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THE APPLICATION OF ESG INSTRUMENTS AS A FUTURE CHALLENGE FOR SUSTAINABLE DEVELOPMENT IN CORPORATE GOVERNANCE

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Abstract
The European Directive on Corporate Sustainability Due Diligence (Directive 2024/1760) introduces significant advancements in promoting sustainable and responsible corporate actions within companies' global operations. This directive marks a pivotal shift in non-financial reporting and the application of Environmental, Social, and Governance (ESG) instruments, creating new expectations for businesses to align with sustainability goals. As sustainable corporate reporting becomes an integral part of the economic landscape, particularly due to the interconnected nature of domestic and EU economies through supply chains, the need for multidisciplinary research and analysis of ESG criteria has become evident. This research focuses on the legal frameworks and economic strategies that companies use to align their operations with sustainable development principles. The study will involve case studies, policy analysis, and evaluations of corporate governance models that integrate ESG standards. Its objective is to identify key success factors in incorporating ESG principles into legal and economic strategies while proposing models to enhance corporate governance. Key outcomes will include defining a model for assessing ESG performance, offering policy recommendations, and providing practical guidelines for companies to implement ESG strategies across various industrial sectors. This process will also focus on the harmonization of domestic legal systems with EU laws to ensure a seamless integration of ESG instruments into the national legal framework.

Key words: *ESG, sustainable development, corporate management*

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1. Introduction

Corporate social responsibility is emerging as a new imperative, especially considering the COVID-19 pandemic, bringing issues of corporate responsibility and sustainable development to the forefront more than ever before. We are witnessing a global interdependence, not only among companies but within society. In recent decades, from a regulatory standpoint, the traditional view of a company as merely a legal entity operating professionally to generate profit has proven insufficient (Dukić Mijatović et al., 2023).

In contrast to the exponential progress achieved during the era of economic liberalism, the period of economic neoliberalism has seen both the economy and society regress, deprived of the opportunity to fully harness the benefits of the last two industrial revolutions. Economic rules and policies have created structural imbalances and anomalies by brutally denying planetary limits and the laws of nature. Without corrective mechanisms in place to address systemic flaws, the economy oscillates between simultaneous supply and demand disruptions, ultimately entering a structural, multifaceted, and permanent crisis, a so-called "permacrisis." Moreover, external asymmetric shocks, such as climate change, pandemics, and geopolitical conflicts, continue to deepen, creating new cracks in the economic system (Đuričin et al., 2024).

2. ESG Instruments, Basic Concepts, and Theoretical Aspects

Contemporary corporate law, or corporate law of the 21st century, as Vasiljević observes, despite numerous changes at the end of the last century and the beginning of this one, differs from contract law, which is characterized by long-term regulation, by confirming its short-term nature and variability (Vasiljević, 2021). This is driven by increasing capital mobility beyond national borders, the globalization of the economy, trade agreements that open national and regional borders, cross-border mergers and acquisitions, the expansion of multinational and transnational corporate networks, the consolidation of leading global financial markets, the affirmation of the free movement of capital, the broadening process of harmonizing corporate law institutions at the regional and broader levels, the strengthening of supranational regulation in relation to national frameworks, a new balance between state regulation and self-regulation in favor of the latter, the dominance of private capital, the development of new forms of public-private partnerships, and more.

In his institutional theory of corporate social responsibility, Campbell emphasizes the importance of institutions in ensuring that market participants behave in a socially responsible manner. However, he refers to free market institutions, whose inadequate functioning was the cause of the global financial crisis that erupted at the end of 2007. This theory reflects the nature of the liberal economic system, which posits that the state's role in the market should be minimal, leaving all third parties interested in corporate operations at the mercy of the conscientiousness and morality of corporate governance and business procedures.

After the financial crisis, this was seen as a fundamental issue. Campbell illustrates this by arguing that if the purpose of corporations is to maximize profit and shareholder value, then it is logical that corporations will do whatever it takes to achieve this goal, possibly acting in socially irresponsible ways if they believe they will go unpunished (Campbell, 2007).

