The Politics and Interests of Upward Regulatory Harmonization: Lessons from the Struggles over the EU's Sustainability Reporting Directive 2014/95/EU

Daniel Kinderman

Associate Professor, Department of Political Science
Director of European Studies, University of Delaware

Presentation Prepared for the Centre for Financial Regulation and Economic Development
The Chinese University of Hong Kong
26 June 2018

Sustainability Reporting is no longer voluntary in the EU

Text

15.11.2014 | EN | Official Journal of the European Union | L 330/1

DIRECTIVE 2014/95/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

of 22 October 2014

amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups

(Text with EEA relevance)

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 50(1) thereof,

Having regard to the proposal from the European Commission,

After transmission of the draft legislative act to the national parliaments,

Having regard to the opinion of the European Economic and Social Committee ([1]),

Acting in accordance with the ordinary legislative procedure ([2]),

Whereas:

(1) In its communication entitled 'Single Market Act — Twelve levers to boost growth and strengthen confidence — "Working together to create new growth"', adopted on 13 April 2011, the Commission identified the need to raise to a similarly high level across all Member States the transparency of the social and environmental information provided by undertakings in all sectors. This is fully consistent with the possibility for Member States to require, as appropriate, further improvements to the transparency of undertakings' non-financial information, which is by its nature a continuous endeavour.

(2) The need to improve undertakings' disclosure of social and environmental information, by presenting a legislative proposal in this field, was

What can be done?

- Requiring information on social and sustainability metrics, not just financial performance, can help address problems with negative externalities
- Markets require information to discipline firms, and the lack of information on companies’ social and environmental impacts has prevented market mechanisms from pushing against the externalization of costs after impacts created by the externalization became a concern to society
- Because non-financial reporting is voluntary, we lack reliable, valid, and trustworthy information on companies’ social and environmental impacts and the risks their activities pose for third parties.
- Requiring information on social and sustainability metrics, not just financial performance, would help address problems with negative externalities

Sustainability Reporting is no longer voluntary in the EU

Text

15.11.2014 | EN | Official Journal of the European Union | L 330/1

DIRECTIVE 2014/95/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

of 22 October 2014

amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups

(Text with EEA relevance)

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 50(1) thereof,

Having regard to the proposal from the European Commission,

After transmission of the draft legislative act to the national parliaments,

Having regard to the opinion of the European Economic and Social Committee ([1]),

Acting in accordance with the ordinary legislative procedure ([2]),

Whereas:

