Making ESG Work:

How investors can help improve low-wage labor and ease income inequality

CASEY O'CONNOR-WILLIS

NYU | STERN

Center for Business
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Author

Casey O'Connor-Willis is a Senior Program Manager and Research Scholar at the NYU Stern Center for Business and Human Rights.

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Executive Summary

In recent years, individual and institutional investors' interest in more socially conscious investment strategies has exploded. At the end of 2020, more than $35 trillion was invested worldwide in funds that consider environmental, social, and governance (ESG) factors in addition to traditional financial analysis. By one estimate, ESG investments will soon account for a third of all global assets under management.

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But the "S," or social, dimension of these funds has so far been limited and ill-defined. This is at least partly attributable to the vast and varied effects companies have on society. Researchers, civil society advocates, and investors rarely agree about what constitutes "good" social performance. And there is often insufficient data on companies' social effects, which inhibits asset owners and managers from understanding how these issues relate to a company's or portfolio's financial performance. To compensate, most "S" metrics assess internal company processes and policies, rather than their core business practices and actual impact on society. This analysis fails to provide a meaningful assessment of corporate actions and risks.

Because of these challenges, and the urgent risks posed by global warming, most ESG funds focus overwhelmingly on the "E." According to one recent study, 68% of U.S. and European assets invested using ESG analysis were in funds that target climate change and other environmental issues.

But the Covid-19 pandemic has drawn increased attention to social concerns, particularly growing income inequality and the plight of low-wage workers who provide many of the goods and services we rely on. In the ESG context, this attention has focused primarily on reining in CEO pay and improving the diversity, health, and well-being of companies' direct employees. These are promising developments, but they pay insufficient attention to the way that outsourcing, both domestically and globally, has fundamentally reshaped the workforces on which most modern companies rely.

Outsourcing the lower-value, more labor-intensive dimensions of company operations is now a central ingredient of most business models. This practice has brought jobs to emerging economies around the world and yielded significant labor cost-savings and improved productivity for lead companies, often based in advanced economies. But it also has reduced corporate managers' visibility into the diffuse and fragmented workforces their businesses now rely on. This arms-length relationship with low-wage workers creates new incentives to press suppliers and contract workers for cost savings and terms that require grueling hours and rock-bottom, unpredictable pay. While outsourced workers within the U.S. and other industrialized states in theory have some protections under national law, large populations of contract and migrant workers, as well as overburdened regulators, can make these hard to access in practice. In many emerging economies, the situation is even more precarious with laws that are weak and enforcement weaker still. As a result, outsourcing often leads to some of a company's most acute labor and other human rights risks.

This dynamic has contributed to a growing share of the value businesses generate going to profits rather than suppliers and workers. As a result, outsourcing—along with other factors, such as the tendency of automation to augment high-wage work and displace low-wage workers—has played an important role in the historic levels of income inequality now found in many mid- and high-income countries. This widening divide has troubling economic, social, and political consequences, but most importantly, it is often paired with economic precarity for workers at the bottom.

The growing demand for ESG investing presents an opportunity for asset managers to encourage companies to strike a better balance between near-term cost savings and the creation of decent, safe jobs around the world. But this will require addressing the challenges that to date have limited the quantity and quality of "S" analysis. Fund managers and ESG data providers must get more creative in assessing social performance and look more directly at the ways company earnings may depend on illegal labor practices, inadequate and inconsistent pay, chronic overtime, and unsafe working conditions. Over time, this will require obtaining more and better information regarding a company's labor costs, including those associated with outsourced workers. Finally, while improving the treatment of workers is likely to yield a host of long-term benefits, both to companies and society, realizing these benefits will not be free. Unlike many environmental and governance improvements, raising the quality of low-wage work is likely to entail persistent costs. Investors who want a genuine "S" in their ESG funds will need to be prepared to pay for it in the form of more modest returns.

Fixing the "S" will require the participation of asset owners and managers, investment consultants, ESG data providers, and governments. Here are our recommendations for how to get started:

> "Outsourcing the lower-value dimensions of company operations is now a central ingredient of most business models. And it often leads to some of a company's most acute labor and other human rights risks."

Recommendations

To Asset Owners, Investment Consultants, and Asset Managers

1. Acknowledge the need to significantly revise and strengthen the "S" in ESG and direct sufficient resources to tackling this challenge.

2. In strengthening the "S," place greater emphasis on the quality of low-wage work and the extent to which outsourcing practices are contributing to lower-paying, precarious jobs. This will entail encouraging companies to report more and better data relating to employment practices, especially for outsourced labor.

3. Asset owners and investment consultants should demand and incentivize better social assessments from asset managers and ESG ratings agencies, particularly relating to outsourced labor practices.

4. Asset managers should:

   Revise and strengthen the metrics for the "S" in ESG funds and offer greater transparency to investors regarding how funds currently define and evaluate the "S" category, including the data on which these measures are based.

   Offer interested investors ESG funds that conduct more rigorous assessments of companies' social performance, even if short-term returns on such investments are not comparable to other funds.

To ESG Ratings Providers

1. Prioritize updating the "S" component of measurement systems with a particular emphasis on causes of income inequality, including corporate outsourcing practices.

2. Develop more and better metrics for assessing outsourcing practices, shifting away from a primary focus on company policies, audits, grievance systems, and controversies. (See the appendix for some preliminary ideas.)

3. Better integrate assessments of financial performance and ESG performance. This means that assessments should flag when a company's profitability or market share reflect or create heightened risk for labor abuse.

To Governments

1. Ensure that asset owners and managers can legally consider investors' and beneficiaries' environmental and social objectives in addition to their financial goals. In the U.S. context, this will require revising "fiduciary duty" requirements to ensure that the "best interests" of investors captures more than just maximum risk-adjusted financial returns.