The dominant theme in the development of economic theory thus far revolves around differing views of various schools of thought regarding the role of two key societal institutions: the market and the state (Čukanović Karavidić et all., 2021).

In addition to financial reporting, the EU requires all large companies and publicly listed companies (except micro-enterprises) to disclose information aimed at identifying potential risks in the environmental and social spheres of their operations, as well as the impact of their activities on people and the environment. Non-financial reporting helps investors, civil society organizations, consumers, and other stakeholders assess the sustainability performance of companies as part of the European Green Deal.

Corporate sustainability, and consequently corporate social responsibility, refers to the activities of a business entity in a way that demonstrates attention to societal and environmental issues during interactions with stakeholders (Van Marrewijk, 2003). The drive for companies to operate with maximum profit, where profit is the sole goal, is tied to the early stages of capitalism. However, a significant shift has been observed since 2015, when the Paris Climate Agreement was adopted, and the United Nations proclaimed the Sustainable Development Goals (UN SDGs) as part of the 2030 Agenda.

The primary goal of the Paris Conference was to reach an agreement and adopt a new legally binding document that would define the obligations of member states of the Convention for the period after 2020, aiming to prevent global temperature increases exceeding 2 degrees Celsius, in line with scientific requirements. The preamble of the Paris Agreement emphasizes the necessity for an effective and progressive response to the immediate threat of climate change. These initiatives have significantly contributed to redefining the concept of ecological and social responsibility (Petrović Tomić, 2023).

Chronologically, the concept of sustainable development became important in the 1980s, especially after the publication of the report titled *Our Common Future* in 1987 by the World Commission on Environment and Development (also known as the Brundtland Report). Sustainable development was defined as development that meets the needs of the present generation without compromising the ability of future generations to meet their own needs. From the year 2000 onward, the term "corporate social opportunity" has increasingly been used, implying the opportunities that arise from a company's commitment to responsible business practices. The difference from the earlier concept lies only in its enhancement. While the concept of responsible business focuses on standards that ensure the immediate image of a responsible corporate citizen, sustainable business emphasizes a business model that will promote values aligned with the general interest in the long term. More and more companies are both declaratively and substantively confirming their commitment to responsible business (I don't have to be responsible, but I choose to be responsible because it's good business!) (Handy, 2003).

In the field of corporate law and governance on a global level, the contours of implementing sustainable development were seen in the adoption of regulations on worker and environmental protection during the 1980s, as well as the impact of business on the environment and vice versa. In recent decades, companies have shifted towards the concept of Corporate Social Responsibility (CSR), which has evolved into the ESG (Environmental, Social, and Governance) framework, aimed at quantifying and ranking companies' impact by industry in terms of sustainability. Different regulatory frameworks in the national legislation of EU member states often present obstacles to cross-border business operations. The use of the Commission's better regulation instruments is another way to ensure further integration of sustainable development into European policies (Simonelli & Iacob, 2021).

According to Vasiljević, the phenomena of financial crises, the need for environmental protection, security concerns, social unrest, abuses of contractual freedom that endanger the concept of "public order," stock market shocks with tectonic shifts in financial markets, and the systemic limitations of the philosophy of a liberal economy without an appropriate regulatory, interventionist, and developmental role of the state (the global financial crisis is precisely a consequence of the systemic deficiency of such an economic concept and cannot be explained, as some attempt, by "the greed of brokers and bankers as bad actors within liberal economics," just as Marxism did not fail "because of bad actors within its ranks" but due to a systemic defect), will lead capitalism to increasingly exhibit its moral side ("moral capitalism"—state capitalism instead of liberal shareholder or managerial capitalism) (Vasiljević, 2013). In this way, the phenomenon of corporate social responsibility in a broader sense, through appropriate regulatory and supervisory state interventions, will increasingly become a legal rather than merely a moral issue (as evidenced by the developmental path of regulating environmental protection, monopolistic behavior, and sustainable development), much like the overall developmental trajectory of law (Vasiljević, 2014).

