Profit Maximization and the Extinction of Animal Species

The Economist (2022)²⁴ reported a fundamental contradiction that ESG investing practices are unable to solve: “unfortunately, it will often be more profitable for a business to dump costs, such as pollution, on to society than to bear them directly.” Therefore, “it falls to governments to reconcile the goals of profit maximisation and a safer climate” (*ibidem*) by adopting a policy mix including well-known and quite traditional measures, such as carbon pricing, Pigouvian taxes, mandatory standards, and disclosures rules.

Similarly, Pucker and King (2022)²⁵ stated that “the separation of profit and planet is by design” and the issue is not effectively tackled by current ESG investing activities. In their view, it is necessary to radically change the way green investments are promoted, moving “from input-based disclosures to outcome-based impacts” (*ibidem*). Concretely, they recommend adopting output-based forms of regulation that explicitly set specific goals in terms of emissions reduction and structural and technological change. In such a framework, public authorities are encouraged to abandon voluntary market-based policies and play a more active and central role, for example, by shifting to electric mobility and prohibiting environmentally harmful activities, as the Netherlands did when “capping flights from Schiphol airport at 12% lower than pre-pandemic levels” (Pucker and King, 2022). According to the authors, adopting this command-and-control approach would be faster and more effective at stimulating companies’ innovation to address climate-related problems.

Finally, an original solution to the trade-off between profit maximization and environmental protection has recently been hypothesized by Chen, Zappalà, and van der Beeck (2018)²⁶, who promoted “carbon quantitative easing,” a new, unconventional monetary policy. According to their analysis, traditional policies based on making companies internalize the social cost of their activities failed. Therefore, they suggested moving from fiscal to monetary policies by creating a new currency (Central Bank Digital Currency), sometimes referred to as carbon coin, that should be guaranteed by the main national central banks and would be used as a tool rewarding accountable efforts to remove carbon dioxide from the atmosphere. In their words, this new currency would “act as an international unit of account for carbon (i.e., 100 kg of CO₂-e mitigated)” (*ibidem*) and could be exchanged on financial markets. However, it is not clear what the price would be for each effort and intervention to remove carbon dioxide. Furthermore, in a recent interview with Delton Chen (DigFin, 2022)²⁷, the main carbon coin

advocate, “inflation is a deliberate outcome of the carbon reward; it is the price the world would have to pay for encouraging the private sector to make rapid

²⁴ The Economist (2022), The fundamental contradiction of ESG is being laid bare, 29 September, <https://www.economist.com/leaders/2022/09/29/the-fundamental-contradiction-of-esg-is-being-laid-bare>

²⁵ K.P. Pucker , A. King (2022), ESG Investing Isn’t Designed to Save the Planet, Harvard Business Review, 1 August, <https://hbr.org/2022/08/esg-investing-isnt-designed-to-save-the-planet>

²⁶ D.B. Chen, G. Zappalà, J. van der Beeck (2018), Carbon Quantitative Easing: Scalable Climate Finance for Managing Systemic Risks, https://globalcarbonreward.org/wp-content/uploads/2021/05/CLIMATE-RISK_Chen-Zappala-Beeck_Paper_V2.17.pdf

²⁷ DigFin (2022), Delton Chen’s carbon coin: from sci-fi to reality, 8 December, <https://www.digfingroup.com/delton-chen-carbon-coin/>

and radical changes.” Carbon coin could then be framed as a relevant injection of money to remunerate climate change mitigation efforts without increasing overall economic output, thereby generating inflation. In this light, it is difficult to imagine how this kind of solution could actually work and be applied.

Conclusions

The future of ESG ratings seems linked with the design of appropriate mechanisms for trustworthiness.

Transparency on prices and methodologies, a competitive market, good investigative journalism, and a system of penalties are factors that can contribute to ESG credibility. However, ESG's credibility is threatened by scandals (like the Sinoforest case of non-existent environmental assets) and fake ESG practices.

Finally, ESG rating could draw inspiration from the recent troubles in the larger market of financial rating agencies, showing the importance of avoiding revolving doors, conflicts of interest, short-term goals, and opportunist complacency.

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About ELF

The European Liberal Forum (ELF) is the official political foundation of the European Liberal Party, the ALDE Party. Together with 59 member organisations, we work all over Europe to bring new ideas into the political debate, provide a platform for discussion, and empower citizens to make their voices heard. Our work is guided by liberal ideals and a belief in the principle of freedom. We stand for a future-oriented Europe that offers opportunities for every citizen. ELF is engaged on all political levels, from the local to the European. We bring together a diverse network of national foundations, think tanks and experts. In this role, our forum serves as a space for an open and informed exchange of views between various EU stakeholders.

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