Intelligence MEMOS

From: Edward Waitzer and Damian Dupuy

To: Green Transition Watchers

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Re: **Most Carbon Reduction Measures Hurt Poorer People Most. Let's Fix It**

In evaluating courses of action, corporate decision makers tend to prioritize present and private benefits while discounting long-term costs – especially external ones imposed onto others. Economists term this "market failure," which is to be publicly regulated by way of taxation, fines, mandates, subsidies or other "nudges."

Such myopia is not unique to private actors, though. Politicians and public bureaucrats are typically more short-sighted, focusing on maintaining and expanding their power.

Regulatory agencies in the US, for example, are increasingly subject to political interference and, because they are specialized, are often incapable of addressing the cascading impacts of risks that spread within and across systems, sectors and societies. That can lead to systems collapse and potentially existential consequences.

This challenge is nicely framed by the current debates over responsibility for climate stewardship. Companies have been pushed to adopt climate initiatives – the movement to prioritize environmental, social and governance, or ESG, factors in investing – largely as a response to governments' lack of effective action over an extended period.

Part of the appeal of the corporate ESG "movement" has been its ability to circumvent the influence of lobbying and interest groups, which tend to stymie environmental efforts by governments. It has also benefitted from the rising influence of large institutional investors that are increasingly focused on trying to manage long-term systemic risks across the "universal" portfolios they necessarily own (in order to diversify market risks).

The movement appears to have led to measurable reductions in carbon emissions, particularly on the part of companies susceptible to influence by these large institutional investors. Mandated sustainability reporting will amplify that effect.

However, even if the ESG movement proves effective when governments fail to act, ESG implemented at scale will replicate the regressive effects of legislative interventions to curb global warming. That is, most carbon reduction strategies disproportionately impose costs on lower-income individuals.

For example, shrinking the fossil fuel sector will result in major job losses. Voluntary fuel efficiency standards penalize those buying used cars relative to those who buy new ones. Likewise, such standards for appliances or homes result in low-income households buying smaller homes.

Unlike governments, market actors have neither the ability to raise revenues that could be used to offset such regressive effects nor the incentive to make distributional adjustments. Moreover, while the odds of governments effectively offsetting the regressive effects of their own climate policies are low (consider the Canadian experience with a carbon price), the chances of them attempting to do so for policies implemented by the private sector are lower.

So, the fact that combatting climate change has largely fallen on the private sector has exacerbated inequality. How can we deal with one known risk without aggravating another? Are efforts to address rising economic inequality and global warming necessarily at loggerheads? Would it make sense to let private firms take the lead on emissions and for governments to try to ensure that the economically disadvantaged are not disproportionately burdened?

Given the incentives that motivate politicians, the challenges of measuring regressive effects and the aversion to committing fiscal resources to fund distributional initiatives, it's hard to imagine the country's leaders even attempting to mitigate effects they had no direct role in creating.

From this perspective, the recent anti-ESG backlash, which has caused politicians to sour on the movement, is predictable, with opponents seizing on job losses and increased energy costs for middle- and low-income voters. The same political forces and lobbyist campaigns that oppose climate stewardship by governments, leading to increased reliance on the private sector's ESG measures, are now causing politicians to object to and frustrate ESG-driven climate reforms.

By default, it will fall on governments to address such systemic societal failures – legislating to combat global warming and protect the poor (here and abroad) from bearing a disproportionate cost of such environmental reforms.

Some additional discipline in the private sector discipline may assist. To the extent corporate lobbying has proven a barrier to such action, institutional investors should be using their influence to remove the obstacles. In addition, mandating public disclosure of corporate lobbying expenditures would facilitate ensuring that portfolio companies' lobbying efforts are aligned with their pledges to protect the environment.

While markets generate wealth, and governments can incentivize corporations to take external costs and benefits into account, neither has proven adequate in guiding the behaviour of complex systems and helping us understand how best to mitigate and cope with increasingly inevitable crises. This is the compelling challenge of today.

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