Porter views interdependence as a two-way relationship through which the operations of firms affect society, and social conditions influence the execution of a firm's strategy and its overall business performance. He identifies four main categories of social conditions: the first involves the quantitative and qualitative conditions of doing business (available labor force, transportation, infrastructure, etc.); the second is the legal framework affecting competition (related to intellectual property, transparency, anti-corruption efforts, and investment incentives); the third is the size and sophistication of local demand (affected by product quality and safety standards, consumer rights, and fairness in public procurement); and the fourth is the presence of supporting industries and equipment manufacturers (Porter & Kramer, 2006).

When we examine the pillars of the ESG concept, as an evolution of the CSR concept, we observe the Environmental (E), Social (S), and Governance (G) pillars. ESG instruments represent a set of standards that banks and other investors can consider if they aim to invest in environmentally and socially beneficial projects (Carroll, 1999).

The environmental criteria (E) focus on how a company incorporates ecological principles into its operations, or how its activities protect the environment. The basic environmental criteria include climate change, resource conservation, pollution and waste management, water and air quality, and biodiversity protection.

The social criteria (S) assess how a company manages its relationships with employees, suppliers, customers, and the community in which it operates, focusing on working conditions, diversity and inclusion, health and safety, human rights, and community engagement.

The governance (G) criterion of a company addresses how it manages its processes, how it rewards its managers, conducts internal audits and controls, and the rights of shareholders. It encompasses the structure of management bodies, risk control and management, ethical codes, issues of corruption, bribery, and conflicts of interest, as well as transparency and reporting.

There is no universal rule about which factors should belong to which group (Mišković et all, 2023). For example, diversity and inclusion in the workplace are sometimes categorized under Social (S) criteria, while other companies may include them under Governance (G) criteria, particularly when discussing the representation of women in top leadership positions.

Given the importance of ESG criteria, it's clear that this form of non-financial reporting, alongside financial reporting, provides a comprehensive view of a company. It is used as a framework to assess how a company manages risks and opportunities created by fluctuating market and non-market conditions. This variability reflects changes in ecological, social, and economic systems that affect the overall environment in which companies operate.

The term "ESG standards" is often mentioned, but in reality, there are no universal ESG standards in the strictest sense. There are multiple frameworks, methodologies, and standards that can be used to define criteria for measuring, disclosing, and evaluating ESG performance. Efforts to measure or compare corporate social responsibility are likely to remain an elusive goal due to the existence of numerous variables related to data and methodology.

3. Legislative Frameworks for ESG Instruments at the European Union Level

Sources of law relevant to the regulation of ESG criteria in the EU are numerous and complementary. Finance and reporting are regulated by the following sources: Directive 2013/34/EU on annual financial statements, consolidated financial statements, and related reports of certain types of companies[1], Non-Financial Reporting Directive[2] (NFR Directive 2014/95/EU),

[1] https://eur-lex.europa.eu/eli/dir/2013/34/oj access 1.7.2024.
[2] https://eur-lex.europa.eu/eli/dir/2014/95/oj access 1.7.2024

Corporate Sustainability Reporting Directive[1] (CSR Directive 2022/2464 EU), and Sustainable Finance Disclosure Regulation[2] (SFDR), The Taxonomy Regulation[3] and Public country-by-country reporting.

The supply chain is regulated by the following documents: the Directive on Corporate Sustainability Due Diligence[4] (Directive 2024/1760), the Conflicts Minerals Directive[5], the EU Regulation on Deforestation-Free Supply Chains[6], and the German Supply Chain Act[7].

Climate factors are legislatively addressed in the Carbon Border Adjustment Mechanism[8], the Fit for 55 Package[9], and the EU Emissions Trading System[10] (ETS).

The foundations of the circular economy are outlined in the Circular Economy Action Plan[11], the Ecodesign Directive[12], the Green Claims Directive[13], and the Sustainable Products Initiative[14].

