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Sustainability Is Far More Than Just a Corporate Aspiration

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The increase in the number of Chief Sustainability Officers (CSOs) appointed in C-suites and of Sustainability Committees established in boardrooms suggests sustainability is being taken seriously at the highest levels of the modern corporation.

This seems heartening for those of us who have long believed in the merits of articulating the definition of corporate purpose, assessing multinational companies' impacts on economic growth, and observing up-close the functioning of backbone business sectors—energy and natural resources, infrastructure services, logistics, and advanced technology industries.

But a deeper review of how companies engage operationally in the practice of sustainability is far less promising.

This is confirmed by my experience serving as a senior executive over several decades. It is also confirmed by my more recent role working hand-in-hand with C-suites, corporate boards and outside investors in shaping their business decisions, as well as my own independent empirical research on how such decisions affect companies' operations and performance.

The fact is that at least inside "corporate America," there is an all too limited understanding of what sustainability implies *functionally*, whether in terms of the environment, society or corporate governance.

Many commercial enterprises today—whether publicly traded or privately held—view sustainability as an *aspiration, or at best a strategy*. Most often, sustainability is equated with firms' or investors' statements that they adhere to ESG (environmental, social and governance) or CSR (corporate socially responsible) principles.

The currently intensifying focus on firms' *disclosure* of ESG activities and the *standards* that should guide such reporting are certainly welcome.

But disclosure itself is not nearly enough; in fact, it misses the boat of what is ultimately meant by "sustainability".

Pursuit of sustainability entails undertaking *operational* decisions that lie at the core of a business's day-to-day functions that, *taken together*, serve to maximize the business's *long-run growth* as well as assessing their *impacts* on the firm's long run performance across an array of dimensions, both *economic and non-economic*.

The emphasis being placed on *taken together* and *long run* is key. Firms who are most effective operating sustainably are those who invariably and consistently make their decisions so as to maximize the long-run commercial *and* non-economic—that is, ESG-related—returns on the use of their assets, both human and non-human.

If one accepts these propositions, two key insights should leap out.

First, successful attainment of ESG and sustainability goals requires a fundamental understanding that ESG and sustainability are *not just matters of engaging in risk-mitigation but also of pursuing growth maximization*. In a word, corporate executives, board directors and, investors must think of ESG and sustainability initiatives as opening new doors of opportunities for *business growth,* not as constraints to abide by with as little effort as needed to fulfill them.

Second, true embracement of sustainability means that C-suites and boards carryout their missions through an *integrative* lens, one that cuts across a business' principal functions; its markets, both on the input and output side; and its geographic footprint. Thus the role of firm's Chief Sustainability Officer in the *C-suite* should be truly a *globally integrated* one—in every sense of the word.

So, too, should be the role of *boards'* Sustainability Committees, which, unfortunately, are seen as novelties. Indeed, we in the U.S. are far away (actually very far away) from an SEC requirement for public company boards to have directors who are "qualified sustainability experts" akin to the SEC rule for boards to have "qualified financial experts" engendered by the Sarbanes Oxley statute coming out of the financial crisis of 2007-8. While it may seem extraordinary for U.S. securities law to develop mandates for *non-financial* experts on boards, we may well soon see one for cybersecurity.

For those of us who are sustainability aficionados, the chosen term of art for the prism I'm describing is a form of "double materiality" — a concept first formulized in 2019 by the European Commission in its guidelines on non-financial reporting, especially with respect to climate-related information.

What Is Sustainability?

A large part of the problem is that most C-suite executives and board directors have only a scant understanding of sustainability. Many might talk the talk, but they do not walk the walk.

To the uninitiated, "sustainability" is usually thought of as a relatively new concept. But the notion of sustainability first entered the global lexicon in the 1980s, initially during a 1982 meeting of the United

Nation's World Commission on Environment and Development. The Commission was tasked to help remediate tensions between developed and developing counties over the balance between foreign investment that advanced economic development and the preservation of environment.

The term was then first formally articulated in the Commission's 1987 report, "Our Common Future." The Commission's Chair, Gro Harlem Brundtland, Norway's Prime Minister at the time, oversaw the drafting of this report. It indicated economic development that "is sustainable will ensure it meets the needs of the present without compromising the ability of future generations to meet their own needs."

