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Global Perspectives on ESG and Implications for Korea

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I. Introduction

ESG, which stands for Environmental, Social, and Governance, has gained significant importance in recent years. Adoption of Paris Agreement and Sustainable Development Goals and efforts to recover from COVID-19 have contributed to this global trend. Businesses and regulators are now placing more emphasis on the sustainability of economic activities and transparent disclosure of ESG information. In light of this, our study focuses on examining global ESG policy trends and supply chain due diligence regulations. We also compare ESG scores of firms across major countries and analyze the impacts of ESG performances on employment and productivity. Based on our findings, we aim to provide recommendations and implications for the government and private sector to address ESG in practice.

II. Global ESG Policy Trends

ESG regulations and policy measures include mandatory or voluntary disclosure, regulations on ESG funds, sustainable finance strategies, stewardship code and taxonomy. The European Union plans to implement the new Corporate Sustainability Reporting Directive which requires more companies to report detailed sustainability information from fiscal year 2024. Moreover, the EU aims to improve an ESG ecosystem by introducing plans and strategies to foster sustainable finance as well as the EU taxonomy for environmentally sound economic activities. Recently, the United States' Securities and Exchange Commission has also made efforts to strengthen disclosure regulations, especially for climate-related information and prevent greenwashing of ESG funds. Asian countries including Korea are also placing increased emphasis on voluntary or mandatory ESG-related information disclosure provisions and guidelines.

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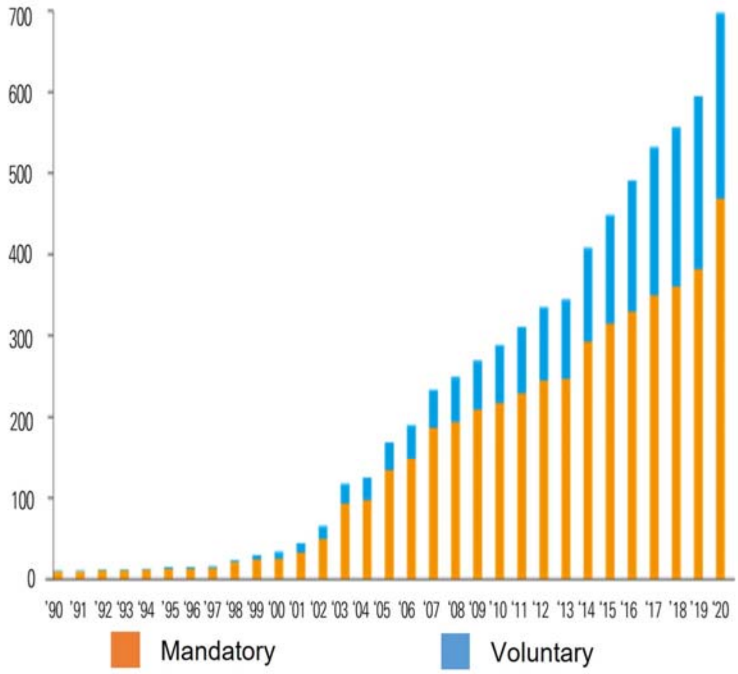
Figure 1. Number of Global ESG-related Policy Measures/Regulations



Source: PRI. 2021. Regulation database update: the unstoppable rise of RI policy.

Both companies and governments should consider main issues and challenges to ensure economic and social sustainability. First, it is necessary to integrate various disclosure standards and establish internationally accepted common standards to improve the consistency and comparability of ESG information. Next, the small and medium-sized enterprises (SMEs) face difficulties to adapt to the changing landscape of ESG, including data disclosure and due diligence requirements, due to their limited resources and capabilities. In addition, enhancing the quality of ESG information is crucial, as it serves as the basis for decision-making by all stakeholders in the ESG ecosystem. Finally, it is important to consider the various factors that determine the sustainability of corporate activities in a balanced manner so that ESG discussions and systems are not overly focused on specific areas.

III. Supply Chain Due Diligence Regulations and Key Issues

In 2022, the EU Commission adopted a 'Proposal for Directive on Corporate Sustainability due Diligence' which requires companies to integrate due diligence into management policies and prevent potential adverse impacts caused by their business activities. The EU's supply chain due diligence proposal is based on existing guidelines and principles made by international organizations such as the UN, OECD, and ILO. Recently, EU member states, the United States and other countries have also proposed or enacted their own due diligence laws on human rights. Unlike other regulations which mainly focus on due diligence of human rights, the EU's proposed rule stipulate obligations for ESG as a whole. This proposal can affect not only directly regulated companies but also domestic and foreign companies with direct and indirect business relationships, making it a significant issue in terms of managing the global supply chain.

