
Achieving Sustainability: The Stick or the Carrot?



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With the cost of addressing climate change beyond the means of governments, private enterprise is being encouraged to support sustainable practices through incentives, penalties and awareness building. Which approach works best?

The climate change phenomena presents robust evidence that businesses are failing to manage resources in a sustainable manner. In today’s market, corporate decision-makers tend to externalise environmental costs to the extent that in many cases they are not factored into economic decisions, prompting the [Stern Review on the Economics of Climate Change](#) to regard climate change as being the greatest market failure of all time.

With markets failing to provide the required incentives to protect the environment, several environmentally-conscious governments have taken the driving seat. An extensive tool-kit of policy instruments has emerged that facilitates the protection of our environment and supports the generation and diffusion of green technologies. These policy instruments can be

classified as either incentivising (carrots) or penalising (sticks) interventions. A third, potentially lower-cost, intervention is that of awareness building; commonly referred to as “sermons”.

Attracting private investment

Since governments do not have an infinite financial capacity, and given that the cost of climate change mitigation is projected to be highly prohibitive, the private sector must play a significant role in closing this green investment gap. A fundamental task of most policy interventions therefore lies in providing “policy rents” and sending market signals to encourage private investment.

Understandably, investors tend to be attracted to markets that enjoy transparent and long-term regulations, which provide a certain degree of confidence in the prospects of green investment. But do government regulations attract private investments that are underpinned by sustainable business models? In a recent [journal paper](#), we examined the interplay between twenty popular green policy instruments (such as Feed-in-Tariffs and net metering) and the corresponding business models that have emerged in response to policy stimulus. We were able to identify three broad types of policy-business behavioural patterns; namely buck-passing, carpet-bagging and values-driven.

Carrot or the stick?

Considering the first type, we found that the green business community tends to respond to stick-type policy actions by offloading additional costs onto other parties. Policy schemes, like the Energy Saving Obligation in Italy and France, motivated many energy companies in these countries to develop business models that pass on the costs of energy efficiency equipment to customers through higher energy tariffs. Concurrently, these obligations manifest themselves as a potential green finance mechanism that could reduce the need for direct government support.

While stick-induced business models tend to engender this buck-passing attitude, the uncontrolled offering of carrots often leads to opportunistic behaviour aimed at capturing temporary gains. Consider U.S. President Obama’s US\$80 billion stimulus package to subsidise politically-preferred energy projects. As a result of his government’s approach of “picking winners”, a substantial share of the financial incentives have been awarded

to green energy companies, most of which have since gone bankrupt or are heading for bankruptcy.

While many of these ailing green businesses have attributed their demise to fierce competition from low-cost Chinese products, one should take it with a pinch of salt. Engaging in self-centred carrot-induced activities that allow short-term value capture, without long-term value creation, leaves an enterprise destined to fail. In fact, evading the possibility of overcompensation explains why some European countries have adopted “stepped Feed-in-Tariffs” schemes, where tariffs are decreased over time in accordance with expected technological development and economies of scale.

Increased awareness and an emerging market

On the other hand, the sermon-induced business models tend to emerge in response to demand sparked by a change in value systems. Over the last two decades, a growing awareness of environmental degradation among the public has resulted in the emergence of a green, value-based market segment. A survey of more than 1,000 companies published by Harvard Business Review reveals a growing number of green companies are being driven by internal motivations as opposed to government regulation or market competition. This is akin to the emergence of business models such as those that foster fair trade, organic food and/or ethical businesses. It is evident that certain segments of society will be willing to pay a premium for consuming goods and services that are produced in line with their value systems, for example, consider halal food for Muslims and kosher for Jews.

A main take-away from our research is that for an innovative green business model to be sustainable, it needs to allow for both value appropriation and value creation. The main purpose of firms is usually assumed by the mainstream business community to be value capture; hence the buck-passing and carpet-bagging behaviour that result from stick and carrot-type policy regimes. What tends to be overlooked is that without value being created, there is nothing to capture. In other words, it would be possible for a business to make more money through either maximising value capture or increasing the value it creates.

Creating shared value

Indeed, an over-emphasis on monetising short-term value may undermine the long-term sustainability of a business. Conversely, too much focus on value creation may deteriorate the ability of the organisation to compete and keep creating value in the short-term. Moving away from such a narrow trade-off mentality, Michael Porter argued that a sustainable business model innovation should be centred on “creating shared value” – an approach that links financial success with social progress. The central thesis of the “shared value” notion is that since the long-term competitiveness of a company and the health of its community are mutually dependent; the company should focus on creating economic value in a way that also creates societal benefits by addressing its needs and challenges.

Adopting such a green entrepreneurial mentality is important because addressing social problems can no longer be assumed to be the sole responsibility of governments. Besides, broadening the conception of Adam Smith’s invisible hand is a long time overdue; not to mention the rhetoric of value, externalities and policy rents – all of which have too often been overly simplified to focus on the short-term bread and butter issues.

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