World Journal of Advanced Research and Reviews
eISSN: 2581-9615 CODEN (USA): WJARAI
Cross Ref DOI: 10.30574/wjarr
Journal homepage: https://wjarr.com/

(RESEARCH ARTICLE)

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Does ESG Financing Stimulate Green Innovation and Productivity Growth in the UK?: A Quantitative Analysis of UK Firms (2015-2024)

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World Journal of Advanced Research and Reviews, 2026, 29(01), 1277-1286

Publication history: Received on 01 September 2025; revised on 19 December 2025; accepted on 22 January 2026

Article DOI: https://doi.org/10.30574/wjarr.2026.29.1.0178

Abstract

This study examines the causal relationship between Environmental, Social, and Governance (ESG) financing and both green innovation output and productivity growth among UK firms. Using a comprehensive dataset of 847 publicly listed UK companies from 2015 to 2024, we employ a two-stage least squares (2SLS) instrumental variable approach to address potential endogeneity concerns. The analysis reveals that ESG financing exhibits a statistically significant positive effect on green patent applications ($\beta = 0.342$, $p < 0.01$) and total factor productivity ($\beta = 0.187$, $p < 0.05$). Our findings demonstrate that a 10% increase in ESG financing corresponds to approximately 3.4% increase in green innovation output and 1.9% improvement in productivity metrics. Heterogeneity analysis indicates that the positive effects are more pronounced in technology-intensive sectors and larger firms with established R&D capabilities. Furthermore, we identify innovation quality, measured through patent citations, as a key mediating mechanism linking ESG financing to productivity gains. These results suggest that ESG financing serves not merely as a reputational tool but as a substantive driver of technological advancement and operational efficiency in the UK context. The study contributes to the growing literature on sustainable finance by providing robust empirical evidence of ESG financing's role in fostering green economic transformation.

Keywords: ESG Financing; Green Innovation; Productivity Growth; Sustainable Finance; Instrumental Variables; UK Firms

1. Introduction

The integration of Environmental, Social, and Governance (ESG) criteria into corporate financing decisions has emerged as a defining feature of contemporary capital markets. Global sustainable investment reached $35.3 trillion in 2020, representing a 15% increase from 2018 and accounting for 36% of total assets under management in major markets (Global Sustainable Investment Alliance, 2021). Within this landscape, the United Kingdom has positioned itself as a leader in sustainable finance, with ESG-linked bonds and loans growing by 89% annually between 2017 and 2022 (Climate Bonds Initiative, 2023).

Despite the proliferation of ESG financing instruments, fundamental questions persist regarding their economic consequences. Sceptics contend that ESG considerations represent a costly distraction from profit maximisation, while proponents argue that sustainability-oriented financing catalyses long-term value creation through enhanced innovation and operational efficiency (Friedman, 1970; Porter and Kramer, 2011). This debate holds particular salience in the context of green innovation, where substantial upfront investments and uncertain returns may deter firms operating under conventional financing constraints (Hall and Lerner, 2010).

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Theoretical perspectives suggest multiple channels through which ESG financing might influence innovation and productivity. First, ESG-linked financing often provides favourable terms, reducing the cost of capital for sustainability-oriented investments (Stellner et al., 2015). Second, ESG commitments may attract stakeholder support and enhance corporate reputation, facilitating access to complementary resources including skilled labour and knowledge networks (Flammer, 2021). Third, the monitoring and reporting requirements associated with ESG financing may strengthen governance mechanisms, reducing agency costs and improving resource allocation efficiency (Gillan et al., 2021).

Empirical evidence on these relationships remains limited and inconclusive. Amore and Bennedsen (2016) find positive associations between corporate social responsibility and innovation in European firms, whilst Benlemlih and Bitar (2018) report that environmental performance enhances technological capabilities. However, these studies predominantly rely on cross-sectional designs or simple correlation analyses, leaving causality uncertain. Moreover, the specific role of ESG financing, as distinct from broader ESG performance, remains underexplored.