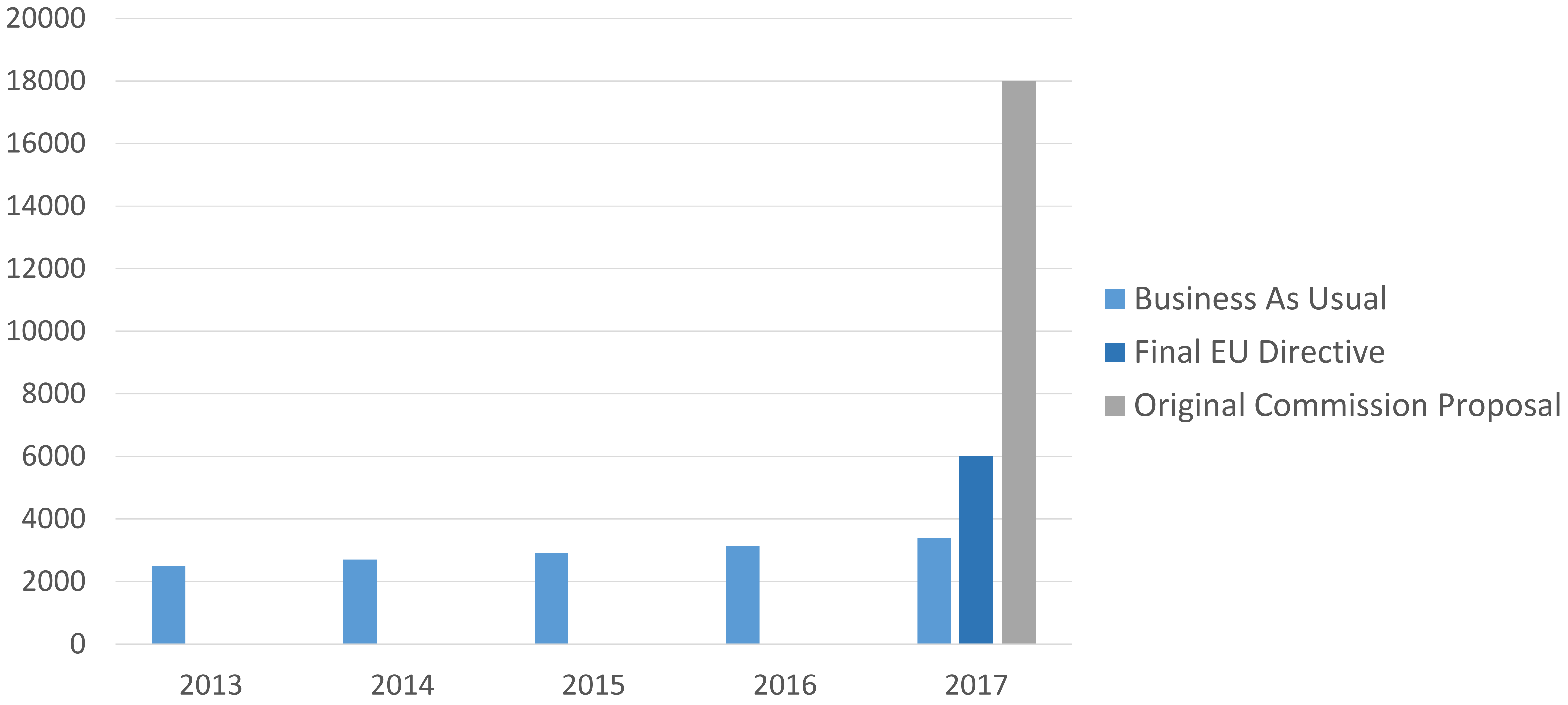
(1) In its communication entitled 'Single Market Act — Twelve levers to boost growth and strengthen confidence — "Working together to create new growth"', adopted on 13 April 2011, the Commission identified the need to raise to a similarly high level across all Member States the transparency of the social and environmental information provided by undertakings in all sectors. This is fully consistent with the possibility for Member States to require, as appropriate, further improvements to the transparency of undertakings' non-financial information, which is by its nature a continuous endeavour.

(2) The need to improve undertakings' disclosure of social and environmental information, by presenting a legislative proposal in this field, was reiterated in the Commission communication entitled 'A renewed EU strategy 2011-14 for Corporate Social Responsibility', adopted on 25 October 2011.

…but there is an Empirical Puzzle

- The circumstances for the Commission’s proposal were favorable
- Following the financial crisis there has been widespread support for re-regulating markets
- There was a growing realization that voluntary disclosure had failed
- Commissioner Michel Barnier made the Directive a high political priority
- None of the major parties in the EP rejected regulation from the very start
- Civil society organization and socially responsible investors provided support
- The proposal was not overly ambitious and contains ‘comply or explain’ provisions which were welcomed by business
- Yet the scope do the directive was substantially reduced in the negotiations: it only applies to 6,000 public interest entities, the original proposal called for 18,000 companies.

Why was the Directive Watered Down so Much?



The Goal of my Presentation is Two-Fold

- To Explain the Weakening of the Initial Text
- To Explain the Divergent Member State Positions

Governments were motivated by three Configurations of Forces:

- Adjustment Costs to Regulation: “a government’s ideal point on regulatory issues is its domestic status quo” (Drezner, 2007: 40)
- Domestic Politics
- The Institutional Framework / the Variety of Capitalism

How the proposal changed during the negotiations

Issue Area	Commission's Original Proposal	Final Compromise
Scope	Large listed and non-listed companies over 500 employees	Public Interest Entities (i.e. listed companies, credit institutions, insurance undertakings) over 500 employees
Form of the report (inside/outside management reports)	The Commission proposed that the non-financial statement should be part of the management (annual) report.	Companies may avoid including non-financial statement in their management (annual) report if it is published together with the management report or if it is made publicly within 6 months after the balance sheet date on the internet.
Materiality	None	Companies should provide information to the extent necessary for an understanding of the undertaking's development, performance, position and impact of its activity

The State of Empirical Research on Upward Regulatory Harmonization

- “there is little consensus among scholars on what determines national preferences over multilateral institutions” (Fioretos, 2001: 215)
- Much of the literature is focused on actor interests: who supports and opposes more stringent binding regulation? Do:

  -more sustainable companies

  -firms from CMEs or LMEs

  -multinationals confronted with a patchwork of different regulations
- support more stringent binding regulation?
- Or do businesses oppose the increase in costs, administrative burdens, legal liabilities and the loss of flexibility and managerial discretion entailed by upward regulatory harmonization?
- With 28 diverse member states, the EU NFR Directive allows us to empirically evaluate these claims. What roles did different countries and interest groups actually play in the negotiations?