2. Expand mandatory corporate reporting to include specific metrics for both direct employees and outsourced workers. These should include, at a minimum, information on the costs associated with these workforces, the nature of worker contracts, the location of workers, and the turnover rate of workers and suppliers.

3. Enhance the reporting requirements of institutional investors to include greater specificity regarding how "E," "S," and "G" factors are evaluated and what happens when these issues conflict with each other or with financial returns. New reporting requirements should also include greater transparency into how ESG funds factor these issues into their stewardship practices and proxy voting.

Introduction

"The pace of technological change and complexity of the modern globalized economy place practical limits on government oversight. Given this reality, consumers and employees are increasingly demanding that companies and their investors assume greater responsibility for the social consequences of corporate strategies and practices."

Even before Covid-19 shocked the global economy in 2020, the widening gap between rich and poor was generating media headlines and policy debates. Finance leaders from Larry Fink to Bill Ackman to Ray Dalio warned that economic inequality posed a mounting threat to the free market system.[1] Politicians across the political spectrum echoed their concerns, calling on businesses and investors to share more of their profits with the workers on whom they rely.[2] CEOs around the globe publicly endorsed the idea that their companies ought to serve the interests not only of shareholders, but also workers, suppliers, and customers.[3]

Beyond pronouncements by the powerful, large numbers of ordinary people believe that, as currently structured, the free market is leaving behind too many. In 2020, the annual "Trust Barometer," a global survey by the Edelman public relations firm, found that most respondents across advanced economies did not expect that they would be better off in five years, and 56% said that capitalism was doing more harm than good.[4]

The Covid-19 pandemic both exposed and exacerbated a growing economic divergence. In the U.S., 90% of high-wage "knowledge workers" retained their jobs during the crisis, in most cases quickly transitioning to working from home.[5] Most low-wage workers, on the other hand, faced one of two fates: More than 35% lost their jobs, while others continued to deliver essential services but risked their health to do so.[6] Low-wage workers typically had no savings to fall back on and in many cases had underlying health issues related to chronic poverty or inadequate healthcare.[7] Low-wage communities experienced coronavirus infection and death rates many times those of their higher-wage neighbors.[8] By December 2020, one in six American households with children reported not having enough food to eat.[9]

For non-Americans working in the global supply chains that are essential to industries ranging from agriculture to apparel, the situation was even more stark. One survey of garment, tea, and flower workers in developing economies found that within months of the start of the pandemic, most had to ration their meals because of lost income.[10] Throughout global supply chains, low-wage workers lost their jobs, in some cases receiving reduced or no pay for hours already worked.[11] Worldwide, incidence of child labor grew for the first time in 20 years, and the UN estimates that, as a result of the pandemic, decades of poverty reduction have been reversed.[12]

Historically, social and economic reformers have looked to governments to ensure that people across the income spectrum have access to safe jobs that afford a decent life. Public institutions still have a major role to play in this regard. But the pace of technological change and complexity of the modern globalized economy place practical limits on government oversight. Regulators are not keeping up. Given this reality, consumers and employees are increasingly demanding that companies and their investors assume greater responsibility for the social consequences of corporate strategies and practices.[13]

One approach that is gaining traction among asset managers, as well as the institutional and retail investors they serve, is ESG investing, which weighs a company's environmental, social, and governance practices, in addition to its financial performance. The basic idea of ESG investing is that, as asset owners and asset managers incorporate environmental, social, and governance considerations into their valuation of, and engagement with, companies, corporations will improve their performance in these areas to attract capital and satisfy shareholders. In other words, ESG investing provides an opportunity for investors to encourage corporate practices that should deliver higher-quality jobs and reduce inequality. (Please see sidebar on page 6.)

Once considered a niche market, ESG investing has grown rapidly and now looms large in global financial markets. Assets in ESG and other "sustainable" funds rose to $35 trillion worldwide at the end of 2020, up 66% from 2016.[14] Analysts at Bloomberg predict that by 2025, ESG funds will account for a third of all global assets under management.[15] Virtually every major asset management firm now offers an array of ESG-branded investment funds. Some of these asset managers are engaging with companies, seeking to reduce their carbon emissions, improve the racial and gender diversity of their boards, and disclose higher-quality information regarding their ESG practices.

But the booming ESG market is not without controversy. Skeptics question whether asset managers can deliver on the twin promises of encouraging corporate reform while providing investors with returns comparable to those of traditional funds.[16] In particular, firms selling ESG funds, and the data providers on whom they rely, are struggling to define the social component, where labor and other human rights issues reside. While the "E" and "G" factors are fairly well understood, "S" remains more amorphous, covering topics ranging from consumer safety to the operation of private prisons. This report focuses on how to sharpen the social component of ESG in ways that will help U.S. investors steer large public corporations toward more equitable labor practices.

Capitalism and its complexities

The relationship between the global economic system and income inequality is complex. In the past century, capitalism has vastly improved the overall well-being of people around the world. Collectively, the world's population is wealthier, healthier, and better educated than ever before.[17] A more integrated global economy has lifted billions of people out of abject poverty.[18] As an economic model, capitalism is arguably more successful than any other in modern history.

