Research on the Incentives and Restraints of Governmental Policies on Corporate ESG Performance

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Abstract: The emergence of ESG (Environmental, Social, and Governance) represents an application of Sustainable Development Goal (SDG) in the realm of business, which can motivate companies to integrate their economic profits with social responsibilities. In the process of implementing ESG principles, government macroeconomic regulation plays a significant role. This essay will pay attention to the influence of public policies made by governments, including incentive policies and regulatory policies, on corporate ESG decisions and performance with the method of qualitative research. It can be concluded that these two policy types can respectively guide or regulate environmental, social, and governance behaviors, and that the integration of incentive and regulatory policies can create a framework enabling companies to holistically enhance their ESG performance through a combination of internal motivation and external oversight.

Keywords: ESG, incentive policy, regulatory policy, sustainable development

1. Introduction

ESG (Environmental, Social and Governance) has become an important approach to businesses that seek to go beyond only maximizing profits [1]. ESG assessments, established by businesses and non-profit organizations, evaluate a company's performance on environmental, social, and corporate governance issues, which is a framework for thinking more comprehensively and, therefore, more accurately about the risks and opportunities that firms face over short, medium and longer time horizons and how these may impact firm performance [2].

Integrating corporate governance with environmental protection and social responsibility has become a shared consensus across the world. The ESG assessment provides a powerful tool for visualizing the effectiveness of corporate social responsibility practices. Currently, the majority of ESG research primarily concentrates on the interpretation of ESG assessments [2], the impact of ESG performance on corporate outcomes [3], and the influence of corporate ESG performance on investment and financing decisions [4]. As a novel evaluation framework, ESG not only fulfills its function within individual companies at the microlevel but also necessitates a response from governments from a macrolevel perspective. Effective public policies from governments will help to improve corporate ESG performance in a stable and sustained manner, thus promoting the long-term sustainability of enterprises. Consequently, investigating the influence of public policies on companies' ESG performance and exploring how these policies can serve as a long-term catalyst for ESG development are both timely and of significant practical importance. This essay will adopt a qualitative approach, first briefly illustrate the theoretical foundation on ESG itself and on how public

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policies affect corporate ESG performance, and then categorize public policies into incentive and regulatory to analyze the pathways and effectiveness of how these two different policies can provide an effective framework for government intervention to improve corporate ESG performance.

2. Theoretical Basis for Government Intervention

From the perspective of ESG itself, the sustainable development theory, the theory of economic externalities, and the corporate social responsibility (CSR) theory together constitute the theoretical foundation of ESG evaluation framework that helps to understand the way government public policies exert external influence on corporate ESG performance. In addition, the regulatory theory focuses on the impact of macrolevel governance on microeconomic enterprises within the market, also offering a theoretical reference for studying the effects of public policies on corporate ESG performance.

The sustainable development theory advocates for creating a balance between the economic development and the natural environment in order to achieve a virtuous cycle of social development. The core idea of this theory embodies the concept of inclusive development, which calls for a balanced approach to social, economic, and environmental sustainability [5]. The theory of economic externalities describes the non-market impacts of economic activities on others and the whole society, and it can be further classified into positive externalities and negative externalities. To maximize the positive influence on corporations, industries, society, and the environment, appropriate government intervention and regulation of market behaviors are necessary. Finally, the corporate social responsibility theory emphasizes the connection between the corporate social responsibilities and the obligations of business leaders to meet various human needs within and outside industries [6]. Except for shareholders and employees, companies should also be responsible to consumers, communities, and the natural environment. The shift from shareholder primacy to stakeholder priority lays a solid foundation for the widespread adoption of ESG principles, and encourages companies to pay more attention to environmental, social, and governance issues, balancing both corporate profitability and societal well-being [5]. In the fulfillment of corporate social responsibility, the government plays an important role as both a guide and a regulator.

Different from the three theories above that describes ESG itself, the regulatory theory examines how governments exert public authority to formulate rules that restrict the behavior of individuals and organizations in the market. To be more specific, the government regulation refers to the actions taken by legally empowered government agencies to administer and supervise microeconomic entities. The central goal of the regulation is to correct market failures and protect public interests. Through the implementation of public policies, which can be further delineated into incentive and regulatory measures, governments can affect corporate behavior to ensure companies' compliance with laws and regulations, as well as the fulfillment of their social responsibilities.

In the context of ESG principles, they reflect the expectations of external entities, such as society and government, for companies to assume greater environmental and social responsibilities, as well as the desire of investors and other stakeholders to influence corporate decisions through governance mechanisms. Those external expectations require companies to incorporate ESG issues into their operations, and companies have to comply to them. On the contrary, the relationship between stakeholders and companies is similar to be contractual, where companies balance stakeholder interests within the framework of corporate law [7]. Companies usually show strong willingness to align the interests of various social groups in order to achieve the most profitability. In this sense, by promoting incentive policies, governments can arouse companies' desire to practice ESG principles in the process of making profits, while companies can be restricted not to do things harm to ESG principles through regulatory policies made by governments. Both types of government policies influence corporate ESG performance in distinct ways, and governments often combine both incentive and regulatory policies in practice to comprehensively affect corporate ESG practices. This

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dual approach can stimulate companies to proactively address economic, environmental, and social concerns while simultaneously preventing potential negative behaviors during the implementation of ESG strategies.

