



Integrating Antitrust Laws Into Environmental, Social, and Governance Disclosures

By Marc Jarsulic | September 8, 2021

There is growing consensus in the United States that corporations need to disclose more about their activities and outcomes to include important environmental, social, and governance (ESG) data. The move to require this information is based on a desire to improve the operation of capital markets. Capital markets function effectively—providing accurate market signals about corporate performance and allocating finance efficiently—when participants are well informed about how corporations are currently performing and how they are positioned to respond to changes on the horizon. As conditions in the economy have changed, the set of information needed by capital markets has expanded beyond the calculation of immediate profit and loss. Climate change, which is altering the physical environment and producing a widening range of governmental responses, requires capital market participants to take into account possibly sharp changes in business conditions.¹ Increased focus on social equity and economic inequality means that demographic, occupational, and compensation data on a firm's employees take on new importance for consumer behavior and business operation and success.²

While efforts to expand corporate disclosures along these dimensions are under way at the U.S. Securities and Exchange Commission (SEC), there is good reason why ESG disclosures also ought to include markers that reflect the market power of firms and competitive conditions in the markets in which they operate. Just as the economy relies on capital markets to allocate finance, it also relies on competition in product markets to incentivize adaptation and innovation. When product markets are competitive, higher rates of return are signals that firms are especially productive or that supply is insufficient relative to demand. Directing finance to higher-profit firms under these conditions would help to increase efficiency, which is socially beneficial and something that capital markets ideally would accomplish.

On the other hand, when competitive conditions are weak, firms that are protected by entry barriers earn supracompetitive profits. These returns are attractive to investors, result in high equity market valuations, and provide these firms lower cost debt finance.

However, allocating capital on this basis, while individually rational for investors, is not optimal. As illustrated below, increases in the market power of firms occur alongside measurable and significant distortions in income distribution, operational efficiency, and capital investment.

Requiring that firms disclose markers of market power can serve several useful purposes. Socially conscious investors may well wish to avoid supporting such firms. Other investors may wish to avoid them because they are likely to experience economic shocks as antitrust enforcement becomes more vigorous. The recent introduction of antitrust legislation aimed at curbing the market power of large online platforms indicates that this is not idle conjecture.³

Moreover, because these markers make it easier for legislators, regulators, and antitrust agencies to identify firms and sectors where competition is weak, disclosure would also improve the overall functioning of capital markets.

This issue brief goes on to identify, using aggregate data, several statistical markers that, taken together, provide strong evidence of the existence of increased barriers to entry as well as declines in overall competition across the U.S. economy since the beginning of 21st century. While the data fluctuate because of business cycle changes and other shocks to the economy, the trends appear to signal increased market power and a decline in competition. Requiring the reporting of firm-level versions of these markers would mean minimal effort on the part of issuers but should lead to routine inclusion in the feeds of data aggregators. This would make analysis of market power easier and facilitate routine consideration of competition issues when capital market developments are discussed.⁴

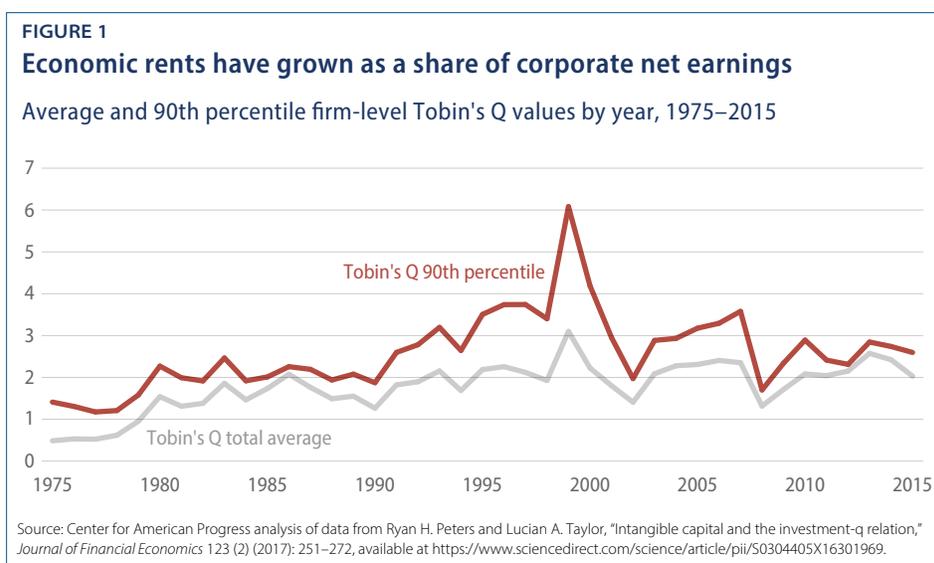
Ratio of market value to replacement cost of capital

There is significant evidence that the competitive environment in the U.S. economy has changed dramatically since the late 1970s, with a significant share of corporations earning returns that exceed competitive levels.