At the same time, however, income inequality has risen, in some countries to historic levels.[19] A growing share of the value that businesses generate goes to owners rather than workers, suppliers, or customers.[20] In advanced economies like the U.S. and UK, wages have grown substantially for high-wage workers, but workers without a college education have had more modest gains.[21] While wages for low-wage workers in emerging economies have grown more steadily than in advanced economies, around the world, low-wage work is still unstable and in many places provides inadequate income to afford even basic necessities.[22]

This widening divide, and worsening hardship for low-wage earners, have troubling economic, social, and political consequences. A series of studies have suggested that increased national income inequality is associated with a decline in the growth of gross domestic product (GDP) over time.[23] In contrast, rising income among the poor and middle class is linked to increased GDP. Researchers have also found that growing financial hardship among voters has contributed to the recent worldwide resurgence of populist ideologies characterized by anti-immigrant, nativist, and protectionist sentiments.[24] Candidates running on such platforms have emerged in countries ranging from the U.S. and France to Turkey and Brazil.[25] Populist movements have inspired political violence and pose a growing threat to free markets and liberal democracies, as illustrated by the January 2021 insurrection at the U.S. Capitol.[26]

While there is no single cause of rising income inequality, asset owners and managers can help by focusing greater attention on how their practices may contribute to the declining quality of low-wage work. A good place to start is to focus on rooting out practices that are illegal or broadly condemned, such as forced or child labor, poverty-level wages, chronic and mandatory overtime, and hazardous working conditions. This will entail looking at the unintended social consequences that can flow from common cost-cutting strategies. Chief among these strategies is outsourcing, in which companies farm out the production of goods and services to third-party suppliers and contract workers. Outsourcing has grown tremendously since the late 1980s, fundamentally changing both the structure of corporations and the nature of work.[27] In one arrangement, a company in, say, the U.S. apparel industry will contract with suppliers in China or Mexico to manufacture shirts and pants. In another, a company may outsource certain functions domestically—for example, janitorial or security services.

ESG: The Basics

Since the term was coined in 2004, ESG investing has been a notoriously slippery concept. In the most general terms, it refers to investment strategies that include consideration of a company's environmental, social, or governance performance alongside more traditional measures of financial performance. However, investment funds differ considerably in which "E," "S," and "G" factors they incorporate and how they attempt to reflect these issues in their strategies.

Asset managers often market their ESG offerings along a spectrum, with funds that place the greatest emphasis on ESG outcomes at one end and those more focused on financial returns at the other. Funds placing the greatest emphasis on ESG performance are often referred to as pursuing "impact investing." These funds seek to have a measurable impact on ESG concerns by investing in companies with a dedicated environmental or social objective, such as a wind farm or a micro-loan organization catering to disadvantaged borrowers. Bonds that fund a specific ESG project or objective also appear at this end of the spectrum.

In the middle are "socially responsible" or "sustainable" funds, which typically avoid companies based on their sale of certain controversial products, such as pornography, fossil fuels, or nuclear power. These funds might also select or weight companies on the basis of ESG scores determined by Bloomberg, MSCI, and other third-party ratings agencies. Last, there are "ESG integration" strategies, which emphasize achieving improved risk-adjusted returns and limit which ESG factors they consider in order to achieve this objective. Integration funds consider ESG issues only when fund managers have determined that they are likely to cause financial harm to a company or portfolio.

As a result of these differences, the ESG issues asset managers consider vary widely across industries and funds, but some common issues in each category include:

- **Environment:** climate change, resource depletion, waste, pollution, and biodiversity
- **Social:** job quality and relationships with employees and suppliers, customer health and safety, data privacy, indigenous land rights, community building, and philanthropy
- **Governance:** shareholder rights, bribery and corruption, executive pay, and board composition

In addition to factoring ESG considerations into stock selection, some asset owners and managers incorporate these issues into their private conversations with board members and senior management of companies in which they invest. ESG concerns may also help shape voting at companies' annual general meetings and communication with the media, regulators, and the public.

Federal regulations require fund managers to disclose some information regarding their investment objectives and ESG strategies, as well as the associated risks. But the funds often provide little to no information regarding which issues they consider and what weight they assign to them. Investors are similarly left in the dark as to when fund managers will tolerate poor ESG performance to preserve expected returns. As the volume of assets flowing into these funds continues to grow, regulators in the U.S., Japan, and Europe are now taking a closer look at these and other fundamental questions. In the meantime, what exactly ESG means is still open to interpretation.

In yet another approach, a company may seek to trim costs by hiring hourly independent contractors instead of direct full-time employees eligible for steady salaries and benefits.

Outsourcing in all of its forms often benefits companies, workers, and consumers. Corporations that undertake outsourcing effectively and equitably are able to focus on areas where they add the greatest value, generate higher returns for their investors, and provide goods and services to customers more quickly and at better prices.[28] The creation of global supply chains for clothing, food, and other products, as well as services like customer support, has also generated millions of jobs for people in developing economies. But outsourcing has many facets. Mid- and lower-skill jobs in advanced economies have disappeared in part as a result of work shifting to poorer countries.[29]

Companies typically outsource to reduce labor costs, obtain specialized skills, and offload responsibility for more ancillary functions.[30] But the phenomenon has another effect. The development of an increasingly vast web of domestic and foreign suppliers and contractors inevitably reduces visibility into the work large companies rely on. The out-of-sight, out-of-mind aspect of outsourcing creates an environment in which remote and contingent workers are readily exploited. Lead companies in advanced economies compound the dangers of this arms-length relationship with workers by pressuring suppliers and contractors to meet unrealistic deadlines and accept prices that barely cover operating costs.[31] This is particularly true in developing countries where wages are generally low, local laws and regulations weak, and government enforcement weaker still. But it is also true among independent contractors worldwide who fall outside the purview of traditional labor protections.[32] Frequently, the result in advanced and emerging economies alike is poor-quality, low-skill jobs, chronic labor violations, and unsafe working conditions, all of which can engender a deep sense of unfairness and, ultimately, social unrest.[33]

Low-wage work and the missing "S"

Labor and other human rights concerns associated with outsourcing are among the issues that have sparked interest in ESG investing. Attention to these concerns falls naturally under the "S," but social performance is often difficult to define and measure. As a result, its relationship to a company's financial performance and share price is often unclear. In light of these difficulties, investors' and asset managers' analysis of "S" issues tends to focus on corporate policies and aspirations, rather than the degree to which core business practices deliver better social outcomes.