3. The Incentive Policy in Corporate ESG performance

The incentive policy usually encompasses financial subsidies, tax reductions, technical support, preferential market access, etc., and all of them can be viewed as inclusive and competitive diversified policy tools [8]. Governments tend to select different incentive policies or a combination of several policies based on factors such as a company's market positioning, internal structure, and business objectives, which can alleviate companies' operational pressures, enhance their enthusiasm for ESG actions, and encourage them to voluntarily integrate ecological protection and social responsibility into their production processes.

To attract corporate attention to environmental protection, governments often adopt tax relief, green subsidies, and improve market mechanisms to encourage companies to reduce emission, promote technological innovation, and strengthen product development. Tax relief includes lowering tax rates, exempting certain taxes, or allowing environmental expenditures to be deducted from taxable income, while green subsidies, on the other hand, involve direct financial support from the government. Through the combination of tax relief and green subsidies, companies can not only reduce the financial burden of implementing environmental projects, but also invest funds into the research and development of eco-friendly technologies, clean energy, and energy-efficient equipment. A notable example of such policies is China's Carbon Emission Trading System (ETS). In this market, the government allocates carbon emission quotas to enterprises. Apart from using their quotas, companies are incentivized to sell the carbon credits they save on the market, thus diversifying their revenue streams. At the same time, the government also rewards companies that adopt low-carbon technologies in the form of financial subsidies, tax relief, and preferential loans. By integrating fiscal subsidies, policy incentives, and market mechanisms, enterprises show great willingness to reduce carbon emission and promote technological innovation in order to protect the environment and further make more profits, which is beneficial for facilitating the corporate transformation and ecological restoration at the macrolevel.

Apart from the environmental domain, the incentive policy also significantly improves corporate performance in fulfilling their social responsibilities. The social dimension of ESG emphasizes that businesses should take responsibility for a range of stakeholders, including employees, consumers, and the entire society, instead of only serving shareholders. It requires companies to protect legal rights and interests of workers, guarantee product quality and safety, and enhance their sense of social responsibility to maintain social harmony and fairness in the pursuit of economic benefits. Moreover, by instituting social incentives, offering governmental subsidies, and alleviating taxation in pertinent sectors, governments motivate corporations to proactively engage in public initiatives, and focus on employee welfare and supply chain oversight, thereby enhancing their social performance from both internal and external standpoints. For instance, the Indian government used to establish the National CSR Awards to recognize companies that have demonstrated outstanding performance in participating in philanthropic activities and social causes. In terms of employee welfare, the Swedish government enacts a series of tax policies to encourage businesses to provide high-quality benefits for employees, such as extended paid parental leave and employee wellness program, which can also increase job satisfaction and loyalty of employees. Such incentive policies at the level of corporate social performance help enterprises fulfill their social responsibilities, as well as create a more competitive brand image and alleviate labor disputes within enterprises.

Through incentive policies, governments guide companies to shift from a shareholder-centric value to one that maximizes shared value among all communities, which means paying more attention

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to balancing economic, social, and environmental benefits. This approach further encourages companies to optimize their governance structure. For instance, in the United States, companies like JPMorgan Chase have pledged to include more stakeholders through their participation in business roundtable initiatives, which wins the support from government incentive programs. Similarly, Norwegian Sovereign Wealth Fund, or Government Pension Fund Global, offers investment rewards to companies with superior governance structures in order to encourage them to include employee representatives and consumer protection advocates on their boards. These incentive policies drive companies to focus more on the interests of various stakeholders, making corporate decision-making more inclusive, transparent, and efficient.

In conclusion, the incentive policy from the government is targeted at guiding enterprises to voluntarily take actions in specific fields through various ways like financial subsidies, tax preferences, technical support, and sound market mechanisms. Through incentive policies, companies are willing to protect the natural environment, shoulder social responsibilities, and enrich the diversity of the governance structure, ultimately improving their ESG performance and achieving long-term development.

4. The Regulatory Policy in Corporate ESG performance

The regulatory policy refers to management measures implemented by governments or other authorities in the form of legislation, administrative orders, or industry standards, which can set clear restrictions and requirements on business operations. These policies are typically mandatory, and the non-compliance will result in legal penalties, financial sanctions, or reputational damage. Compared to the incentive policy, the regulatory policy is rooted in legal and administrative commands, thus allowing for quicker observable outcomes. Besides, the regulatory policy is typically accompanied by stringent supervision and punishment, which can ensure a high level of enforcement and accountability. Therefore, the regulatory policy primarily focuses on setting boundaries for enterprises to prevent excessive neglect of environmental and social responsibilities.