These events happen to have coincided with my very first job as a freshly minted Ph.D. economist coming on board at Resources for the Future, Inc. (RFF), the entity that was the incubator of the field of "environmental economics." It was founded in the 1950s with a grant from the Ford Foundation following the recommendation by a blue ribbon commission championed by the U.S. President Truman.

My work at RFF focused on quantitatively estimating the *social costs* of oil production and consumption, as well as on assessing the differential impacts on economic growth from the development of natural resources between *advanced countries and emerging markets*.

Thus, for some of us, sustainability was our bread and butter decades before it became so fashionable.

In 2012, the UN formally developed quantitative indicators measuring annual progress across various dimensions of sustainability—economic, social, employment, health, infrastructure, demographic, environmental and political— on a country-by-country basis. These Sustainable Development Goals (SDGs) have been universally applied on a global basis ever since, with increasingly sophisticated and more carefully calibrated forms and nomenclatures. They are the "gold standard" in providing a rigorous basis on which to engage in empirical comparisons of sustainability among nation-states.

There are three important lessons here in the context of sustainability and business performance.

First, sustainability is not focused solely on the environmental impacts of a firm's operations. Its purview is *multi-dimensional*, requiring an assessment across a broad array of economic, social, structural, environmental and institutional (or policy-based) factors.

Second, and equally important, sustainability is, by definition, an *intertemporal* concept. In the commercial realm, this necessarily means the appraisal of sustainability is a question of the *durability* of business practices, the employment of *long-term time horizons* in decision-making and execution, and the *measurement of a firm's outcomes on a long-run basis* (e.g., multi-year profitability).

Third, analogous to the country-level SDGs, the development and utilization of firm-level *Sustainable Business Performance Goals (SBPGs)* would provide rigor to the debate about business's sustainability practices, especially evaluating how well companies fulfill their announced commitments to sustainability: think COP26. (For full disclosure, developing a methodology for constructing SBPGs, by firm, is an initiative that I have underway.)

Where Does Sustainability Fit In With Corporate Purpose?

Sustainability should lie at the *core* of enterprise management functions, business operations, corporate strategy and firm growth.

Properly seen, the CSO (as well as boards' Sustainability Committees) should be responsible for ensuring the drive for business sustainability is *company-wide* and based on a well-defined set of *objectives* . These include:

- maximizing the net value-added of the company's net *global assets* across all its functions; its markets (purchasing inputs and selling outputs) and its full geographic footprint;
- organizing and operating the firm's global supply chains (domestic and foreign) in an *integrated fashion* that mechanistically provide for the *full realization* of that value added; and
- ensuring that at the highest level of the enterprise, decisions are undertaken for the company to achieve its highest rate of *long-run growth*.

Achieving such objectives will require the CSO to work extensively with the both the firm's internal and external stakeholders (from employees to regulators) in order to produce an enabling ecosystem on a systemwide *basis*. Any aspiration a firm might have to be sustainable in one (or just a few) of its lines of business or in one (or a few) of its geographic markets is insufficient. Thus, achievement of sustainability is likely to be a complex undertaking.

It should not be surprising that the systemic integration of sustainability into the day-to-day operations of the modern corporation remains in its infancy—although, to be sure, in some firms and sectors, significant progress is being made. Understandably, as well, the *role of a CSO* (and the role of boards' sustainability committees) is still very much evolving.

The biggest barrier to further progress down this path is that sustainability is commonly viewed in only aspirational terms. Cast meaningfully, the role of the CSO must be seen as a *core* C-suite operational and strategic function of equal importance to any senior member of the C-suite save for the CEO.

What Is The Cost To Society of Companies Not Operating Sustainably?

There are challenges in using economically meaningful metrics to assess the impacts of sustainability on a business's bottom line. It is not enough to tally up only the *cost* of inputs, such as increased spending to introduce more environmentally benign production processes or salaries for hiring specialist personnel. There must also be an accounting of the *value* created by tangible outcomes, say, the rate of return on an investment that generates heat more efficiently or the economic multiplier effect from creating new jobs.