In 2017, The NYU Stern Center for Business and Human Rights published a report that examined more than 1,700 social indicators used to evaluate potential ESG investments. We found that 92% focused on evaluating company efforts rather than improved outcomes.[34] Every indicator related to the treatment of outsourced workers focused on policies and processes rather than results. Most often, this entailed tallying the number of audits a company undertakes of its global suppliers or whether workers can report grievances, but not the outcomes of those audits and grievances. How companies engage with domestic suppliers was entirely missing from the indicators we reviewed, as was companies' increasing use of independent contractors.

Most critically, there was no systematic assessment of the core business practices that exacerbate or mitigate social harms—how a retailer manages inventory risk, for instance, or how a hospitality firm handles its variable labor needs, from peak to off season. Instead, most assessments of social performance rely on anecdotes or the number and severity of public controversies a company has been embroiled in. This makes current "S" assessments reactive and scattershot, as they typically evaluate symptoms, not root causes.

As demand for ESG strategies continues to grow, asset owners and managers need to reckon with the missing "S." Focusing on improving low-quality, low-wage work presents a good way to begin. Like climate change, which has brought clarity to the "E," the growing hardship experienced by low-wage workers is a mounting social and economic crisis to which corporate and investor behavior contributes. It is relevant to all industries and has the potential to destabilize markets if left unaddressed. A more serious, data-driven approach to evaluating the extent to which companies rely on outsourcing and how they mitigate its inherent risks would help to improve the lot of low-wage workers around the world.

This report examines why corporate outsourcing has grown since the 1970s in ways that contribute to poor-quality, low-wage jobs. It then proposes how asset owners and ESG fund managers can better engage with the forces behind this shift, including a new approach to identifying companies more likely to have labor abuses in their outsourced workforces, whether domestic or foreign. We recommend this approach in response to three challenges that have hampered existing methods of analyzing "S" issues:

- First, data relevant to low-wage work are limited and generally of poor quality. There is very little public information on the changing nature of corporate workforces and the quality of the jobs companies provide. These limits are particularly acute for outsourced jobs. While regulators and firms like Bloomberg and MSCI that provide ESG data are exploring ways to address this gap, understanding the quality of outsourced work is likely to remain a challenge for some time. But we are exploring metrics that, once finalized, can help asset

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owners and managers identify companies that are at greater risk of relying on chronic labor abuse to deliver their outsourced functions. This will help them begin immediately to seek more targeted information from companies and identify changes to push for when necessary. Specifically, we suggest that, in the absence of direct evidence of labor exploitation, “S” analysis needs to examine factors commonly associated with labor abuse, such as severe downward cost pressure on outsourced work and extreme imbalances in bargaining power between lead companies and their suppliers and contractors.

■ A second challenge is the lack of consensus among researchers, civil society advocates, and socially minded investors as to what constitutes “good” social performance. Even if more relevant information becomes available, determining whether outsourcing leads to adequate jobs will remain a subjective and highly contextual exercise. Evaluating social performance will never be as straightforward as measuring carbon-emission levels. That said, there are practices that nearly everyone agrees cross the line. These include forced labor and labor by children, illegal or delayed wages, mandatory overtime, and patently unsafe work conditions. Using metrics that track the root causes of these practices and discussing them in greater detail and more regularly with corporate management should become an essential part of “S” analysis.

■ A third obstacle inhibiting asset owners and managers from examining the “S” more rigorously is the ongoing corporate investment that is typically necessary to reduce social harms. Unlike adding a female director to the board or reducing packaging waste, improving companies’ social performance almost always entails persistent costs that can cut into corporate profits and, ultimately, investor returns. Moreover, while improved wages and working conditions may yield a host of benefits—from greater innovation to more loyal suppliers and workers—these gains are uncertain and generally take time to realize. But the expenses associated with these advances begin to affect the bottom line right away. This means that asset managers and owners who want to move beyond box-ticking assessments of social considerations may need to tolerate short-term margin declines in the interest of the longer-term value of the firm. Candor about this potential tradeoff should be an aspect of marketing any ESG offering.

Over time, embracing a more rigorous approach to the “S” should create new incentives for companies to strike a better balance between cost savings and decent work. It will require global companies to identify cost-efficient ways to enhance the data they disclose about outsourced workers and improve the low-wage jobs on which they rely. In the long run, companies that figure this out are likely to avoid regulatory surprises; enhance customer loyalty; and get more creativity, dedication, and partnership from workers throughout their value chains. In short, this approach ought to identify sound, long-term investments. Achieving these ends will require that asset owners and managers experiment with more ambitious approaches to ESG investing than they have to date.

Part 1. Outsourcing and the Low-wage Worker

Understanding when and how corporate outsourcing contributes to worsening low-wage work requires looking at three shifts that have occurred since the 1970s: increasing incentives to cut costs, growing power imbalances in outsourcing relationships, and large corporations' increasing reliance on vulnerable workforces. This analysis focuses primarily on changes that occurred in the American context, but these trends are evident in other advanced economies, too.[35] By tracing these shifts within a given company or industry, investors should gain greater insight into the drivers of, and risks associated with, common outsourcing practices.

> "Evolving attitudes toward corporate structure and efficiency created pressure to cut labor costs, often by means of outsourcing."