As for the corporate environmental performance, governments often compel companies to reduce pollutant emissions, improve resource efficiency, and restrict activities in ecologically sensitive areas by implementing fines, enacting laws and regulations. For instance, EU Deforestation Regulation (EUDR) requires companies to conduct due diligence on goods in supply chains, such as collecting geolocation information regarding the production sites of these products and assessing the risk levels associated with the countries of production. This mandatory regulation can guarantee that goods entering the EU market or being exported from the EU will not result in deforestation or degradation, contributing to environmental protection and green transformation of the global supply chain. In the Carbon Emission Trading System in China, the government limits companies' emission allowances through quotas. Companies that exceed their carbon limits are required to purchase extra quotas or receive penalties. Furthermore, companies are mandated to monitor, report, and verify their carbon emissions so as to ensure the accuracy and transparency of the data, which is also an approach to strengthen the supervision from the government. The regulatory and punitive measures lay a foundation for the Carbon Emission Trading System in China, leading to a significant reduction in corporate carbon emissions.

Concerning corporate social performance, the regulatory policy is manifested through mandatory measures that improve the relationships between companies, employees, consumers, and communities. In terms of the labor relations, some regulations like National Labor Law usually set clear standards of minimum wage, overtime pay, working hours, and also mandate improvements in working conditions and employees' welfare and health, thus creating a better work environment and protecting workers' legal rights. In the realm of production and consumption, governments enforce regulations on product quality and consumer privacy protection, making the production of goods

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serves human needs. In the relationship between businesses and society, governments mandate companies to shoulder their social responsibilities. For example, the Companies Act in India requires companies with a certain revenue threshold to allocate 2% of their profits to CSR activities, while also offering tax incentives for these projects. This policy has encouraged local companies like Tata Group to invest in improving education, healthcare, and infrastructure, which enhances their roles in social welfare.

At the level of corporate governance performance, the regulatory policy primarily focuses on mandating the disclosure of corporate information and enhancing compliance review. Governments require companies to disclose both financial and non-financial information to prevent the abuse of information asymmetry that could harm the legal rights of laborers and consumers or disrupt market and social order, which in the end can strengthen public supervision of corporate social responsibility. Taking the EU's Non-Financial Reporting Directive (NFRD) as an example, it mandates that large and medium-sized enterprises disclose ESG-related data, thereby providing investors and the public with information for decision-making. In the meantime, governments also enforce strict anti-corruption and anti-monopoly policies to prevent capital concentration from disturbing market stability and interfering with state functions. These mandatory measures can regulate companies to improve governance transparency, enhance internal control mechanisms, and ultimately boost corporate governance performance.

In conclusion, the regulatory policy tends to define the boundaries of corporate behavior to create a clearer market environment. Compared to the incentive policy, the regulatory policy can exert a positive influence on the market, ecology, and society in a relatively short period.

5. The Overlap and Balance of Incentive and Regulatory Policies

According to the previous analysis, the incentive and regulatory policy play different but complementary roles in driving corporate ESG performance. Through positive incentives, the incentive policy increases companies' willingness to fulfill their ESG responsibilities, while the regulatory policy ensures that companies do not cross legal and ethical red lines. However, if all ESG matters are imposed as mandatory governance requirements, companies would be overwhelmed and struggle to perform their fundamental business function, that is, to make profits. Conversely, if ESG governance is merely viewed as a moral appeal to companies, it would be difficult to respond to social issues or realize the institutional goals of ESG [7].

Governments typically combines various incentive and regulatory policies to create a systematic framework that guides corporate behavior in a particular area [9]. When encouraging businesses to explore new fields or industries, incentive policies can provide necessary support, while regulatory policies can prevent companies from pursuing profits at the expense of ethical standards. However, compared to regulatory policies, incentive policies tend to offer more long-term benefits for improving corporate ESG performance. Regulatory policies can constrain companies through punitive measures, but it is the voluntary commitment of companies that can continuously support them to achieve sustainable and long-term development. Incentive policies can stimulate intrinsic motivation within companies while providing material and environmental support to them, which helps to create a positive interaction between companies and governments, and in the long run, it is more likely to have a robust effect.

The corporate contract theory supports the idea that stakeholders should be able to decide to deviate from the original shareholder maximization paradigm by agreement, but opposes mandatory legal requirements that force companies to assume additional social responsibilities [7]. In this sense, companies inherently have a legitimate responsibility to society, but they should not deviate from their fundamental purpose of profitability. Instead, governments should use a combination of incentives and regulations to create dual forces that drive companies toward green technological

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innovation and transformation, strengthen internal development, establish brand images, and mitigate operational risks arising from policies, laws, and markets. This holistic approach can help to enhance the competitiveness of companies, finally enabling them to achieve both economic and social benefits.

6. Conclusion

Under the guidance of basic theories, this essay comprehensively investigates the influence of different types of public policies on corporate ESG performance. By balancing incentive and regulatory policies, companies are effectively guided and constrained to achieve sustainable development. Nonetheless, this essay still suffers from problems like overly generalized classification and relatively limited case sources. Future researches on the impact of public policies on corporate ESG performance should shift focus to the conditions of industry heterogeneity and regional differences, particularly between developed and developing countries. In summary, to effectively leverage the role of macroeconomic regulation by governments, policy decision-making must consider diverse policy combinations, strive for a balance between incentives and restrictions, ensure the sustainability of corporate ESG performance, and facilitate societal progress towards the objective of green and sustainable development.

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