The European Union, as a single space and market, aims to harmonize the national regulations of member states. This harmonization is implemented through three instruments that ensure the compatibility of legal rules in corporate law among member states. First is the harmonization of national regulations in corporate law, which member states must incorporate into their national legislations through adopted directives. The second instrument is the creation of new supranational organizational forms for conducting business activities, which coexist with national forms and serve as alternatives for entrepreneurs (Dukić Mijatović, 2023). The continuity of solutions in our corporate laws is clear, with the legislator intending not only to harmonize domestic legislation with EU law but also to introduce new institutes and to regulate existing ones through more precise and concrete norms (Dukić Mijatović et all, 2016). We expect this approach to be applied in the implementation of legislative solutions regarding ESG instruments. The Republic of Serbia should follow the rules and standards of the European Union,

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1 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32022L2464 access 1.7.2024
2 https://finance.ec.europa.eu/sustainable-finance/disclosures/sustainability-related-disclosure-financial-services-sector_en access 1.7.2024.
3 https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-taxonomy-sustainable-activities_en access 2.7.2024
4 https://commission.europa.eu/business-economy-euro/doing-business-eu/sustainability-due-diligence-responsible-business/corporate-sustainability-due-diligence_en, access 1.8.2024
5 https://policy.trade.ec.europa.eu/development-and-sustainability/conflict-minerals-regulation_en access 2.7.2024.
6 https://environment.ec.europa.eu/topics/forests/deforestation/regulation-deforestation-free-products_en pristup 2.7.2024.
7 https://www.csr-in-deutschland.de/EN/Business-Human-Rights/Supply-Chain-Act/supply-chain-act.html pristup 3.7.2024.
8 https://taxation-customs.ec.europa.eu/carbon-border-adjustment-mechanism_en pristup 3.7.2024.
9 https://europa.rs/commission-welcomes-completion-of-key-fit-for-55-legislation/?lang=en pristup 3.7.2024.
10 https://climate.ec.europa.eu/eu-action/eu-emissions-trading-system-eu-ets_en pristup 3.7.2024.
11 https://environment.ec.europa.eu/strategy/circular-economy-action-plan_en pristup 3.7.2024.
12 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32024R1781&qid=1719580391746 pristup 3.7.2024.
13 https://environment.ec.europa.eu/topics/circular-economy/green-claims_en pristup 3.7.2024.
14 https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12567-Sustainable-products-initiative_en pristup 3.7.2024.

particularly the 2014 Non-Financial Reporting Directive, and pay special attention to large enterprises and their impact on aspects of corporate social responsibility, considering that entrepreneurs, small and medium enterprises, do not hold the same significance and should not be unduly burdened with such obligations (Dukić Mijatović et all, 2023).

New rules will ensure that investors and other stakeholders have access to the information they need to assess companies' impacts on people and the environment and that investors can evaluate financial risks and opportunities arising from climate change and other sustainability issues. Finally, reporting costs for companies will be reduced in the medium and long term by harmonizing the information that needs to be provided (İyigün, 2015).

4. Conclusion

The benefits of ESG reporting are significant and diverse. For example, the integration of ESG criteria helps companies identify and manage risks related to climate change, working conditions, human rights, corporate governance, business ethics, and other relevant factors. Similarly, a focus on sustainability can drive innovation, save resources, ensure more efficient supply chain management, reduce energy and resource costs, and increase productivity. ESG integration can open doors to various sources of capital, such as ESG funds, investors with specific ESG criteria, or institutional investors seeking sustainable business models. Commitment to sustainability, responsible practices, and transparency in reporting can significantly enhance reputation and build trust among stakeholders, including customers, suppliers, employees, investors, and the broader public. Companies recognized as socially responsible are more likely to attract loyal customers and talent. Regulatory bodies are increasingly introducing regulations that require companies to report on ESG factors or meet certain sustainability standards. ESG integration allows a company to adapt to these requirements in a timely manner and ensure compliance with regulations. This can reduce the risk of fines, legal issues, and damage to the company's reputation. Considering all of the above, we assess that the application of ESG instruments presents a challenge for the future of sustainable development in corporate governance that domestic legislation and the economy must adequately address in order to promote the common good.

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