Increased incentives to aggressively cut costs

By almost every measure, the 1970s and 1980s brought marked changes to the U.S. economy. Popular expectations for business and government changed in profound and enduring ways. Milton Friedman, the celebrated University of Chicago economist and advocate of free markets, came to personify this shift, which entailed a potent mix of deregulation, expanded global trade, weakened enforcement of antitrust laws, and hostility to unions. The net effect was an intensified focus on corporate profits and fewer restrictions on how CEOs could pursue them. Friedman, who was awarded a Nobel Prize in economics in 1976, famously declared that "there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays in the rules of the game."[36]

During this same period, individual investors were largely eclipsed on Wall Street by the rise of large, institutional investors who professionally managed vast asset pools on behalf of individual employees, clients, and other beneficiaries. These institutional investors included mutual funds—which allow investors to join their assets toward a common investment objective—as well as public and private pension funds that invest on behalf of employees for their retirement, university and charitable foundation endowments, and sovereign wealth funds that invest on behalf of nation states and their citizens. By 2017, institutional investors collectively owned 78% of the market value of the Russell 3000 index, a broad representation of the U.S. stock market, up from just 15% of U.S. common stock in 1950.[37] When the holdings of the largest three asset managers—BlackRock, State Street, and Vanguard—are added together, they constitute the biggest slice of equity in 88% of the companies in the Standard & Poor's 500 Index.[38] This extraordinary consolidation gave institutional investors considerable potential influence over the companies whose stocks they held. It also created new practical challenges for asset managers tasked with overseeing increasingly vast portfolios.

In the late 1980s, these challenges deepened when U.S. rule makers signaled that institutional investors had a responsibility to vote on the resolutions that companies put forward at their annual general meetings. This required investment professionals to develop positions on tens of thousands of corporate decisions across myriad industries. To ease the burden, most institutional investors turned to one of two proxy advisory services—Institutional Shareholder Services (ISS) and Glass Lewis—whose shareholder-voting recommendations they generally aligned with.[39] Since these recommendations usually were shareholder-friendly, this tendency had the effect of expanding shareholder rights and reducing defensive corporate tactics designed to limit investor influence.[40]

Over time, these changes paved the way for more "activist" investors, such as Carl Icahn and Nelson Peltz, some of whom were also referred to disapprovingly as "corporate raiders." Activists typically acquire a stake in a limited number of targeted companies where they see an opportunity to influence managers' decisions. To bolster their influence, activists often ally themselves with institutional investors who have considerably more voting power.[41] Activists commonly focus on cutting costs and returning money to shareholders by means of dividends and share repurchases.[42] In many cases, this cost discipline helps companies streamline their operations and boost productivity.[43] More productive companies, in turn, may lead to more and better-paying jobs for workers.[44] But combined with other factors, including greater automation and the globalization of trade, growing investor power and attention to costs has resulted in a broad shift toward permanently smaller corporate workforces, lower discretionary spending on things like research and development, and more generous shareholder payouts.[45]

Changes to executive compensation and the emergence of formalized quarterly earnings forecasts further amplified the preference for "lean" corporations and large payouts to shareholders.

Beginning in the mid-1990s, performance-based stock options became a significant component of most executive-compensation plans.[46] This focused corporate managers' attention on increasing near-term profits and payouts. Stock options are usually tied to firm profitability and total shareholder return.[47] And the value of those options further depends on the company's stock price, which for many companies is highly influenced by the degree to which managers meet financial analysts' quarterly earnings expectations.[48]

The growth of outsourcing

Evolving attitudes toward corporate structure and efficiency created additional pressure for cutting labor costs, often by means of outsourcing. Conglomerates that had bolted together diverse businesses came to be seen as bloated and stifling to productivity. With many Americans struggling to make ends meet due to rising inflation and stagnant growth, policy makers and business leaders were searching for new ways to get the economy back on track. In the 1980s, a management theory instructing businesses to focus on their "core competencies" gained in popularity.[49] This led many companies to cut costs by selling off or outsourcing the lower-value dimensions of their business.[50] Jack Welch, the prominent CEO of General Electric from 1981 to 2001, famously reduced GE's workforce by 115,000 jobs during his first five years at the helm.[51] In 1989, Peter Drucker, known as the "father of modern management," raised the outsourcing flag as the business strategy of the day in an op-ed for *The Wall Street Journal* titled "Sell the Mailroom."[52] Drucker acknowledged that outsourcing would cause social disruptions but argued that it provided the best path to higher productivity and upward mobility for lower-skill workers.[53]

Outsourcing also allowed companies to respond to changing consumer demands and competitive dynamics. The rise of the personal computer and e-commerce gave consumers greater ability to chase low-cost goods and services.[54] Companies responded by competing not just on price but by offering consumers a growing range of more customized products.[55] The Japanese car maker Toyota was a pioneer of this approach, which soon spread to numerous other industries, such as food retailing, consumer electronics, and fashion.[56] The increased volatility in consumer demand and radically shortened product life cycles made it riskier for companies in advanced economies to hold large inventories and directly employ large workforces.[57] Companies turned to outsourcing to bring down their costs and improve their flexibility.

Many companies began domestically, hiring third-party vendors to handle lower-skill, on-site services, such as clerical functions, janitorial and catering services, and security.[58] In the hospitality industry, housekeeping and concierge services were outsourced to third parties, even though these functions are arguably core to the business.[59] Marriott, for instance, now owns only 20 of the 7,642 hotels bearing its brands globally and operates less than 30%.[60] This means that the company no longer employs the vast majority of the housekeepers, security staff, or concierges that visitors encounter. Under this "asset-light" model, Marriott earns its revenues predominantly by charging fees for franchising and licensing its brands, marketing, and overseeing a global reservation system.[61]

More recently, another form of domestic outsourcing has become prevalent, as employers have begun relying on workers classified as independent contractors, rather than employees.[62] The ride-sharing company Uber is the most famous example of this practice. It now relies on 227 independent drivers for every full-time worker it employs.[63] But the practice is far more widespread than most people realize. Independent contractors comprise a sizable portion of workers in industries ranging from construction to food service.[64]

In the offshore version of outsourcing, large companies ranging from banks to retail chains, shifted service positions like customer support to vendors in emerging economies, such as India and the Philippines, which have large workforces available at relatively low wages.[65] Car makers and certain other manufacturers largely outsourced the production of component parts but continued to have direct employees assemble the final products.[66] In other industries, such as apparel, toys, and electronics, multinational corporations typically outsourced all manufacturing, retaining only design, marketing, and retail functions.[67]