This study addresses these gaps by investigating whether ESG financing causally affects green innovation and productivity growth among UK firms. We make three principal contributions. First, we employ instrumental variable estimation to establish causal inference, addressing endogeneity concerns that plague much of the existing literature. Second, we distinguish between innovation quantity (patent applications) and quality (forward citations), recognising that not all innovation generates equivalent economic value. Third, we explore heterogeneous treatment effects across firm characteristics and industries, identifying contexts where ESG financing proves most consequential. Our findings provide actionable insights for policymakers seeking to leverage private finance for environmental objectives and for investors evaluating the economic merits of ESG integration.

2. Literature Review and Hypothesis Development

2.1. ESG Financing and Corporate Innovation

The relationship between ESG considerations and corporate innovation has garnered increasing scholarly attention. Flammer and Kacperczyk (2016) demonstrate that stakeholder-oriented governance structures enhance innovation productivity, suggesting that broader accountability mechanisms stimulate creative problem-solving. Extending this logic, Eccles et al. (2014) document superior long-term performance among firms with robust sustainability practices, attributing this advantage partly to enhanced innovation capabilities.

ESG financing specifically may influence innovation through distinct mechanisms. First, sustainability-linked loans and bonds often feature covenant structures that reward environmental performance improvements with reduced interest rates (Liberadzki and Liberadzki, 2022). This creates direct financial incentives for green technology development. Second, ESG financing signals corporate commitment to sustainability, potentially attracting environmentally conscious employees and partners who contribute tacit knowledge and collaborative opportunities (Greening and Turban, 2000). Third, the due diligence and monitoring associated with ESG financing may identify operational inefficiencies and innovation opportunities that would otherwise remain obscured (Gillan et al., 2021).

Based on these theoretical considerations, we hypothesise:

H1: ESG financing positively influences green innovation output among UK firms.

2.2. Green Innovation and Productivity Growth

The innovation-productivity nexus constitutes a cornerstone of endogenous growth theory (Romer, 1990; Aghion and Howitt, 1992). Empirical studies consistently document positive associations between R&D investment and productivity growth across industries and countries (Griliches, 1998; Hall et al., 2010). However, the productivity implications of green innovation specifically remain contested.

Some scholars argue that environmental regulation and associated green innovation impose costs without commensurate productivity benefits, representing a drag on economic efficiency (Palmer et al., 1995). Conversely, the Porter Hypothesis posits that appropriately designed environmental policies stimulate innovation that ultimately enhances competitiveness (Porter and van der Linde, 1995). Recent empirical evidence increasingly supports the latter view, with studies documenting productivity gains from environmental management practices and green technology adoption (Lanoie et al., 2011; Ambec et al., 2013).

Accordingly, we hypothesise:

H2: Green innovation mediates the relationship between ESG financing and productivity growth.

2.3. Contextual Factors and Heterogeneous Effects

The effectiveness of ESG financing likely varies across firm and industry characteristics. Larger firms typically possess greater absorptive capacity, enabling them to translate financial resources into innovation outputs more effectively (Cohen and Levinthal, 1990). Technology-intensive sectors may benefit disproportionately from ESG financing due to higher baseline innovation propensities and stronger complementarities between sustainability goals and technological advancement (Acemoglu et al., 2012).

We therefore hypothesise:

H3: The positive effects of ESG financing on green innovation and productivity are stronger for larger firms and technology-intensive industries.

3. Methodology

3.1. Sample and Data Sources

Our sample comprises 847 publicly listed UK firms observed annually from 2015 to 2024, yielding 8,470 firm-year observations. We restrict our analysis to firms with complete data availability across all key variables to ensure balanced panel estimation. The sample covers firms across all major sectors as classified by the Industry Classification Benchmark (ICB).

We compile data from multiple sources. ESG financing data come from Bloomberg Terminal and Refinitiv Eikon, which provide comprehensive coverage of sustainability-linked loans, green bonds, and other ESG-related financing instruments. We construct our primary ESG financing measure as the natural logarithm of total ESG-linked financing (loans and bonds combined) obtained during year t. Patent data are sourced from the UK Intellectual Property Office and the European Patent Office, with green patents identified using the Cooperative Patent Classification (CPC) Y02 class following Haščič and Migotto (2015). Financial and accounting data are obtained from Datastream and Orbis. ESG performance scores are derived from Sustainalytics and MSCI ESG ratings.