The proposal was weakened because of business opposition in the Council. Which countries supported and which ones opposed the Directive?

Supporters

- France
- Denmark
- Belgium
- Netherlands
- UK
- Slovenia

Opponents

- Germany
- Austria
- Poland
- Hungary
- Ireland
- Estonia
- Czech Republic
- Romania (….)

The Positions of Interest Groups in the Negotiations

- BusinessEurope categorically opposed the Directive: ‘reporting must remain voluntary and business-driven!’
- Sustainable investors supported the Directive
- CSR Europe provided cautious support for the Directive
- The European Coalition for Corporate Justice (ECCJ) pushed very hard for the Directive, but civil society organizations at the national level were not very successful in influencing their governments’ positions in the negotiations

What Motivates Supporters and Opponents?

Supporters

- Domestic NFR regulations – which are associated with high CSR reporting rates and strong ESG performance
- Left Governments
- Socially Responsible Investors and Deep Capital Markets

Opponents

- Don’t Have Domestic NFR regulations
- Less Well-Developed Capital and SRI markets

Fuzzy Score	Degree or Support or Opposition	Characteristics	Country
1	Strongest Support	Strongest most ambitious and outspoken supporter who played the leading role in strengthening the proposal, for example by mandating reporting on companies' supply chain and companies' impacts on stakeholders	France
0.9	Supporter	Strong supporter, played an important role in the negotiations, but less ambitious and more business-oriented than France, in line with Denmark's NFR regulations	Denmark
0.8	Supporter	Supported France in the negotiations but did not play a leading role	Belgium
0.7	Supporter	Supported the Commission's proposal, but relatively late in the negotiations. Also, sought to reduce the scope of the Directive	Netherlands
0.6	Supported, but also played a leading role in weakening the proposal	Probably the most influential country in the negotiations. Supportive in principle, but weakened the text by proposing a safe harbor clause, a reduction in the scope to listed companies only, and the publication of non-financial information outside of the annual report	UK
0.5	Ambiguous position	Concerned about Directive's impact on SMEs	Italy
0.5	Ambiguous position	Ewa Björling, one of the two Swedish government ministers responsible for the NFR file, opposed the Directive. While she was unable to Opposed reporting on risks and supply chain.	Sweden
0.5	Ambiguous position	Very concerned about the imposition of increased administrative and regulatory burdens on companies	Finland
0.5	Ambiguous position	Appeared to support the proposal during the negotiations but voted against it	Spain
0.2	Strong Opposition	Followed the German position of opposing the Directive during the negotiations, but were willing to support the final weakened compromise in the end	Austria
0.2	Strong Opposition	Followed the German position of opposing the Directive during the negotiations, but were willing to support the final weakened compromise in the end	Poland
0.1	Strongest Opposition	Most outspoken, hard core opponent, categorically opposed to a Directive throughout the negotiations.	Germany

Propositions for a More Systematic Analysis

P1. Firms with high levels of Economic, Social, and Governance (ESG) performance will tend to support the Directive; firms with low ESG performance will tend to oppose it

P2. Countries where a high proportion of large companies prepare non-financial or sustainability reports are more likely to support the Directive than countries where a small proportion of large companies prepare non-financial or sustainability reports.

P3. Responsible business organizations should support the Directive.

P4. Countries with a disproportionately large number of Medium-Sized Enterprises should oppose the Directive.

P5. Business and employers' associations will oppose the Directive

P6. The higher the level and intensity of civil society engagement, the greater the probability that a given government will support the Directive in the negotiations.

P7. Left wing or social democratic governments will be more supportive of the Directive than right wing or conservative governments

P8. CMEs will tend to be more supportive of the Directive than LMEs; Nordic companies and countries will be particularly supportive

P9. The deeper a country's capital markets, the greater its support for the Directive.

P10. Socially Responsible Investors are key supporters of mandatory disclosure: the larger the size of Socially Responsible Investment (SRI) markets in a given country, the greater the likelihood that the government in question will support mandatory ESG disclosure at the EU-level.

P11. Businesses in countries that already mandate non-financial reporting will tend to support the Directive while businesses organizations in countries that are not currently subject to such reporting requirements will tend to oppose it.