For many large companies, outsourcing has yielded significant labor-cost savings.[68] This is particularly the case in the United States, where health-care expenses associated with direct employees have ballooned in recent decades.[69] CEOs who have proactively slimmed their workforces generally have seen their stock price rise as a result.[70] In many cases, outsourcing has also allowed firms to specialize and streamline management structures and processes, boosting productivity.[71] In the context of global supply chains, outsourcing has extended some of the benefits of large flourishing economies to poorer countries that are still industrializing. China has lifted 745 million people out of poverty in just 30 years, in large part by becoming "the world's factory."[72]

But in advanced economies, outsourcing has also disrupted workforces and increased the complexity and opacity of large global companies' operations. In the U.S., domestic outsourcing has contributed to a sorting of the economy into high- and low-wage employers.[73] Most successful firms in the U.S. now employ smaller, higher-skill workforces relative to their sales than was typical in the past.[74] More than ballooning CEO pay, this fact—the segregation of a higher-skill, high-wage cohort from lower-skill, low-wage workers—has driven rising income inequality.[75] This segregation is not entirely due to outsourcing, but lower-skill workers are now far less likely to work alongside higher-skill peers and have fewer pathways to higher-skill positions.[76] For most low-wage workers, upward economic mobility is more myth than reality.[77] As low-wage jobs are out-sourced, the workers who hold them also no longer benefit from the higher pay rates typically associated with large successful companies in advanced economies.[78] In studies of cleaning, security, and logistics positions in the U.S. and Germany, covering 1983-2000 and 1975-2009, respectively, wages for outsourced workers dropped by as much as 24% and 15%.[79] When these jobs also shift to part-time or contractor status, workers typically lose health and retirement benefits as well and must accept fewer, less-reliable hours.[80]

The complicated effects of 'offshoring'

The effects of outsourcing in emerging economies is more complicated. Wages and general conditions associated with jobs that have been "off-shored" to poorer countries generally are less favorable than those that direct employees enjoyed before outsourcing. But the development of global supply chains often results in the creation of new jobs in emerging economies and better opportunities for workers than are otherwise available in local markets.[81] In countries such as China and Vietnam, these jobs offer a springboard to improved well-being and, for some, a path to middle-class employment.[82] At a societal level, low-wage manufacturing, which can often be done with limited capital investment or formal training, historically has offered the most assured path to economic growth for poor countries.[83]

These same features, however, make low-skill manufacturing and other types of offshore outsourcing subject to intense competition among emerging economies. This has resulted in a "race to the bottom" on price and working conditions, as governments compete to

The scale of outsourcing

Selected examples of the degree to which major companies rely on contractors and vendors for key tasks

Uber
Contracts with 227 ride-share drivers for each direct employee

Marriott
Of 7,642 hotels, actually runs fewer than 30% and owns only 20

Unilever
Has 59,800 suppliers operating in 161 countries

Google
Temporary workers, contract workers, and vendors now account for 54% of the company's workforce

Walmart
Discloses 25,800 facilities in active use by its suppliers in more than 100 countries

Sources: Uber; Marriott; Unilever; Google; Walmart

> **Despite record corporate profit levels in advanced economies in recent decades, too many lower-skill jobs are characterized by poverty-level wages, long and unpredictable hours, and unsafe working conditions.**

offer lead companies the most financially attractive terms.[84] As a result, despite record corporate profit levels in advanced economies in recent decades and the creation of numerous jobs in global supply chains, too many lower-skill jobs are characterized by poverty-level wages, long and unpredictable hours, and unsafe working conditions.[85] Often, workers do not earn enough to provide decent food and shelter for themselves and their families.[86] Even more troublingly, the International Labor Organization estimates that as of 2016, 16 million people working in global supply chains faced conditions amounting to "forced labor," meaning that they were coerced to work by violence or other means of intimidation.[87]

Outsourcing, by its nature, creates an imbalance of power: As a result of their purchasing power, large multinational lead companies typically have enormous influence over vendors and contractors. Consider Nestle, which alone bought 10% of the world's cocoa and coffee supply in 2016.[88] Power imbalances grow when outsourced work requires limited specialization, as is the case for tasks like manufacturing basic clothes or harvesting crops or, in the domestic context, driving a ride-share car or delivering packages.[89] In all of these cases, suppliers and contractors are more likely to be interchangeable and to compete exclusively on the price, speed, and flexibility they can offer.

In the absence of adequate labor protections, workers are likely to face relatively low wages, unpredictable and unstable hours, and less-secure employment contracts.

In recent years, growing market concentration in advanced economies has amplified these power differentials. A 2019 study estimates that 75% of U.S. industries are now more concentrated than they were in the 1990s.[90] These industries have fewer, larger dominant firms that on average report larger profits than in prior decades.[91] Rising profits are to be applauded when they are fairly earned and reinvested in ways that create good jobs and broader access to innovative products and services. But a growing body of research finds that firms in more concentrated markets are reducing their R&D investments and even limiting their sales volume, preferring strategies that leverage their bargaining and pricing power to boost margins.[92] Across industries, market concentration is associated with high-pressure negotiation tactics that shift costs and risks onto the suppliers and independent contractors who undertake outsourced work.[93] A 2019 survey in the global apparel industry found that such tactics resulted in 63% of suppliers, at times, accepting prices that do not allow them to cover their costs of production.[94] This downward pressure on prices leads inexorably to lower wages, less stable employment contracts, and corner-cutting on workplace safety.[95]

Concentration and enhanced bargaining power enable lead companies to squeeze suppliers in a variety of ways. When Dutch beer giant InBev acquired Anheuser-Busch in 2008, Anheuser-Busch suppliers were forced to accept new terms that gave the company 120 days to pay them instead of 30, or risk losing InBev's business.[96] The move left suppliers effectively providing an interest-free loan to the largest company in the industry. Companies ranging from Procter & Gamble to Energizer to Rubbermaid have come under fire for the same tactic.[97]

In 2020, when sales collapsed during the Covid-19 pandemic, buyer firms went even further, forcing suppliers to foot the bill for unused materials and, in some cases, even completed orders.[98] Researchers have found that suppliers often manage such added costs and risks by reducing or delaying wages, requiring overtime, and relying on more flexible, contingent workforces that they can quickly scale up and down.[99]

Part 2. The Investor's Role in Improving Low-wage Work

Improving the lot of low-wage workers will require ambitious new approaches. Governments can and should do more to ensure that markets are competitive and workers at all skill levels thrive. But businesses face growing calls to assume greater responsibility for the quality of jobs they are creating, whether through direct hiring or outsourcing. ESG strategies, if designed and pursued rigorously, will allow investors to reward businesses that do so.

