Insight

ESG Backlash: Cost & Competition Implications for States & Taxpayers

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Executive Summary

- Elected officials at state and federal levels have increasingly called for financial services firms to cease what they see as aggressive environmental, social, or governance (ESG) policies.
- In acute cases, states have enacted legislation preventing them from contracting with banks and asset managers with ESG policies, removed state funding from these firms, or reinvested state pension policies.
- Private actors should be allowed to follow whatever course is set by their shareholders, and government officials by their constituents, but ideological restrictions on market transactions will necessarily decrease competition and quality and increase costs for the stakeholders government officials seek to represent.

Introduction

Recent months have seen a surge in aggressive rhetoric toward financial services firms from members of Congress and state officials in response to the environmental, social, and governance (ESG) lenses through which some firms make business, operating, and investing decisions. Government officials seeking to control, or at least direct, how banks, insurers, and asset managers serve certain clients and categories of interest is not a new phenomenon; previously there have been efforts to limit the ability of financial services firms to work with gun manufacturers or the operators of private prisons.

The current discussions on Capitol Hill and beyond are largely among Republicans. At the state level, wheels are already in motion to curtail the adoption of ESG policies as state treasurers look to exclude financial services firms they see as boycotting fossil fuels. In the main, this involves disinvesting from pension funds held by asset managers or legislation designed to prevent procurement contracts with banks. This illustrates an interesting tension for market-oriented economists. On the one hand, it seems entirely appropriate that banks, asset managers, and other financial actors consider the wishes of their shareholders, and state treasurers and other government officials the wishes of their constituents, in making business and financial decisions.

On the other hand, these market actors must recognize and take ownership for the fact that artificially restricting the market by picking and choosing with whom they will or won't do business will necessarily increase prices for, and reduce the competition and quality of, goods and services received by the very same stakeholders they are seeking to represent. Government officials must also recognize that the appropriate role of governance is to empower free markets rather than seek to direct how financial services firms run their business on the basis of political ideology.

Increasing Hostility

State officials, and state Republican financial officials in particular, have taken unusual steps to terminate relationships with financial services firms. State treasurers have pulled millions of dollars out of funds invested with asset manager BlackRock and others. In early December the Florida Chief Financial Officer Jimmy Patronis announced that the state would pull $2 billion in investments from BlackRock in protest against the asset manager's stance on ESG issues. West Virginia Treasurer Riley Moore leads a coalition of 15 state treasurers threatening to continue to apply pressure against firms seen to have aggressive ESG policies. The goal of this approach is the implementation of state legislation governing contracts with ESG investors in a further 12 to 20 states. For state legislators, the intent is the creation of a stronger or new kind of "fiduciary duty" (see below) that requires financial services firms to consider only financial returns in their decision-making. These questions are not purely limited to finance – for a governance example, Arizona Treasurer Kimberley Yee pulled state funding for Unilever after its subsidiary, Ben and Jerry's, stopped doing business in Israeli-Palestinian territories (a decision subsequently overturned by the Unilever board).

Companies will pursue the ESG policies supported by their shareholders, but a more aggressive stance against firms with ESG policies puts those companies in the invidious position of having satisfied neither end of the political spectrum – any individual firm can be pilloried by Democrats for not having done enough to distance itself from fossil fuels and *simultaneously* excoriated by Republicans for having done too much; all while following their ESG requirements as set by the federal regulators.

There is, of course, a role for federal and state regulators and government officials in the appropriate oversight of financial firms in the application of ESG policies. In late November the Securities and Exchange Commission (SEC) fined bank Goldman Sachs $4 million for several "policy and procedural failures" related to their ESG policies. Yet supervising the financial services firms that fall within the purview of the federal financial regulators is significantly different from distorting market decisions in which those firms operate in order to serve a political ideology (regardless of what that ideology is). The potential for government overreach is particularly vivid where it comes to the business of asset managers, which already have a fiduciary duty to their customers, a legal standard that requires them to operate in their best interests. If a breach of fiduciary duty is not demonstrated, going any further in demanding how asset managers conduct their business is both uneconomic and an improper use of government resources.

The Likely Economic Implications

The current trends demonstrated at a state level by financial officials are too recent for there to be significant data available on the economic implications of these decisions. It is likely axiomatic that artificially reducing the number of market participants will decrease competition and in doing so decrease quality and increase the price of goods and services.

These conclusions seem to be backed by one of the few studies performed in this arena by the University of Pennsylvania, which tracked the flight of five large municipal bond underwriters from the state of Texas following the enactment of state law prohibiting municipalities from contracting with firms, but particularly asset managers, that held certain ESG policies. The study estimated Texans would pay an additional $300–$530 million in interest on $32 billion in borrowing during the first eight months following the introduction of these laws. For some, however, these costs may be worth it, and a particular contention of some in this debate is that ESG policies have marginal impact on, for example, the reduction in global carbon footprint, but do come at increased costs to American consumers – and that it is therefore appropriate to attempt to disincentivize those firms from enacting those policies.

Notably, for most financial services firms denied state pension fund or contracting access, the economic implications are slight. In another significant divestment, for example, Louisiana Treasurer John Schroder announced in October that the state would withdraw almost $800 million out of funds with BlackRock, noting that BlackRock's positions on ESG investment strategies would "cripple" Louisiana's energy sector. With an estimated $10 trillion in assets under management, the economic implications for BlackRock will be significantly smaller than Louisiana.

Louisiana will, of course, reinvest these funds elsewhere, but this will likely come at a significant cost to the pension holders, in line with the University of Pennsylvania study. These are significant financial decisions made by, in the case of some state treasurers, single actors with wide ramifications for their states. By comparison, with $8.5 trillion in assets under management, BlackRock will not face significant financial implications from Louisiana's fund withdrawal. Nonetheless, despite the immediate financial implications being slight, the potential for heavy-handed regulation and reputational damage still has firms concerned, with BlackRock in particular launching a new website devoted to showcasing the firm's efforts to continuing to fund fossil fuel extraction.

Conclusions

Capitalism at its core is based on the benefits provided by market incentives. The appropriate role of government should be to encourage the growth of companies in providing the products and services to whatever interest groups are determined by shareholder demand. Instead, increasingly strident demands from either end of the political spectrum seek to tell financial firms what products they should offer, and to whom. The uncertainty generated by seemingly capricious decisions made at the state level on ideological grounds also contributes to inefficient market outcomes. The efficient flow of goods and services around markets requires choice. Private actors should be able to choose with whom they will do business, as should state treasurers. Any restrictions on the ability to choose will necessarily harm consumers the most, particularly where those restrictions are in excess of the limits already placed on their activities by regulators and the markets.