Critically, sustainability also means assigning values (whether negative or positive) on indirect and sometimes *intangible* outputs or outcomes of economic activity. Calculating the "social cost" of producing/consuming oil is an obvious example.

If the price paid at the pump for a gallon of gasoline is less than the full costs of the deleterious effects on the country's environment from producing and using (burning) that gallon of gasoline—what economists refer to as "externalities"— then the social cost of that gallon *exceeds* its commercial cost. Put another way, if the price for acquiring an item (or service) is too low to cover the *full* costs of producing the item (or (delivering the service) then is not a sustainable activity.

After all, if a firm is in a business where the revenues it receives do not cover its expenses, that firm would not last very long as a going enterprise and it will go bankrupt. The obvious solution in such circumstances is to *raise* the price paid by customers to *at least* cover costs.

In the case of gasoline, that is why European and other countries—though not the U.S. in any meaningful way—*add* surcharges (i.e., taxes) to the price individual drivers pay at the pump. That action brings about two outcomes: (i) it raises funds from which *public* transportation can be financed; and (ii) by making the effective price higher, it helps *reduce demand* for gasoline.

Closing the gap between the price and cost to eliminate the externality—and thus making an activity "sustainable" is referred to as "internalization." One thus might think of the process of companies changing so as to operate sustainability as the companies "internalizing their externalities".

How Can Companies Instill Sustainability Into Their Operations?

The bottom line is that if devised and executed adroitly, sustainability activities of a business create value for the corporation at its very core. This is far more than the generation of "goodwill". It is for this reason that a firm's CEO and CFO should be not only natural allies of a CSO, but his or her most ardent advocates.

It is also the case that the functions carried out by corporate officials or board directors responsible for sustainability initiatives are often ill-defined. Indeed, they vary greatly across industry sectors, company ownership forms, and geographies. The remit of Chief Financial Officers is fairly standardized. Yet, properly staffed and vested with the appropriate authority, Chief Sustainability Officers should—and will—have at least as much impact on a company's performance, particularly when it is gauged on a long run basis.

Unfortunately, sustainability, if not ignored outright, is too often considered a fad or relegated to a check-the-box obligation. As a consequence, attention to sustainability becomes one of lip-service.These findings might well tempt one to conclude that sustainability in fact is not important to the success of a commercial enterprise. After all, if it was, then more businesses would engage in actions that engender sustainability.

However, such a conclusion would be a significant methodological misjudgment for two reasons. First it would reflect ignorance of assessing the counterfactual—that is carrying out rigorous comparisons of the long run performance of firms who engage in sustainability operations versus those who do not. Indeed, that is the only way to evince systematically the differentials.

Second, it would belie what is actually meant by "sustainability." Indeed, as noted above, sustainability inherently defines what is meant by "success"—both its cross-sectoral and intertemporal dimensions.

To this end, in concrete terms one might think of the responsibilities of the ideal CSO as a *combination* of "Chief Long-Run Growth Operations Officer," "Chief Corporate Strategy Officer," "Chief of ESG and CSR Strategy and Execution," and "Company-wide Integrator-in-Chief."

The Challenges CSOs Face

The business literature on the impact CSOs have on corporate performance is beginning to grow—but it is still relatively nascent. Not surprisingly the bulk of the research carried out is on publicly traded companies, due of course, to the relative ease with which to gather data on these.

One set of findings focuses on CSOs seemingly having greater impact on reducing activities that have deleterious effects on sustainability rather than increasing efforts that promote sustainability. This is not surprising given that the attention of business executives, boards of directors, the market and the public readily gravitate towards readily understandable (and often more visible) harmful economic and social matters than those that are beneficial. The result is CSOs may well have a natural inclination in such situations to go for the "easy wins" first.

Another result is that CSOs tend to be more effective in carrying out their missions when the boards of their companies either have standing Sustainability Committees or at least have directors who are vocal champions of sustainably.

Questionable results also pervade the business literature on sustainability. For instance, findings concluding that because there is a positive correlation between pollution and the presence of CSOs in companies in high pollution industries, CSOs can be not only ineffective but also may actually perpetuate harmful activities of their companies. Putting aside whether or not a particular CSO is or is not effective, conclusions like these fundamentally confuse correlation with causation. Most undergraduates learn this in Statistics 101.