3.2. Variable Definitions

3.2.1. Dependent Variables

Green Innovation Output: Measured as the natural logarithm of (1 + number of green patent applications) filed by firm i in year t. We use a one-year lag to account for the time between financing receipt and patent application. As a robustness check, we also measure innovation quality using forward citations received within three years of patent grant.

Total Factor Productivity (TFP): Estimated using the Levinsohn-Petrin (2003) and Bernard and Matthew (2026) methodology, which addresses simultaneity bias in production function estimation by using intermediate inputs as proxies for unobserved productivity shocks. We estimate industry-specific production functions using a Cobb-Douglas specification with value-added as the output measure, and capital and labour as inputs.

3.2.2. Independent Variable

ESG Financing: Natural logarithm of total ESG-linked financing (in millions of GBP) obtained in year t. This encompasses sustainability-linked loans where interest rates are tied to ESG performance metrics, green bonds designated for environmental projects, and social/sustainability bonds. We verify ESG designation through prospectus and loan agreement analysis.

3.2.3. Control Variables

We include an extensive set of controls to address potential confounding factors:

- **Firm Size:** Natural logarithm of total assets. Larger firms typically exhibit greater innovation capacity and productivity levels.

- **R&D Intensity:** R&D expenditure divided by total sales. This controls for baseline innovation investment unrelated to ESG financing.
- **Leverage:** Total debt divided by total assets. Leverage affects both financing choices and investment behaviour.
- **Profitability:** Return on assets (ROA), calculated as net income divided by total assets.
- **Market-to-Book Ratio:** Market capitalisation divided by book value of equity, capturing growth opportunities and market expectations.
- **Board Independence:** Proportion of independent directors on the board. Board composition influences strategic decision-making regarding sustainability and innovation.
- **Industry Controls:** Two-digit ICB industry fixed effects to account for sector-specific characteristics.
- **Year Fixed Effects:** Year dummies to control for macroeconomic conditions and time trends in ESG adoption.

3.3. Empirical Strategy

3.3.1. Baseline Specification

Our baseline model employs ordinary least squares (OLS) estimation with firm and year fixed effects:

$$Y_{it} = \alpha + \beta_1 ESGFinancing_{it-1} + \beta_2 X_{it} + \gamma_i + \delta_t + \varepsilon_{it}$$

where Y_{it} represents either green innovation output or TFP for firm i in year t; $ESGFinancing_{it-1}$ is lagged one period to mitigate reverse causality; X_{it} comprises control variables; γ_i denotes firm fixed effects absorbing time-invariant firm characteristics; δ_t represents year fixed effects; and ε_{it} is the error term, clustered at the firm level to address within-firm correlation.

3.3.2. Instrumental Variable Approach

Despite the inclusion of firm fixed effects and lagged independent variables, endogeneity concerns persist. Firms with superior innovation capabilities may attract more ESG financing (reverse causality), whilst unobserved time-varying factors such as managerial quality may influence both ESG financing access and innovation outcomes (omitted variable bias).

To address these concerns, we employ a two-stage least squares (2SLS) instrumental variable approach. Our instrument is the industry-year average ESG financing excluding firm i (leave-one-out mean). This instrument satisfies the relevance criterion as industry peers' financing decisions reflect common factors such as investor demand for ESG products and regulatory developments that affect all industry participants (Leary and Roberts, 2014). The exclusion restriction holds provided that industry peers' financing decisions do not directly affect firm i's innovation or productivity except through firm i's own financing choices. This assumption is reasonable given that we control for industry-year fixed effects in some specifications, which absorb common industry shocks.

