

The Difficult Balance of Earnings and Environmental Ethics

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Interest in “socially responsible” investing is growing quickly, and it’s often driven by concerns over climate change. The movement to divest from fossil-fuel companies is sweeping university campuses, foundations, and institutional investors, with the latest high-profile announcement coming from a leading British newspaper. The calculus needed to drive such investment decisions is difficult – but it would be simplified considerably if carbon pricing were as common as income taxes.

Socially responsible investors face two analytical challenges when determining their optimal portfolio.

First, they need to determine which investments are socially responsible and which ones aren’t. For two reasons, this is not as easy as many people seem to think, even if their focus is solely on climate change. Some investors think divesting from fossil-fuel companies is justified because of the greenhouse-gas emissions associated with their product. But on what logical basis would they divest from oil companies and not from the banks that lend to them or from the countless firms that supply the materials required to produce those oil-laden profits?

In addition, it is the consumption of fossil fuels, rather than their production, that is mostly responsible for the emission of greenhouse gases. For coherent socially responsible investors, doesn’t this fact point to the need to divest from airlines, railways, trucking, steel, plastics, chemicals – and every other industry that uses oil?

In a modern economy in which almost all firms are either directly or indirectly involved in the production or consumption of fossil fuels, it is almost impossible to draw a clean line between what is and is not socially responsible. Individual investors may nonetheless draw such a line – but their choice will be intuitive rather than fact-based.

The second broad challenge for socially responsible investors is just as difficult. A socially responsible decision to divest from fossil-fuel companies will sometimes align with a decision driven purely by conventional risk-return criteria. For example, many people now argue that climate risks have not been sufficiently recognized by some fossil-fuel companies, and that investments in these firms are less financially attractive than is commonly believed. Even if this is true – and it is certainly debatable – such situations are actually the easier ones for the socially responsible investor.

The more difficult, and probably more common, situation occurs when the investor faces a clear trade-off between profits and social responsibility. Divesting from particular fossil-fuel companies is likely to cause an overall deterioration in the performance of the portfolio – otherwise the investment managers wouldn’t have selected these investments in the first

place. These situations inevitably pose a difficult question: How can investors trade off an increase in social responsibility with a reduction in the portfolio's financial performance? To put it differently, what is the dollar value of an increase in social responsibility?

I have no useful advice for investors trying to grapple with these two challenges, and I doubt anyone has. But both of these problems would be much easier to address if carbon pricing was a central part of the policy landscape.

To see why, imagine a world in which carbon prices fully reflected the social costs of greenhouse-gas emissions. All emitters would be required to pay fees based on their emissions, and these costs would be explicitly built into their financial accounts. Costs for intensive emitters would rise more than for less-intensive emitters – and this would be true for all emitters, directly or indirectly connected to the fossil-fuel industry.

A widespread carbon price would also change relative prices faced by consumers and producers, rising for carbon-intensive products and falling for low-carbon ones. These changes would drive a reallocation of the economy's resources, altering the pattern of employment, investment, and production. Profits would rise in some industries and fall in others. And these changes would all make socially responsible investing much easier.

With the social costs of carbon emissions built right into corporations' books, the social impact of business activities would be fully captured by measures of financial performance. Financial profits would be *over and above* any social costs coming from carbon emissions. There would no longer be any need for investors to compare a dollar's worth of return against a difficult-to-measure change in social responsibility.

Carbon pricing wouldn't just drive a much-needed reduction in greenhouse-gas emissions. By bringing profits together with social responsibility, it would also simplify decision-making in the investment community. Add this to the growing list of benefits.

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