Under competitive conditions—in which capital owners with funds to invest maximize their profits and there are no barriers that prevent these funds from flowing to the projects with the highest rates of return—it is expected that rates of profit on invested capital will converge across firms and industries to a common, equilibrium value. The logic behind this expectation is simple: Supranormal rates of return in any line of business create the incentive for their own elimination, since profit-maximizing investors will have extra incentive to enter that business, replicate the productive process used by incumbent firms, and earn some of the higher profits for themselves. Entry should continue until the effects of increasing supply reduce prices and eliminate rents—that is to say, the difference between competitive and supranormal profits.

However, data from financial markets reveal that, in the aggregate, the share of rents in corporate income is positive and has trended upward since the late 1970s. To visualize this, consider the ratio of the market value of corporations to the replacement cost of the physical and intangible capital stock that they employ. This ratio, called Tobin's Q, should be equal to 1 under competitive market conditions. Otherwise, there is an arbitrage opportunity; a new entrant could buy a unit of capital and immediately earn a return equal to the difference between the cost of capital and the existing market value.

However, Q values for many nonfinancial corporations have been trending upward since the late 1970s and are now significantly greater than 1, as seen in Figure 1, which graphs average and 90th percentile Q values from 1975 to 2015. Over this period, there has been an upward trend in average Q and the 90th percentile value of Q.⁵



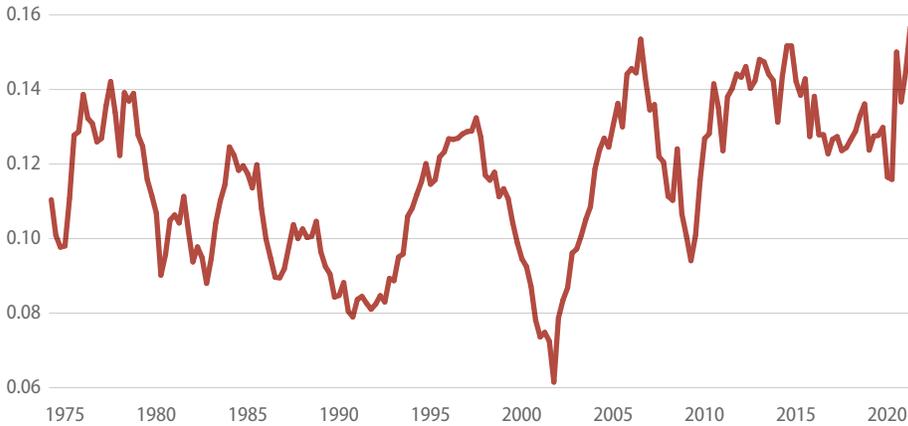
If publicly traded firms were required to disclose their average Q ratios over five years, observers would have an easy metric to help identify firms protected by entry barriers and possessing market power.⁶

Profit margin

A firm's profit margin measures its ability to raise the price for a good above the marginal cost of producing it. The aggregate profit margin for nonfinancial corporations—measured as the ratio between unit profits (net of depreciation) and unit price—is graphed in Figure 2.⁷ From 1975 to 2001, the average value was 10.7 percent; and from 2001 to 2021, it was 12.5 percent. Since competition should push prices in the direction of marginal cost, this upward drift is consistent with a rise in market power in the past two decades.⁸ Requiring firms to report profit margins would provide another marker that could be used to distinguish firms that may be protected by barriers to entry.

FIGURE 2
Nonfinancial corporate margins have increased

Profit margin for nonfinancial corporations, 1974–2020



Sources: Federal Reserve Bank of St. Louis, "Profit per unit of real gross value added of nonfinancial corporate business: Corporate profits with IVA and CCAdj (unit profits from current production)," available at <https://fred.stlouisfed.org/series/A463RD3Q052SBEA> (last accessed July 2021); Federal Reserve Bank of St. Louis, "Price per unit of real gross value added of nonfinancial corporate business," available at <https://fred.stlouisfed.org/series/A455RD3Q052SBEA> (last accessed July 2021).