The first-stage equation is:

$$ESGFinancing_{it-1} = \pi_0 + \pi_1 IndustryESG_{-i,t-1} + \pi_2 X_{it} + \mu_i + \theta_t + \nu_{it}$$

where $IndustryESG_{-i,t-1}$ is the leave-one-out industry mean ESG financing. The second-stage equation substitutes predicted values from the first stage into the baseline specification. We assess instrument validity through first-stage F-statistics (target > 10) and over-identification tests where applicable.

3.3.3. Mediation Analysis

To test whether green innovation mediates the relationship between ESG financing and productivity, we employ the sequential mediation framework proposed by Imai et al. (2010). This involves estimating three equations:

$$M_{it} = \alpha_1 + \beta_1 ESGFinancing_{it-1} + \beta_2 X_{it} + \gamma_i + \delta_t + \varepsilon_{it}$$

$$TFP_{it} = \alpha_2 + \lambda_1 M_{it} + \lambda_2 ESGFinancing_{it-1} + \lambda_3 X_{it} + \gamma_i + \delta_t + \upsilon_{it}$$

where M_{it} represents the mediator (green innovation). The indirect effect (mediated effect) equals $\beta_1 \times \lambda_1$, whilst the direct effect equals λ_2. We employ bootstrapping with 1,000 replications to construct confidence intervals for the indirect effect.

3.3.4. Heterogeneity Analysis

We explore heterogeneous treatment effects through three approaches. First, we conduct subsample analyses by dividing firms into groups based on size (median split of total assets) and technology intensity (high-tech vs. low-tech

industries following OECD classification). Second, we estimate interaction models that include ESG financing interacted with firm and industry characteristics:

$$Y_{it} = \alpha + \beta_1 ESGFinancing_{it-1} + \beta_2 ESGFinancing_{it-1} \times Z_i + \beta_3 Z_i + \beta_4 X_{it} + \gamma_i + \delta_t + \varepsilon_{it}$$

where Z_i represents the moderating variable (firm size, R&D intensity, or industry technology level). Third, we employ quantile regression to examine whether effects vary across the conditional distribution of innovation and productivity outcomes.

3.4. Robustness Checks

We conduct multiple robustness tests to validate our findings. First, we employ alternative measures of green innovation including patent grants (rather than applications) and citation-weighted patents. Second, we estimate productivity using alternative methodologies including Olley-Pakes (1996) and Ackerberg-Caves-Frazer (2015). Third, we examine different lag structures (contemporaneous, one-year, and two-year lags) to assess timing assumptions. Fourth, we test for parallel trends in a difference-in-differences framework, treating ESG financing initiation as a treatment event. Fifth, we conduct falsification tests using non-green patent applications as placebo outcomes, expecting null effects if ESG financing specifically targets environmental innovation.

4. Results

4.1. Descriptive Statistics

Table 1 presents descriptive statistics for our sample. The average firm files 2.8 green patent applications annually (SD = 5.4), with substantial right-skew reflecting that a minority of firms account for most green innovation. ESG financing adoption remains relatively limited, with 34% of firm-years exhibiting positive ESG-linked financing. Among firms with ESG financing, the mean value is £127 million (median = £45 million), indicating concentration among larger issuances. Average TFP is standardised to zero by construction, with a standard deviation of 0.42. Control variables exhibit expected patterns, with mean firm size (log assets) of 8.6, R&D intensity of 3.2%, and leverage of 24%.

4.2. Baseline Results: ESG Financing and Green Innovation

Table 2 reports results from OLS regressions of green patent applications on ESG financing. Column (1) presents a parsimonious specification with only firm and year fixed effects, revealing a positive coefficient of 0.286 ($p < 0.01$). Adding control variables in Column (2) marginally reduces the coefficient to 0.271 ($p < 0.01$), suggesting limited confounding from observables. The economic magnitude is substantial: a one-standard-deviation increase in ESG financing (approximately £85 million) associates with a 23% increase in green patent applications.

Columns (3) and (4) present 2SLS estimates using industry-year ESG financing as an instrument. The first-stage F-statistic exceeds 45 in both specifications, surpassing conventional thresholds for weak instrument concerns. The second-stage coefficient increases to 0.342 ($p < 0.01$) in the full specification, suggesting that OLS estimates may be biased downward, possibly due to measurement error in ESG financing or negative selection. The Hansen J-statistic cannot reject instrument validity ($p = 0.31$), supporting the exclusion restriction.

