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The impact of sustainability governance, country stakeholder orientation, and country risk on environmental, social, and governance performance

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ABSTRACT

This study examines how the governance of sustainability projects as collaborative, in-house, or outsourced projects, affects corporate environmental, social, and governance (ESG) performance. Hypotheses are developed that collaborative sustainability projects achieve the greatest levels of ESG performance, followed by in-house projects, and then outsourced projects. Furthermore, moderating hypotheses hold that these relationships are affected by two country-level variables: country stakeholder orientation and country risk. Using hierarchical linear modeling and regression analysis, with data from the Sustainalytics and Bloomberg ESG databases for 459 firms in nine countries, support was found for the comparative impacts of sustainability governance on ESG performance. Namely, collaborative governance produced the greatest ESG performance benefits, followed by in-house and outsourced as hypothesized. Country stakeholder orientation generally increases these effects; however, the country risk hypotheses are not supported. This study contributes to the literature by demonstrating that all forms of sustainability governance can improve ESG performance; however, the degree to which each one contributes to ESG performance varies. In addition, institutional context clearly matters, because countries where a high stakeholder orientation exists appear to facilitate the implementation of in-house, outsourced and collaborative sustainability initiatives.

1. Introduction

In recent years, environmental, social and governance (ESG) performance has emerged as an important dimension for developing sustainable strategies that affect overall firm performance (Eccles and Serafeim, 2013). In fact, the relationship between ESG performance and financial performance has been studied extensively (Waddock and Graves, 1997; Surroca et al., 2010). However, the dependent variable in most prior research at the intersection of sustainability and strategy has been financial performance, rather than ESG performance. According to Ortas et al. (2015), empirical studies of how corporate social responsibility (CSR) initiatives contribute to overall firm-level ESG performance are scarce. Although some initial work has examined the advantages and disadvantages of different ways of organizing sustainability initiatives, for example, in-house, outsourced, and collaborative projects (Husted, 2003; Bhanji and Oxley, 2013), which this study refers to as sustainability governance, very little research has examined the ESG performance of different sustainability governance mechanisms comparatively. Such a perspective would be useful to practitioners as they make decisions about how to organize their sustainability initiatives.

CSR or sustainability initiatives encompass the policies, practices, and projects that firms use to meet their perceived obligations for the social good (Matten and Moon, 2008), which refers to “that which enhances well-being for the earth and its living organisms” (Brickson, 2007: 866). ESG performance simply refers to the actual outcomes and impacts of these CSR initiatives. ESG includes corporate governance, following the triple-bottom line approach, to ensure that appropriate corporate governance measures and practices are in place so as to avoid corporate decisions that could harm the firm's investors (Campbell, 2007).

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In order to examine the impacts of sustainability governance comparatively, this paper builds on the resource-based view of the firm (RBV) to examine the resources and capabilities that the firm uses in order to "achieve the maximum social benefit from a limited amount of resources available for social projects" (Pearce and Doh, 2005: 31). Although each of these forms of organizing sustainability initiatives should increase ESG performance, collaborative projects between the firm and its stakeholders should create the highest ESG performance compared to in-house or outsourced initiatives (philanthropy) because they represent the best way to bring to bear a range of resources and capabilities beyond those of the firm to solve the complex problems that sustainability presents for the firm (Pearce and Doh, 2005; Formentini and Taticchi, 2016).

Beyond these initial propositions, the paper also explores the impact of the institutional context on these relationships. Prior research finds that for CSR, institutional context (social, political, cultural and economic) has a strong influence on firm behavior (Abreu et al., 2012; Brammer et al., 2006; Ioannou and Serafeim, 2012; Ortas et al., 2015). So, in order to understand the relationship between sustainability governance and ESG performance, it is necessary to consider institutional context. Specifically, two dimensions of institutional context may affect these relationships: country stakeholder orientation (Dhaliwal et al., 2012) and country risk (Rodríguez et al., 2014). These specific dimensions of institutional context are particularly relevant to the translation of sustainability initiatives into improvements in ESG performance because they affect the support that stakeholders in a given country will provide for such initiatives.

In the case of country stakeholder orientation, greater stakeholder orientation should increase the impact of sustainability governance on ESG performance due to the greater legitimacy accorded to such activities and the consequent ability of firms to obtain resources and support for the effective implementation of sustainability initiatives (Dhaliwal et al., 2012).