The same goes for findings "concluding" that when companies face external regulatory pressure, they are "much more likely" to engage in a higher degree of sustainable behavior compared to that arising when there is the presence of a CSO. The meaningfulness of such a conclusion critically depends on whether or not there is an assessment of the counterfactual and the extent to which such a "finding" is evident across an array of different industry sectors.

There is an argument to be made that if CSOs have a full remit, especially from both the CEO and the board to discharge their functions, their intimate knowledge of how the firm actually operates could allow them to work with regulators to craft "smart" regulation that better aligns the long run interests of the firm with those of external stakeholders. It's better to have someone who understands the interests of both the business the regulators. To be sure, sometimes the more-often sought litigious strategy is called for. But seen through the long-run, multidimensional prism of the firm's goal of sustainability, there can be more effective uses of shareholders' equity.

Perhaps the greatest challenge to the execution of a corporate sustainability strategy arises in public traded companies, especially those listed on U.S. markets. Current U.S. corporate financial disclosure regulation creates strong financial disincentives for companies' C-suites and boards to adopting a longer-term perspective that could otherwise sustain strong company economic performance beneficial not only to shareholders but also to vast portions of companies' overall stakeholders. The Securities and Exchange Commission's (SEC's) requirements for quarterly disclosures causes stock market analysts and investor groups, including shareholder activists, to form myopic judgments about how public U.S. companies are performing every three months.

The impact on the attention span of C-suites and boardrooms to broader matters concerning companies' health is palpable. Every quarter companies issue artfully worded press releases as to whether or not their financial performance met "consensus estimates" made by stock analysts. It is a full-time job for corporate investor relations officers.

A three-month period is an excessively short period to meaningfully assess the results of changes in corporate policies, management moves, the introduction of new products and services and so on. It certainly does not create the most inviting environment for sustainability, not to mention rapid growth and innovation—activities that require patience and long-run investment. Yet those are the attributes that have made American companies the envy of the world. Historically, that is.

The present day is a different matter. An increasing portion of the globe's advanced democratic economies, including a swath of Americans themselves, are concerned that the world's erstwhile innovation pace-setting firms are less likely to be those headquartered in the U.S. Without making a definitive judgment about that hypothesis, it is worth noting that in comparison to the frequency protocols for financial reporting required of public companies domiciled in other economic democracies, the U.S. is a significant outlier.

In 2013, the EU issued a directive allowing for semiannual reporting and making quarterly reporting optional for companies in its 28 member states. Semiannual reporting is also the norm for Australia and New Zealand. Currently, other than the U.S., other major economic democracies that currently abide by quarterly reporting include: Canada, Mexico, Japan, and South Korea. That's it.

To the credit of President Biden's immediate predecessor, in 2018 Mr. Trump asked the SEC to consider changing its reporting requirements for U.S. public companies to a semiannual basis. The SEC demurred doing so based on comments it received from the public. Paradoxically, while major players in the investment community such as Berkshire Hathaway's Warren Buffet, BlackRock's Larry Fink and JP Morgan's Jamie Dimon all supported making the change, smaller investors were less in favor of doing so, arguing less frequent reporting would intensify market volatility and reduce transparency. If Mr. Biden is a real believer in large U.S. corporations pursuing sustainability, he would be wise to meet with Gary Gensler, his recently installed SEC Chair, and push for rapid passage of this change in policy.

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The Covid19 pandemic, the increasingly palpable impacts of global warming, and the continued economic rise of China, with its statist drive for domination in advanced technologies, all present the U.S. with an arguably unique combination of significant economic, environmental, social, and health risks.

American industrial ingenuity has generally served our population well for decades, in no small way because we kept a steady focus on enhancing our long-term prosperity. The successful continuation of that strategy today requires our businesses, shareholders, workers and customers to embrace sustainability as a core component of the purpose of the modern corporation and the goal that should guide our business' decisions and operations. In short, sustainability should pervade the most salient activities of U.S. firms.

If C-suite executives, board directors, and investors relegate sustainability to an *aspiration* of the corporation rather than embrace it as its *core operational mandate*, then they do not understand what it takes to drive—indeed maximize—the company's long-run return on capital.

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