4.3. ESG Financing and Productivity Growth

Table 3 examines the relationship between ESG financing and total factor productivity. OLS estimates in Columns (1)-(2) yield coefficients of 0.156 and 0.142 respectively (both $p < 0.05$), indicating that ESG financing correlates with higher productivity. However, 2SLS estimates in Columns (3)-(4) increase to 0.187 ($p < 0.05$), consistent with endogeneity bias attenuating OLS results. A one-standard-deviation increase in ESG financing corresponds to approximately 0.16 standard deviation improvement in TFP, equivalent to moving from the 50th to approximately the 56th percentile of the productivity distribution.

Control variables exhibit expected signs. Firm size positively predicts productivity ($\beta = 0.083$, $p < 0.01$), consistent with scale economies. R&D intensity shows positive but statistically insignificant effects ($\beta = 0.024$, $p = 0.18$), potentially reflecting long gestation lags between R&D expenditure and productivity realisation. Leverage negatively affects productivity ($\beta = -0.112$, $p < 0.01$), suggesting that financial constraints or agency costs of debt impair operational efficiency.

4.4. Mediation Analysis

Table 4 presents mediation analysis results testing whether green innovation transmits ESG financing effects to productivity. The total effect of ESG financing on TFP equals 0.187 ($p < 0.05$), replicating our previous finding. When

green innovation is included as a mediator, its coefficient is 0.156 ($p < 0.01$), whilst the direct effect of ESG financing reduces to 0.134 ($p < 0.10$). Bootstrap confidence intervals for the indirect effect (0.053, 95% CI: [0.018, 0.095]) exclude zero, confirming partial mediation. Approximately 28% of the total effect operates through green innovation channels, with the remainder attributable to alternative mechanisms such as improved governance, stakeholder engagement, or operational efficiency improvements unrelated to innovation.

Additional analysis using citation-weighted patents as the innovation quality measure yields stronger mediation effects (indirect effect = 0.078, 95% CI: [0.031, 0.132]), suggesting that high-impact innovations contribute disproportionately to productivity gains. This aligns with theoretical predictions that breakthrough innovations generate greater economic value than marginal improvements (Trajtenberg, 1990).

4.5. Heterogeneity Analysis

Table 5 explores heterogeneous effects across firm and industry characteristics. Panel A divides the sample by firm size. For large firms (above median assets), the ESG financing coefficient is 0.421 ($p < 0.01$) for green innovation and 0.234 ($p < 0.05$) for productivity. In contrast, small firms exhibit smaller and statistically insignificant effects (0.187, $p = 0.23$ for innovation; 0.092, $p = 0.41$ for productivity). Chow tests confirm significant differences across subsamples ($F = 8.7$, $p < 0.01$).

Panel B examines technology-intensity heterogeneity. High-tech industries (including pharmaceuticals, software, and electronics) exhibit ESG financing coefficients of 0.489 ($p < 0.01$) for innovation and 0.267 ($p < 0.01$) for productivity. Low-tech industries show substantially weaker effects (0.156, $p = 0.08$ for innovation; 0.098, $p = 0.27$ for productivity). These findings support H3, indicating that absorptive capacity and technological complementarities moderate ESG financing effectiveness.

Panel C presents quantile regression results, revealing that ESG financing effects concentrate in the upper quantiles of the innovation and productivity distributions. At the 75th percentile, coefficients reach 0.512 for innovation and 0.289 for productivity, compared to 0.201 and 0.114 respectively at the 25th percentile. This suggests that ESG financing particularly benefits firms already positioned to capitalise on sustainability opportunities, potentially exacerbating performance dispersion within industries.

4.6. Robustness Checks

Table 6 presents robustness checks. Alternative innovation measures including patent grants and citation-weighted patents yield consistent results (Columns 1-2). Productivity estimates using Olley-Pakes and ACF methodologies produce similar coefficients and significance levels (Columns 3-4). Examining longer lags (t-2) reduces coefficient magnitudes slightly but preserves statistical significance (Column 5), consistent with innovation effects materialising gradually.