Ratio of net investment to profits

Empirical research has shown that firms protected from competition by barriers to entry have diminished incentive to invest, which suggests that, in the longer term, innovation becomes less likely.⁹ With less competitive pressure, one would expect the ratio of capital investment to profits to decline for such firms: Why invest so much when few can contest your market? The aggregate value of this ratio for nonfinancial corporations trends downward after 2000, as shown in Figure 3.¹⁰

FIGURE 3
Nonfinancial corporate investment has fallen relative to after-tax profits

Nonfinancial corporate net investment as a share of after-tax profits, 1975–2020



Sources: Net investment: Board of Governors of the Federal Reserve System, Nonfinancial corporate business; gross fixed investment [BOGZ1/FA105019005.A] minus Nonfinancial corporate business; consumption of fixed capital, structures, equipment, and intellectual property products, including equity REIT residential structures (NIPA basis) [BOGZ1/FA106300005.A]. See Board of Governors of the Federal Reserve System, "Financial Accounts Guide," available at <https://www.federalreserve.gov/apps/fof/Default.aspx?ck=d> (last accessed August 2021). Profits: Federal Reserve Bank of St. Louis, "Net value added of nonfinancial corporate business: Corporate profits with IVA and CCAdj; Profits after tax with IVA and CCAdj," available at <https://fred.stlouisfed.org/series/W328RC1Q027SBEA> (last accessed August 2021).

Requiring firms to report the annual ratio of capital investment to after-tax profit over five years would also help to identify firms that face limited competitive pressure.

Labor share in firm value added

The ability of firms to increase their returns above competitive levels is also reflected in the decline in share of labor in value added. As seen in Figure 4, there has been a long-term decline in labor's share in the gross value added of nonfinancial corporations, beginning around the year 2001.¹¹ Although labor's share began to recover somewhat after 2012, it still remains well below levels reached in the 1975–2000 period. Economist Simcha Barkai has shown that this decrease in labor share cannot be explained by the substitution of capital for labor in the production process and is therefore attributable to increased firm market power in either product or labor markets.¹²

FIGURE 4

Labor's share of nonfinancial corporate income has declined

Index of labor's share of nonfinancial corporate income, 1975–2021



Source: Federal Reserve Bank of St. Louis, "Nonfinancial Corporations Sector: Labor Share for Employees," available at <https://fred.stlouisfed.org/series/PRS88003173> (last accessed June 2021).

Requiring firms to report the share of labor compensation in value added would help identify firms and markets where market power is significant.

Conclusion

There are well-established statistical markers that can help identify firms that have market power and are protected from competitive entry. Examining these markers using aggregate data illustrates how pervasive market power has become across the U.S. economy. If the SEC were to require disclosure of firm-level versions of these markers,

the efficiency of capital markets would be improved, because standardized disclosures would make important information about structure of the economy more easily available and would make it easier for legislators, regulators, and competition agencies to identify markets where competition is inhibited. All of these outcomes are desirable and would place little burden on corporate filers.

Moreover, requiring these disclosures is consistent with the mission of the SEC and well within its legal authority. This is evident from the language of Securities Exchange Act of 1934:

Whenever pursuant to this chapter the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.¹³

It also follows from sophisticated legal analysis of the scope of SEC rulemaking authority.¹⁴

It therefore seems useful and reasonable to include these markers of market power on the ESG disclosure agenda.