> **In his 2021 annual letter, Larry Fink warned CEOs that ESG investing will have 'a dramatic impact on how capital is allocated' and that 'every management team and board will need to consider how this will impact their company's stock.'**

The flourishing market for ESG investment products offers retail and institutional investors a new way to encourage higher-quality jobs around the world. Once considered the purview of socially minded religious institutions and environmental activists, ESG funds are now a rapidly growing part of global financial markets. In the U.S., assets in "sustainable" funds topped $700 billion in 2021, while in Europe, $1.4 trillion is invested in funds using ESG criteria.[100] Contrary to expectations, the pandemic did not dampen demand. The volume of assets moving into ESG-focused mutual funds and ETFs rose 96% in 2020, compared to 2019.[101] Looking to the future, both institutional and retail investors say they plan to increase the share of their assets in sustainable funds.[102]

Though ESG investing is still a relatively recent phenomenon, it is beginning to influence corporate behavior. Following years of shareholder demands for greater transparency, more companies are now disclosing information about their carbon emissions and the diversity of their boards and workforces.[103] Some companies have additionally committed to performance targets in these areas.[104] This activity has spurred the Securities and Exchange Commission in the U.S. to explore making such disclosures mandatory, and similar efforts are underway in Europe.[105]

In his 2021 annual letter, Larry Fink warned CEOs that ESG investing will have "a dramatic impact on how capital is allocated" and that "every management team and board will need to consider how this will impact their company's stock."[106] It is no surprise, then, that a growing number of companies are integrating ESG considerations into their governance structures, adding board committees on issues such as human capital oversight, and incorporating ESG metrics into CEO performance assessments.[107]

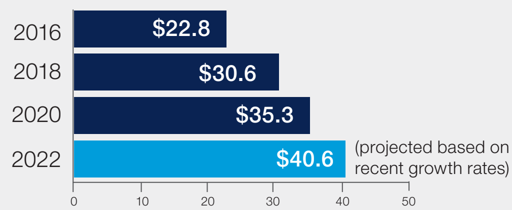
The most dramatic example of ESG's rising prominence came in May 2021, when Engine No. 1—a small hedge fund whose credo is that a company's success "is greatly enhanced by the investments it makes in its employees, customers, communities, and the environment"—led a successful campaign to oust three ExxonMobil board members and replace them with directors who vow to push the company toward a quicker transition to "green" energy.[108]

The victory took financial analysts and Exxon management by surprise, both due to Engine No. 1's mere .02% stake in Exxon and because the company has fiercely resisted outside pressure to forsake fossil fuels.[109] But Exxon's refusal to respond to shareholders' calls for more planning and transparency regarding climate change, combined with its lackluster earnings, left it vulnerable.[110] Ultimately, Exxon's three largest investors—BlackRock, Vanguard, and State Street, which together hold 20% of its stock—broke with management and joined Engine No. 1 in demanding a board shakeup.[111]

It will take time to assess the ramifications of the Exxon episode. But at a minimum, it provided a wake-up call to any other large companies that have discounted the growing clout of ESG interests. It proved that, under the right conditions, ESG-oriented investors can borrow the Carl Icahn-style activist playbook to serve new ends. Engine No. 1 has signaled that more campaigns are on the horizon, and other socially minded funds are taking preliminary steps to place directors with civil rights credentials on the boards of tech companies like Facebook, Twitter, and Google's parent, Alphabet.[112]

ESG investing is expanding rapidly

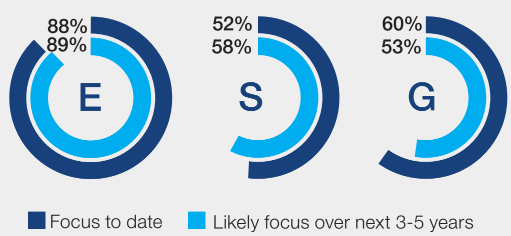
Combined growth in assets under management using ESG strategies in Europe, the U.S., Canada, Australasia, and Japan (USD, trillions).



Sources: Bloomberg; Global Sustainable Investment Alliance

Investors are focused on the environment

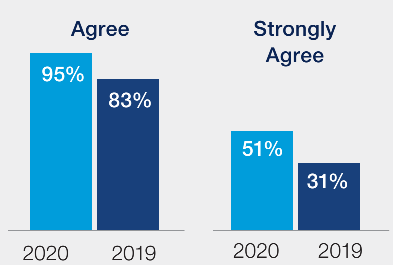
According to a survey of institutional investors conducted by BlackRock in 2020, the vast majority currently focus their ESG activities on environmental concerns and plan to do so in the next 3-5 years.



Source: BlackRock Global Client Sustainable Survey, July - September 2020

Shareholders intend to take a more activist approach

According to a survey of institutional investors conducted by Edelman, a growing number agree with the statement: "As a firm, we are more interested in taking an activist approach to investing."