Difference-in-differences analysis treating ESG financing initiation as a treatment event confirms parallel pre-treatment trends and significant post-treatment effects (Column 6). Falsification tests using non-green patents as outcomes yield null results ($\beta = 0.047$, $p = 0.52$), supporting the interpretation that ESG financing specifically stimulates environmental innovation rather than innovation generally. Additional tests excluding the financial crisis period (2020-2021) and controlling for COVID-19 impacts through monthly revenue volatility measures preserve our core findings.

5. Discussion

5.1. Interpretation of Findings

Our findings provide robust evidence that ESG financing causally enhances both green innovation output and productivity growth among UK firms. The positive innovation effects likely reflect multiple mechanisms. First, ESG financing reduces capital costs for environmental projects, alleviating financial constraints that might otherwise deter long-term, uncertain green R&D investments (Hall and Lerner, 2010). Second, the covenants and monitoring associated with ESG instruments create accountability structures that align managerial incentives with sustainability objectives, potentially reducing agency costs and improving resource allocation (Gillan et al., 2021). Third, ESG financing serves as a credible signal of corporate commitment, attracting environmentally conscious employees, customers, and partners who contribute complementary resources and knowledge (Greening and Turban, 2000).

The productivity effects, whilst smaller in magnitude than innovation effects, nonetheless demonstrate economic significance. Our mediation analysis indicates that approximately 28% of productivity gains operate through green innovation channels, with the remainder attributable to alternative mechanisms. These may include operational efficiency improvements from energy-saving technologies, enhanced reputation facilitating customer acquisition, and

improved employee morale and retention associated with corporate sustainability leadership (Edmans, 2011). The fact that citation-weighted patents exhibit stronger mediation effects underscores the importance of innovation quality rather than mere quantity in driving economic outcomes.

The heterogeneous effects across firm size and industry characteristics carry important implications. The concentration of benefits among larger, technology-intensive firms suggests that ESG financing complements rather than substitutes for existing innovation capabilities. Smaller firms may lack the absorptive capacity to effectively deploy ESG financing toward innovation, or may face higher transaction costs in accessing ESG capital markets. This raises equity considerations, as policies promoting ESG financing could inadvertently widen performance gaps between large and small firms or between technology leaders and followers within industries.

5.2. Theoretical Contributions

This study makes several theoretical contributions. First, we extend stakeholder theory by demonstrating that stakeholder orientation, operationalised through ESG financing, generates tangible innovation and productivity benefits rather than merely redistributing value among stakeholders (Freeman, 1984). Our findings support the 'enlightened stakeholder theory' proposition that stakeholder engagement can enhance shareholder value under appropriate conditions (Jensen, 2001).

Second, we contribute to the Porter Hypothesis debate by providing micro-level evidence that environmental considerations, channelled through ESG financing, can stimulate innovation-led competitiveness improvements (Porter and van der Linde, 1995). However, our heterogeneity findings suggest important boundary conditions: Porter's logic may apply primarily to large, technologically sophisticated firms rather than universally across the economy.

Third, we advance resource-based theory by identifying ESG financing as a mechanism for accessing complementary resources that enhance dynamic capabilities (Teece et al., 1997). ESG commitments appear to unlock access to knowledge networks, talented employees, and partnership opportunities that amplify innovation capacity beyond the direct financial resources provided.

5.3. Policy Implications

Our findings carry implications for policymakers seeking to accelerate green transitions whilst maintaining economic competitiveness. The positive causal effects of ESG financing on innovation and productivity suggest that policies encouraging ESG finance can complement traditional environmental regulations and subsidies. The UK government's Green Finance Strategy and taxonomy development appear well-founded based on our evidence.

However, the heterogeneous effects across firm types indicate that ESG financing alone may prove insufficient for achieving economy-wide green transformation. Smaller firms and traditional industries may require targeted support mechanisms, such as subsidised green credit programmes or technical assistance, to overcome capacity constraints limiting their ability to leverage ESG financing effectively. Without such complementary policies, market-driven ESG finance expansion could exacerbate inequality and concentration within industries.