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Endnotes

- 1 Allison Herren Lee, "A Climate for Change: Meeting Investor Demand for Climate and ESG Information at the SEC," U.S. Securities and Exchange Commission, March 15, 2021, available at <https://www.sec.gov/news/speech/lee-climate-change>.
- 2 Jill Cornfield, "Millennials look to make a social impact with their investing dollar, study finds," CNBC, July 14, 2020, available at <https://www.cnbc.com/2020/07/14/millennials-look-to-make-a-social-impact-with-their-investing-dollar.html>; Leslie Albrecht, "This is what millennials care about when they invest," MarketWatch, September 11, 2018, available at <https://www.marketwatch.com/story/some-millennial-investors-care-more-about-doing-good-than-making-money-2018-09-10>; Audrey Choi, "How Younger Investors Could Reshape the World," Morgan Stanley, January 24, 2018, available at <https://www.morganstanley.com/access/why-millennial-investors-are-different>.
- 3 See Christiano Lima, Leah Nylen, and Emily Birnbaum, "Tech crackdown survives House panel's marathon slugfest," *Politico*, June 24, 2021, available at https://www.politico.com/amp/news/2021/06/24/judiciary-tech-anti-trust-495903?_twitter_impression=true.
- 4 The information conveyed in these markers will, of course, not be news to professional financial market participants who already reward those with market power with high equity values.
- 5 For a discussion of Q ratios and what they indicate, see Eric B. Lindenberg and Stephen A. Ross, "Tobin's Q Ratio and Industrial Organization," *The Journal of Business* 54 (1) (1981): 1–32, available at https://www.researchgate.net/publication/24102787_Tobin's_Q_Ratio_and_Industrial_Organization; Marc Jarsulic, Ethan Gurwitz, and Andrew Schwartz, "Toward a Robust Competition Policy" (Washington: Center for American Progress, 2019), available at https://www.americanprogress.org/issues/economy/reports/2019/04/03/467613/toward-robust-competition-policy/?_ga=2.56185707.1777557696.1624727090-2016575909.1624727090.
- 6 A five-year period is suggested for this and subsequent markets to allow construction of averages that reduce the influence of short-term factors.
- 7 Profit per unit and unit price data are from the U.S. Bureau of Economic Analysis. See Federal Reserve Bank of St. Louis, "Profit per unit of real gross value added of nonfinancial corporate business: Corporate profits with IVA and CCAj (unit profits from current production)," <https://fred.stlouisfed.org/series/A463RD3Q052SBEA> (last accessed July 2021); Federal Reserve Bank of St. Louis, "Price per unit of real gross value added of nonfinancial corporate business," available at <https://fred.stlouisfed.org/series/A455RD3Q052SBEA> (last accessed July 2021).
- 8 A firm might have a higher profit margin, or Lerner index, because it is relatively efficient in some way, allowing it to have higher margins than competitor firms. However, the firm-level statistical analysis below shows that barriers to entry are a better explanation of abnormal profits than efficiencies, which suggests that the observed changes in the aggregate Lerner index reflect changes in market power. See Gustavo Grullon, Yelena Larkin, and Roni Michaely, "Are US Industries Becoming More Concentrated?," *Review of Finance* 23 (4) (2019): 697–743, available at <https://academic.oup.com/rof/article/23/4/697/5477414>.
- 9 See Germán Gutiérrez and Thomas Philippon, "Investment-less Growth: An Empirical Investigation" (Cambridge, MA: National Bureau of Economic Research, 2016), available at <https://www.nber.org/papers/w22897>; Germán Gutiérrez and Thomas Philippon, "Declining Competition and Investment in the U.S." (Cambridge, MA: National Bureau of Economic Research), available at <https://www.nber.org/papers/w23583>; Thomas Philippon, *The Great Reversal: How America Gave Up on Free Markets* (Cambridge, MA: The Belknap Press of Harvard University Press), chapter 4.
- 10 Net investment and profits data are from the U.S. Board of Governors of the Federal Reserve System and the U.S. Bureau of Economic Analysis, respectively. See U.S. Board of Governors of the Federal Reserve System "Financial Accounts Guide: Nonfinancial corporate business; gross fixed investment & Nonfinancial corporate business; consumption of fixed capital, structures, equipment, and intellectual property products, including equity REIT residential structures (NIPA basis), transactions," available at <https://www.federalreserve.gov/apps/fof/Default.aspx?ck=d> (last accessed August 2021); Federal Reserve Bank of St. Louis, "Net value added of nonfinancial corporate business: Corporate profits with IVA and CCAj; Profits after tax with IVA and CCAj," available at <https://fred.stlouisfed.org/series/W328RC1Q027SBEA> (last accessed August 2021).
- 11 Index of labor's share data are from the U.S. Bureau of Labor Statistics. See Federal Reserve Bank of St. Louis, "Nonfinancial Corporations Sector: Labor Share for Employees," available at <https://fred.stlouisfed.org/series/PRS88003173> (last accessed June 2021).
- 12 Simcha Barkai, "Declining Labor and Capital Shares" (2016), available at <http://home.uchicago.edu/~barkai/doc/BarkaiDecliningLaborCapital.pdf>.
- 13 Securities Exchange Act of 1934, Public Law 291, 73rd Cong., 2nd sess. (June 6, 1934), 15 U.S. Code § 78(c), available at <https://www.law.cornell.edu/uscode/text/15/78c>.
- 14 See Alexandra Thornton and Tyler Gellasch, "The SEC Has Broad Authority To Require Climate and Other ESG Disclosures" (Washington: Center for American Progress, 2021), available at <https://www.americanprogress.org/issues/economy/reports/2021/06/10/500352/sec-broad-authority-require-climate-esg-disclosures/>.