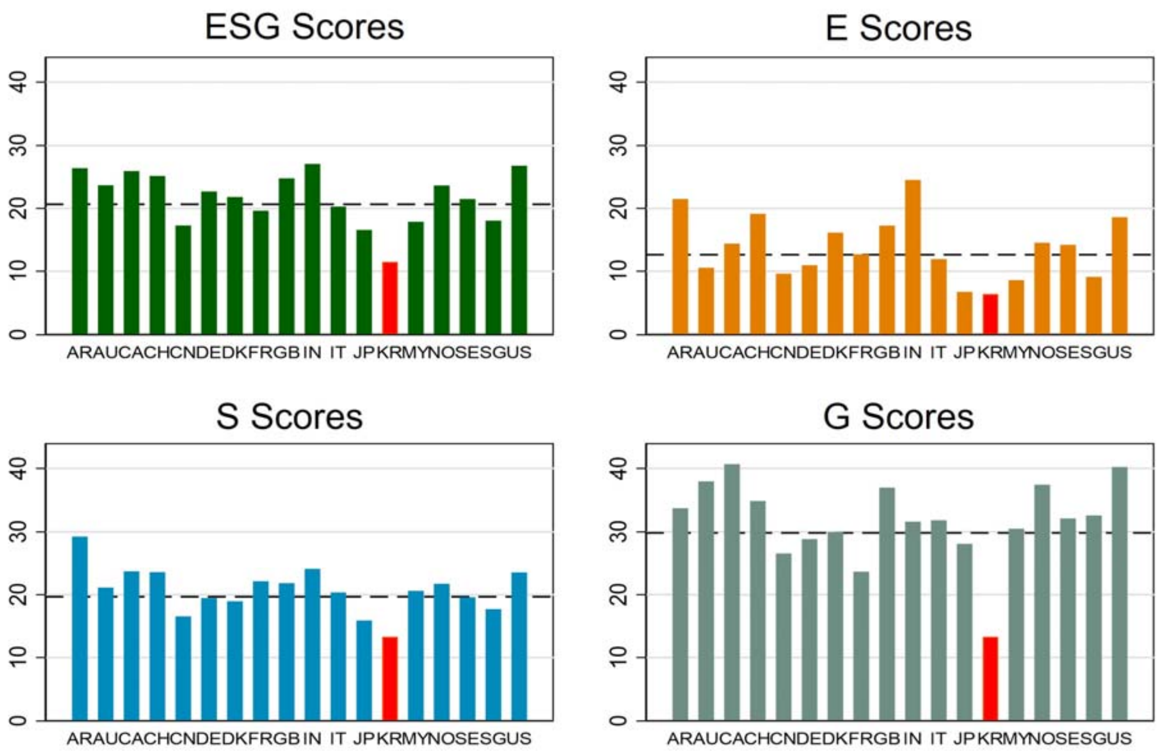
While the EU supply chain due diligence regulation is pending approval by parliament, there are differing opinions among stakeholders on regarding the inclusion of climate change and governance issues within due diligence procedures for the supply chain. There is also a lack of consensus on which tier of suppliers is subject to due diligence. Besides the EU, as increasing number of major economies such as the United States, Australia, and Canada has established similar regulations, it is more likely for corporates to face higher compliance cost. This changing regulatory environment might act as de facto barriers to market entry. In this context, the Korean government has also recently enhanced its supports to help corporates meet global due diligence requirements on the supply chain. However, except some large-sized global companies, majority of the industry shows low level of interests and alertness regarding this matter.

IV. Cross-country Comparison of ESG Rating Scores

In this study we conducted a comparison of the total ESG score across 18 countries, including Korea, using ESG rating scores complied by Moody's, one of the most well-known ESG rating agencies. Unlike other rating agencies that only evaluate large companies, Moody's provides prediction scores for small and medium-sized companies that lack ESG data and thus cover most listed and externally audited companies in Korea. Our empirical analysis reveals that Korean companies' scores in 2021 lag behind in all areas (ESG/E/S/G) when compared to 17 high-income countries and major Asian countries. The scores remain low even after controlling for companies' financial characteristics and industry fixed effects, especially in the G area.