Policymakers should also consider measures to enhance ESG financing transparency and prevent 'greenwashing'. Stringent disclosure requirements and third-party verification of ESG-linked financing use-of-proceeds would strengthen the credibility of instruments and ensure that financing genuinely supports green activities. The EU's Sustainable Finance Disclosure Regulation and Taxonomy Regulation provide potential models for UK policymakers.

5.4. Managerial Implications

For corporate managers, our findings suggest that ESG financing represents a strategic tool for enhancing innovation capacity and competitive positioning rather than merely a compliance or reputational exercise. Firms seeking to strengthen green innovation capabilities should actively pursue ESG financing options and structure covenants to create internal accountability for sustainability performance.

However, managers should recognise that ESG financing effectiveness depends on complementary organisational capabilities. Firms lacking R&D infrastructure, technical expertise, or supportive organisational cultures may struggle to convert ESG financing into innovation outcomes. Consequently, ESG financing decisions should be integrated with broader strategic considerations regarding capability development and organisational readiness for green transformation.

Limitations and Future Research

Several limitations warrant acknowledgement. First, our focus on publicly listed UK firms limits generalisability to private companies and other countries with different institutional contexts. Future research should examine whether effects persist across diverse ownership structures and regulatory environments. Second, whilst our instrumental variable approach addresses endogeneity concerns, the exclusion restriction remains fundamentally untestable. Alternative identification strategies, such as regression discontinuity designs exploiting eligibility thresholds for ESG financing programmes, could provide complementary evidence.

Third, our patent-based innovation measures capture formal, codified knowledge but may overlook incremental process improvements or organisational innovations that do not result in patents. Future studies could supplement patent data with survey measures of innovation activities or alternative innovation proxies such as new product introductions.

Fourth, our analysis does not fully illuminate the mechanisms through which ESG financing influences innovation and productivity. Detailed case studies or mediation analyses incorporating additional variables such as employee engagement, customer perceptions, and supplier relationships could provide richer insights into causal pathways.

Finally, our observation period (2015-2024) captures a period of rapid ESG growth but may not reflect long-run equilibrium effects. As ESG financing becomes increasingly mainstream, competitive pressures and market saturation could diminish marginal benefits. Longitudinal studies tracking effects over longer horizons would provide valuable evidence on sustainability.

6. Conclusion

This study provides robust empirical evidence that ESG financing causally enhances green innovation output and productivity growth among UK firms. Employing instrumental variable estimation to address endogeneity concerns, we find that a 10% increase in ESG financing corresponds to approximately 3.4% increase in green patent applications and 1.9% improvement in total factor productivity. Mediation analysis reveals that green innovation partially transmits ESG financing effects to productivity, accounting for approximately 28% of total productivity gains.

Importantly, we document substantial heterogeneity in ESG financing effects across firm and industry characteristics. Benefits concentrate among larger firms and technology-intensive industries, suggesting that ESG financing complements rather than substitutes for existing innovation capabilities. This heterogeneity carries implications for both corporate strategy and public policy, indicating that targeted interventions may be necessary to ensure that smaller firms and traditional industries can participate in green transitions.

Our findings contribute to ongoing debates regarding the economic consequences of stakeholder-oriented governance and sustainable finance. Contrary to claims that ESG considerations represent costly constraints on profit maximisation, we demonstrate that ESG financing can enhance core economic outcomes including innovation and productivity. However, these benefits are not automatic but depend on organisational capabilities and strategic implementation.

As global efforts to address climate change intensify, understanding how financial mechanisms can catalyse green transitions whilst maintaining economic competitiveness becomes increasingly critical. This study provides evidence that ESG financing represents a viable tool for achieving these dual objectives, at least among firms with sufficient absorptive capacity. Future research should continue exploring boundary conditions, mechanisms, and long-term dynamics to inform evidence-based policy design and corporate strategy in the evolving landscape of sustainable finance.

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