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Anti-ESG Legislation is Demonstrating the Peril of Meddling in Markets

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In early May, Florida Governor Ron DeSantis signed into law stringent legislation aimed at limiting the use of environmental, social, and governance (ESG) factors in financial decision-making in the state. But Florida is hardly alone in mounting an anti-ESG crusade. After years of headlines about the growing ESG movement in investing and corporate governance, ESG has been met with backlash, with some of the loudest voices coming from state lawmakers and presidential hopefuls.

But the anti-ESG movement falls victim to the same faults of its pro-ESG counterpart: by seeking to enshrine political ideology into financial decision-making, ESG opponents undermine the same free markets they purport to protect, in turn decreasing returns for pension beneficiaries and raising costs for taxpayers.

This is largely because anti-ESG rhetoric often conflates multiple concepts.

While ESG is an umbrella term indiscriminately applied to a variety of management and investment decisions and strategies, it is critical when analyzing potential legislation to differentiate between *value*-based ESG and *values*-based ESG.

Value-based ESG refers to integrating financially material ESG factors when evaluating a company's economic prospects. There is little new about this type of ESG. It may not be simple to determine whether a factor is financially relevant, but making such determinations are not well-served by one-size-fits-all pronouncements mandating or prohibiting consideration of ESG factors.

In contrast, *values*-based ESG seeks to achieve an outcome consistent with a particular set of values, like decreasing carbon footprints or increasing diversity on boards of directors. Regardless of whether the values are progressive or conservative, this type of ESG is comfortable with sacrificing investment returns in exchange for a non-financial outcome.

Back in March, DeSantis and 18 other Republican governors announced an "anti-ESG alliance," agreeing to protect "taxpayers from ESG influences across state systems" and "citizens from ESG influences in the financial sector." These self-described "freedom-loving states" refer generally to uniting against "woke ideology," but other statements by conservative officials specifically focus on protecting certain industries, such as fossil fuels and firearms manufacturers.

A wide range of anti-ESG measures have been proposed at the state level, including boycotting or divesting from disfavored financial institutions, limiting the grounds for decision-making by state officials, and constraining the discretion of banks in making loans. While approaches in individual states differ, Florida, for example, has adopted an "all of the above" approach.

What unites these approaches, though, is that they inject a particular ideology into financial decision-making. That is simply values-based ESG by another name, *not* market-based decisions based on financial results. And, like with all values–based ESG, pursuing non-financial outcomes can lead to diminished investment returns or other economic detriment.

For example, state laws already generally require that pension plan fiduciaries act in the best financial interest of the plan's beneficiaries. Under these standards, fiduciaries should not be choosing funds—whether values-driven or not—that aren't in the plan beneficiaries' pecuniary interests. For that reason, nothing at all has changed for some funds in states where officials have taken strong anti-ESG stances.

But artificially limiting the pool of investments through boycott and divestment—or by categorially preventing plan fiduciaries from considering ESG factors—can negatively impact a plan's investment returns. Pension funds in some states have objected to such anti-ESG measures as inconsistent with their fiduciary responsibilities. And pension funds in other states have estimated losses under anti-ESG provisions, including $3.6 billion in Kansas, $6.7 billion in Indiana, and $6 billion in Texas over a 10-year period.

These negative impacts are not limited to pension investing. A recent study looking at Texas, which prohibits local jurisdictions from contracting with banks that have adopted ESG policies against oil and gas and firearms industries, estimates that Texas cities will face higher costs in issuing municipal bonds.

It's also not at all clear that such restrictions will even benefit the industries that ESG opponents favor. Recent research found that Texas' prohibition on ESG funds didn't meaningfully shift the allocation of Texas retirement funds toward the energy sector.

Thus, it makes sense to ask, as a Wyoming state representative did: "are we biting off our nose to spite our face?" And that question equally applies whenever officials seek to constrain the free market by imposing a state-sponsored ideological screen on financial institutions. Such measures harm taxpayers and pension beneficiaries and create an environment where each state feels empowered—or compelled—to add an increasing number of ideological or protectionist demands on financial institutions that wish to serve them.

Recognizing these difficulties, some states, like Arkansas, have passed anti-ESG bills that make exceptions where following the law's proscriptions will increase costs. But rather than taking this route—which imposes more administrative costs, at the very least—states should decline to pass anti-ESG measures, as Wyoming and North Dakota did, and welcome competition in financial services.

Such competition is not at odds with a state's right to make contracting decisions; where a financial firm is engaging in values-based ESG, the state may choose not to buy what the company is selling. But the state's decisions should be motivated primarily by investment performance and pecuniary interests, rather than exogenous policy or ideological concerns.

Anti-ESG rhetoric is likely to remain a talking point among lawmakers and campaigners, but it shouldn't be translated into legislation. The voices may be loud, but as Edmund Burke observed, "it is a general popular error to imagine the loudest complainers for the public to be the most anxious for its welfare."

When it comes to ESG, the public's welfare is served by preventing the government from dictating how investment decisions should be made.

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