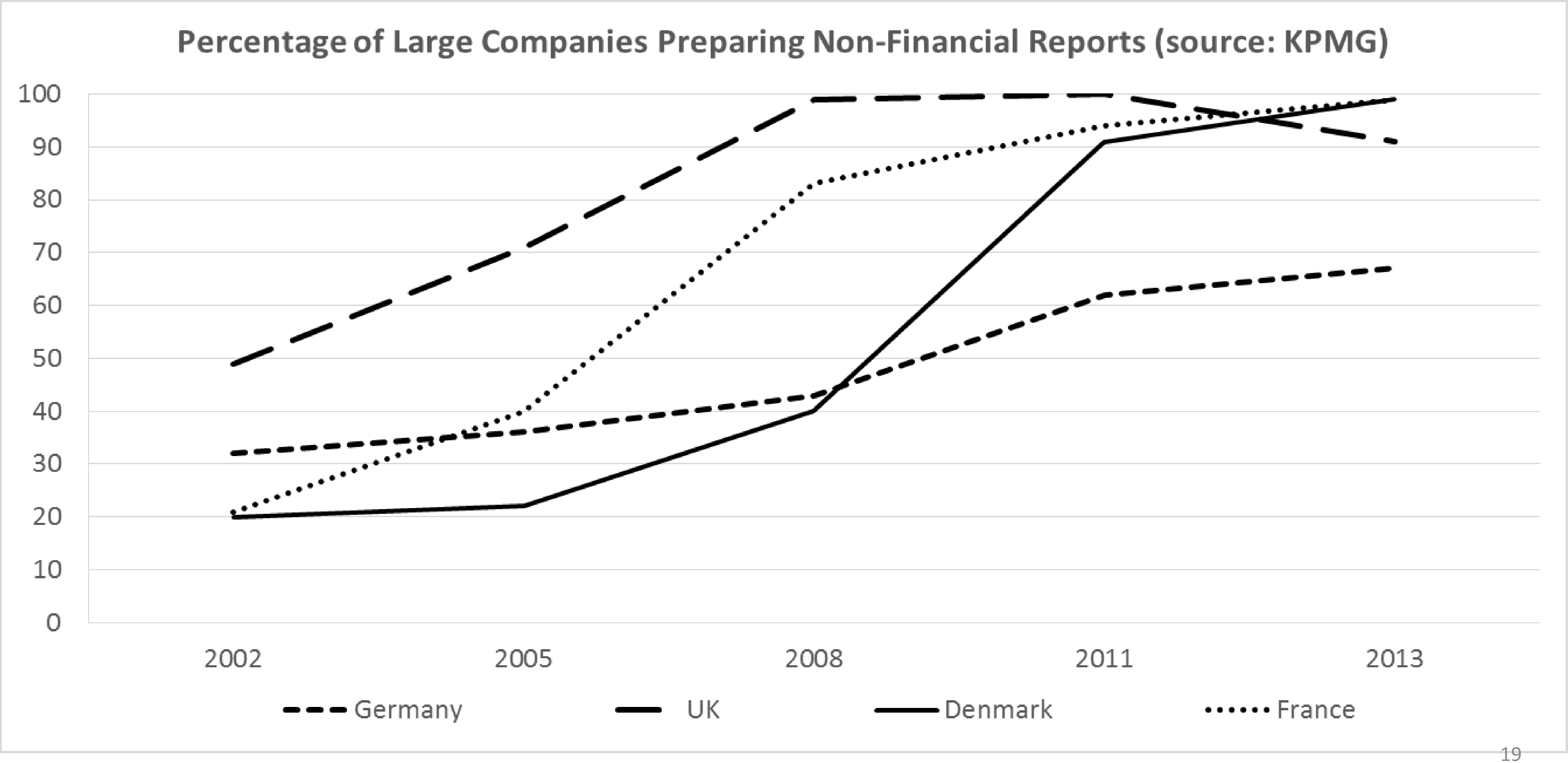
Bivariate Correlations

		Domestic Politics		Adjustment Costs to Regulation			Varieties of Capitalism & Domestic Capitalism							
Country	Degree of Support	Civil Society Pressure	Left Gov	Domestic NFD mandate yes/no	Asset4 Overall CSR Score	% Reporting KPMG 2013	CME (S&P 2012 fuzzy)	LME (S&P 2012 crisp)	LME (S&P 2012 fuzzy)	SRI Norms Based Screening	SRI Exclusion Investments	Market Capitalization	Share of SMEs	SMEs without Germ.
Austria	0.2	0.2	0.53	0	0.68	0.55	1	0	0.1	0.01	0.05	0.23	0.62	0.62
Belgium	0.8	0.3	0.41	0	0.75	0.68	1	0	0.1	0.04	0.33	0.52	0.31	0.31
Denmark	0.9	0.8	0.78	1	0.72	0.99	0.1	1	1	0.70	0.55	0.60	0.62	0.62
Finland	0.6	0.25	0.52	0	0.98	0.81	0.7	0	0.7	0.27	0.28	0.54	0.42	0.42
France	1	0.35	1	1	0.95	0.99	1	0	0.1	0.44	0.13	0.59	0.31	0.31
Germany	0.1	0.8	0.00	0	0.77	0.67	1	0	0.1	0.00	0.18	0.37	1.00	-
Italy	0.5	0.2	0.46	0	0.74	0.77	0.7	0	0.4	0.18	0.18	0.20	0.19	0.19
Netherlands	0.7	0.6	0.48	0	1	0.82	0.3	0	0.7	1.00	1.00	0.69	0.50	0.50
Poland	0.2	0.1	0.12	0	0.40	0.56	0.7	0	0.4	0.00	0.00	0.31	0.42	0.42
Spain	0.4	0.25	0	0	0.98	0.81	0.4	0	0.7	0.01	0.05	0.64	0.27	0.27
Sweden	0.5	0.25	0	0	0.88	0.79	0.4	0	0.7	0.82	0.88	0.89	0.27	0.27
UK	0.6	0.95	0	1	0.84	0.91	0.1	1	1	0.03	0.14	1.00	0.58	0.58
CORRELATION		0.20	0.67	0.62	0.44	0.79	-0.26	0.34	0.26	0.60	0.38	0.44	-0.37	0.00

My Argument

- Domestic regulations are key – they are a sufficient but not necessary condition for support
- Independent political initiative by left-of center politicians also contributed to support. Even when it comes to low salience issues and regulatory politics, political partisanship matters and business does not *always* win.
- Opposition to regulation is the default position of business associations, which were quite effective in weakening the proposal
- Varieties of Capitalism has limited explanatory power, but LMEs tend to be more supportive than CMEs