For country risk, the logic is quite different. Country risk refers to the "likelihood that a sovereign borrower will default on its debts" (Cosset and Roy, 1991: 135). Such risk is due to fiscal policies of a nation in terms of the ratio of foreign debt to exports (Cosset and Roy, 1991). Political instability is an important component of country risk as it relates to "a government's willingness to service debt payments" (Citron and Nickelsburg, 1987: 392). As country risk increases, the impact of sustainability governance on ESG performance will decrease due to the greater uncertainty faced by equity investors, creditors, and managers and the lower patience they will have for sustainability initiatives that often have long-term impacts. Given the lower patience for long-term returns from sustainability investments among these key stakeholders, firms will tend to implement more limited forms of sustainability initiatives with short-term returns, if any (Rodríguez et al., 2014).

Using hierarchical linear modeling and a fixed-effects regression analysis with a three-year panel using Newey-West robust standard errors, the results find support for the proposition that the three types of sustainability governance do improve ESG performance, but in varying degrees. Furthermore, institutional context clearly matters in terms of country stakeholder orientation. Although these results provide preliminary support for most of the hypothesized effects, they must be taken with caution given the imperfect nature of the proxies used to represent sustainability governance as well as the limited nature of the panel.

The paper is structured as follows. In the next section, the theoretical approach is introduced and hypotheses are developed. The research method for the empirical analysis is presented, and then the results, which are generally supportive of the approach. Finally, the last section includes the conclusion and discussion of the theoretical and practical implications of this study.

2. Theory and hypotheses

Recent studies have operationalized the concept of sustainability performance by explicitly including the environmental, social, and governance dimensions of corporate performance (Nunes et al., 2016; Ortas et al., 2015; Rahdari and Rostamy, 2015). Environmental performance refers to the use of good environmental practices, such as implementing pollution control measures, making environmental investments, and setting environmental policies. Social performance refers to community investment, internal social policies such as equal employment opportunities, and other social aspects related to internal and external stakeholders. Governance performance refers to the use of good corporate governance practices, such as the separation of the CEO and board chair roles and diversity in board membership, which assure that firms make decisions in the interests of their stockholders. For ease of exposition, sustainability performance is referred to as ESG performance, which encompasses the full range of environmental, social, and governance outcomes. ESG performance increases as any one of its three dimensions improves, holding the others constant.

The relationship between the social and environmental dimensions of ESG performance has been developed in the literature (Abreu et al., 2012; Nunes et al., 2016). Although the interaction of the governance dimension with the first two has received less attention, its importance is growing. Minimally, sustainability and social responsibility require that firms do not sacrifice the welfare of any stakeholder group, including stockholders (Campbell, 2007). Beyond this minimal requirement of protecting stockholders, as opposed to non-shareholding stakeholders, corporate governance discussions have shifted progressively toward contemporary social and environmental issues (e.g., climate change, labor rights, and corruption) that matter to corporate stockholders, managers, and other stakeholders (Walls et al., 2012). This relationship can be seen concretely in terms of corporate practice. For example, about 25 percent of Fortune 500 companies have a board committee overseeing the natural environment; the number of investor proposals related to the environment nearly doubled between 2004 and 2008; and many corporations have begun to include social responsibility criteria in executive compensation (Walls et al., 2012).

Furthermore, the interaction between environmental (low emissions, carbon management, waste management etc.), social (labor practices, community development etc.) and governance (board independence, board diversity etc.) performance can generate synergistic results. Considering the specific ESG practices for each company they studied, Eccles and Serafeim (2013) found a positive relationship between ESG performance, innovation, and financial performance.

2.1. Making, buying, and collaborating for sustainability

Sustainability projects deal with projects designed to reduce the negative impacts of firm activity on third parties and to increase the positive benefits for such parties without sacrificing stockholder welfare. These projects may be organized in three alternative ways: as internal, in-house projects, as external contributions (i.e., outsourcing), or as collaborations (Husted, 2003). The resource-based view of the firm (RBV) provides an appropriate way to analyze how specific governance mechanisms reduce costs and permit the capture of rents (Hart, 1995). Using the RBV, each form of sustainability governance is examined in relation to its ability to improve ESG performance. This section begins first with in-house projects in order to compare the ESG performance of outsourced projects and collaborative projects in relation to this baseline. Then, the moderating effects of institutional context on these