Specifically, the average of Moody's ESG scores in the 18 countries is 20.7 points, with average scores of 12.7 for E, 19.7 for S, and 29.9 for G. In contrast, ESG, E, S, and G scores of Korean firms are 11.5, 6.5, 13.3, and 13.3, respectively. Considering that financial characteristics and industrial distribution of companies vary across countries, the difference in scores may have contributed to the low ESG score regardless of corporate characteristics. However, even when comparing only companies sensitive to ESG evaluation, such as major listed companies and large companies, the ESG performance of Korean companies is relatively low. This finding is consistent when using Refinitiv scores, another global ESG rating agency.

Figure 2. ESG Scores of Selected Countries



Note: Dotted horizontal line shows the average score of selected 18 countries.
Source: Author's calculation using Moody's data.

V. Analysis of ESG Evaluation and Firm-level Economic Performances

We further examine how ESG evaluation affects firm-level employment and productivity growth. The correlations between the explanatory variables (environmental, social and governance scores) and the dependent variables (employment growth rate, labor productivity, and total factor productivity) were positive in general, except for the case of employment growth rate, regardless of time lag in the explanatory variables. However, in our panel regression analysis that includes control variables, there were many cases where no effect or a negative effect was observed. The common conclusions gained from the panel regression analysis can be summarized as: (1) governance scores reduce employment growth rate in the non-manufacturing sector, (2) environmental scores negatively affect labor productivity growth in all industries, and (3) environmental and social scores improve total factor productivity growth in non-manufacturing sectors. For the overall score, no common conclusion could be found between the model with the lag and the model without.

Given that ESG activities mainly provide information to investors through disclosures in the capital market and encourage companies to pursue long-term sustainability, it is not easy to identify a visibly positive effect on corporate productivity or employment growth in the short run, which generally requires more time than financial performance. On the other hand, the positive effect on productivity in some literature studying cases for the advanced economies may reflect the fact that their ESG activities were established earlier than ours. Compared to these economies, Korea has only recently begun fully embracing ESG activities. Therefore, instead of interpreting these results as a negative effect of ESG activities, it would be more appropriate to approach and interpret them from the perspective of incurring current costs to contribute to the long-term sustainability of society, businesses, and market participants.

VI. Policy Implications

ESG is everywhere. It has become a standard for sustainable economic activities. Based on global trends and domestic conditions as we analyzed above, this study provides policy implications as below. First of all, Korean government need to focus on reviewing and revising the institutional and regulatory infrastructure to encourage voluntary efforts by companies and investors, rather than imposing compulsory requirements on ESG-related activities. When providing non-financial information reporting guidelines, it is necessary to ensure the autonomy of the private sector by adhering to the minimum standards when possible. In addition, the government should identify what particular policy support is needed for SMEs participating in global supply chains who are potential subjects to the due diligence obligation. Regulators should also consider measures to prevent and address greenwashing or ESG-washing practices. In order to internalizing sustainability into a society, government should play a vital role in improving fundamental socioeconomic conditions such as creating safter workplaces and sound labor-management relations.

It is necessary to continuously monitor and actively participate in discussions on international supply chain regulations, focusing on the currently proposed EU's supply chain due diligence directive, and to strengthen the supply chain due diligence support system for SMEs. In particular, in the case of the EU supply chain due diligence regulation, both government and private stakeholders should closely monitor the discussion and approval process. As increasing number of countries have discussed or enacted supply chain due diligence regulations, not only domestic companies but also foreign companies and suppliers may have direct and indirect impacts. Thus, in-depth research on the potential impacts on the Korean industry and companies due to these regulations is needed. Moreover, it is essential to proactively participate in international trade cooperation related to supply chain due diligence that may be discussed in the future as well as supporting response efforts by firms.

Considering the fact that ESG scores of Korean companies are relatively lower than other major economies and also only a limited number of Korean companies are evaluated by global ESG rating agencies, governments and companies need to make great efforts to address these issues. First of all, the government could actively inform major institutional investors and ESG rating agencies of the progress both government and businesses have made to promote ESG activities. Companies also need to inform investors and the general public of their efforts to improve non-financial performance using various communication channels such as sustainability reports or ESG information disclosures.

Finally, the government's support should prioritize SMEs participating in global supply chain and potential subject to due diligence. Although current ESG ecosystem is mainly shaped and determined by large-sized global companies, sustainability issue might affect the SMEs' financial and non-financial performance in a longer term. Given the difficulties faced by SMEs in integrating ESG into their business operations, the government and related agencies should provide financial support, consulting services, and ESG training for professionals. KIEP