The Effect of NFR Mandates on CSR Reporting Rates

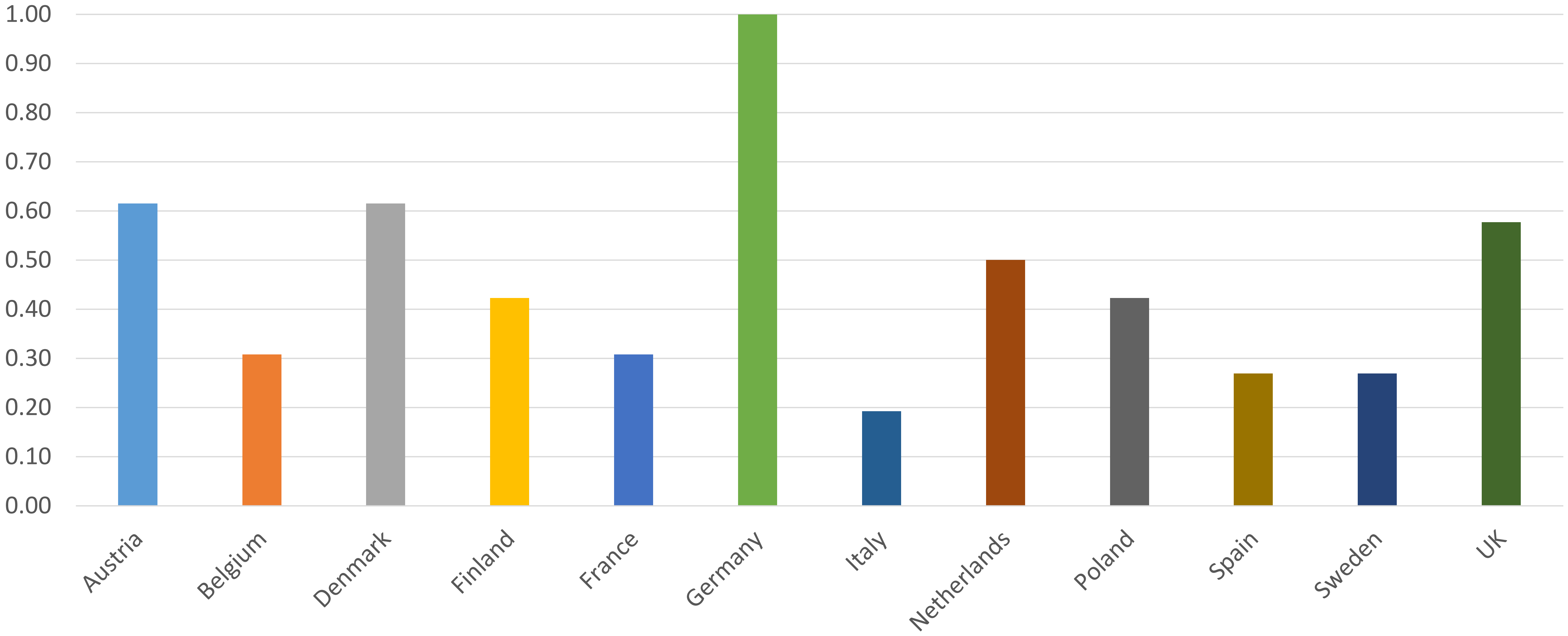


What motivated government support and opposition? Key findings

- The minimization of adjustment costs was very important: countries with existing CSR reporting regulations all supported EU level regulations and sought to ‘level the playing field.’ Countries where the business community anticipated high adjustment costs tended to be opposed.
- Domestic CSR reporting regulations helped construct a coalition of interest groups that support, or at least tolerate upward regulatory harmonization.
- Politics matters: left-wing politicians in the governments of Belgium and the Netherlands supported the Directive in spite of national business association opposition
- What explains Germany’s hard-core opposition?

Why was Germany so Fiercely Opposed? The Importance of Firm Size

Share of Medium-Sized Enterprises, Controlling for the Size of the Economy



Data source: European Commission, SBA factsheets, various countries, 2013

Conclusions (1 of 2)

- The evidence in my paper illustrates the challenges that proponents of global governance (such as John Ruggie) face in raising regulatory standards: even in favorable circumstances, upward regulatory harmonization is difficult.
- The causes of support for and opposition to upward regulatory harmonization are complex. Institutional complementarities don't matter much. Domestic regulation and partisan political initiative are key elements of support. Domestic NFR regulation is important as it contributes to high NFR and ESG performance and *constructs a coalition of supporters for upward regulatory harmonization*.
- National governments have sought to upload their domestic / national arrangements to the transnational level. This helps explain the weakness of the final compromise: most EU member states do not have existing regulations in this area
- Self-regulation and voluntarism is business's preferred strategy. Voluntarism provides reputational benefits, it is a source of power and legitimacy for employers – *even and perhaps especially* for firms with high performance. Perhaps this helps explain why it is hard to regulate CSR-related issues such as non-financial reporting
- There is limited business support for upward regulatory harmonization. But SRI, which has a vested interest in high-quality information, supports regulation. Countries with deeper capital markets are also more likely to provide support than countries with shallow capital markets

Conclusions (2 of 2)

- But France and Denmark show that business associations *can* learn to live with and even support regulation. Furthermore, the fact that Belgium and the Netherlands ended up supporting the Directive in spite of low salience and business opposition leads us to qualify Culpepper's argument that business is likely to win when it comes to "quiet politics," to "policy process in arenas shielded from public view" (Culpepper, 2011: xv). *Business does not always win in low salience conflicts.*
- Business associations are often decried as 'dinosaurs' pursuing lowest common denominator positions, but the success of these organizations in weakening the Directive suggests that they are alive and in comparatively good health.
- Germany's harsh opposition is at least partly attributable to its *Mittelstand* – to the large number of medium-sized enterprises
- Will business associations become more accepting and supportive of non-financial disclosure regulations now that this Directive has been passed? Will the Directive lead an increasing number of companies to adopt strengthened disclosure practices, or will the flexibility and loopholes in the legislation lead to a continuation of business as usual? Will the Directive lead the hundreds of trillions of dollars in the global capital stock to be invested in a more sustainable way? Will mandatory NFR cannibalize the business case that currently legitimates CSR's adoption?

Questions

- The underlying reasons for business association opposition are still unclear. Do many businesses oppose CSR reporting requirements because of the ‘red tape’ and administrative costs it imposes on them? Or are they opposed because they worry about the reputational costs of disclosing material they would rather hide?
- Do CSR reporting requirements cannibalize the business case, as CSR leaders would lose the reputational benefit of reporting?
- How do you feel about sustainability reporting requirements?
- How do these dynamics compare to other cases with which you are familiar?

THANK YOU!

Xièxiè

I look forward to your questions.

Let's keep in touch:

dpk24@cornell.edu