Source: Edelman 2020 Trust Barometer Special Report: Institutional Investors

ESG's 'social' problem

Despite, or perhaps in response to, these developments, a number of regulators, academics, and journalists are beginning to take a skeptical look at what ESG funds promise and what they deliver. Topping the list of concerns is the ambiguity that frequently envelops the core objective of ESG investing: Is the point that by using ESG factors to analyze companies, asset managers will achieve heftier returns for their clients? Or is the main goal to pursue clients' non-financial interests, such as combatting climate change and promoting social well-being, for their own sake? In other words, is ESG about value or values?

To date, most ESG advocates have suggested that the answer is both. But, as ESG matures, investors and asset managers who take these issues seriously will have to determine what to do when the pursuit of better returns clashes with seeking a better world.

Surveys of institutional and retail investors consistently find that the primary reason investors give for choosing ESG funds is to achieve environmental and social objectives, not improved financial returns.[113] A 2017 study that relied on customer data from a mutual fund provider augmented with survey and experimental data lent support to these claims, finding that investors who selected ESG or socially responsible funds did so with the assumption that they would pay higher management fees and earn lower returns.[114] That said, institutional investors are more likely to say they do not believe there is a tradeoff between social and financial goals.[115] This may be, in part, due to the fact that large asset owners are in some cases legally prohibited from pursuing ESG objectives for their own sake. (Please see sidebar on page 15.) Having it both ways may not be possible, however.[116] Of the investment vehicles currently on the ESG market, most mutual funds and ETFs give primacy to financial returns, often at the expense of the "S." This tendency will have to change for ESG to become a meaningful tool in improving the nature of low-wage employment.

The Long Shadow of 'Fiduciary Duty'

Around the world, asset owners and managers who invest money on behalf of others typically have a "fiduciary duty" to act in the best interests of beneficiaries. In defining this duty, courts and regulators have tended to assume that investors' sole objective is achieving the highest risk-adjusted return possible. The growing demand for investments that target non-financial objectives related to ESG concerns has presented novel challenges that legislators, regulatory bodies, and courts have yet to resolve.

In the U.S., the ambiguity surrounding fiduciary duty as it relates to ESG investing has generated fierce debates regarding whether, and under what circumstances, asset owners and managers may consider ESG issues in their investment choices, engagement with companies, and voting practices. If fiduciary duty is interpreted narrowly, with an exclusive focus on financial returns, it is likely to chill the more ambitious ESG investing and engagement practices that could encourage corporate reforms on pressing social issues.

Given the dizzying array of applicable laws and regulations, the interpretation of fiduciary duties currently depends on the type of institution involved. Public and private pension funds face the strictest limitations and in most cases may consider ESG factors only in service of risk-adjusted returns.[1] One reason for this restriction is the assumption that, as a practical matter, it is difficult to solicit and balance the preferences of a diffuse and diverse set of beneficiaries. But at least one Dutch pension fund has shown that these challenges are not insurmountable. In 2018, Pensioenfonds Detailhandel partnered with academic researchers and asked participants to vote on whether they would like it to expand its engagement with companies on four issues—climate change, job quality, protection of democratic institutions, and responsible production—even when they expect this activity to hurt financial performance. Roughly 70% of beneficiaries voted "yes," 20% had no opinion, and only 10% voted "no."[2] The experiment showed two things: that it is possible to efficiently solicit beneficiaries' views, and that there may be more support for non-financial objectives than many regulators and courts assume.

In the case of private retirement funds, such as 401(k) accounts, it would be even easier for beneficiaries to opt in to ESG, since most of these individuals already select funds from a menu of approved options. Despite growing investor demand for ESG strategies, however, the Trump administration—acting through the Department of Labor, which oversees employer-sponsored funds—issued a new rule emphasizing that ESG considerations are permissible only when "they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories."[3] The rule also imposed onerous new documentation requirements when ESG funds are selected, and it banned employers from including ESG funds among their default options when employees fail to designate a fund choice.[4] Shortlyafter the Biden administration took office, the Labor department announced that it would not enforce the new rule—along with another that had increased the barriers to reflecting ESG considerations in stewardship activities—but it has yet to formally rescind or revise the rules.[5] Until it does, both public and private pension fund managers are unlikely to explore new creative approaches to understanding and addressing their beneficiaries' non-financial interests.

Other fund managers and asset owners have more latitude. While managers at foundations and endowments are similarly bound by fiduciary duties, they may consider non-financial factors, regardless of their relationship to financial performance, if values-based restrictions are included in their governing documents. Similarly, asset managers who are investing on behalf of wealthy individuals or ordinary retail investors may explicitly incorporate ESG objectives into their investment mandates and manage their funds accordingly, even if doing so results in reduced financial performance.[6]

As investors look for investment strategies that target environmental and social objectives, regulators should clear the way for measured experimentation. Investors need to have a clearer understanding than they currently do of how ESG funds evaluate and pursue these non-financial goals. Once they do, they should be free whenever possible to seek out investment strategies that maximize more than just their financial interests.

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1 Freshfields Bruckhaus Deringer LLP, "A Legal Framework for Impact: Sustainability impact in investor decision-making," Principles for Responsible Investing, United Nations Environmental Program Finance Initiative, and Generation Foundation (2021).

2 Rob Bauer, Tobias Ruof, and Paul Smeets, "Get Real! Individuals Prefer More Sustainable Investments," *Review of Financial Studies* 34, no. 8 (August 2021).

3 "Financial Factors in Selecting Plan Investments," *Federal Register* 85, no. 1 (November 2020). Part of the 2020 DOL rule requiring employee benefit plans to only consider pecuniary factors also limited application of the "tie-breaker test," which is used when a plan manager cannot distinguish between investment decisions on pecuniary factors alone. The rule required strict documentation of these scenarios including: 1) why pecuniary factors were not sufficient to select the investment; 2) how the selected investment compares to the alternative investments; and 3) how the chosen non-pecuniary factors are consistent with the interests of beneficiaries in their retirement income under the plan. The documentation requirements would have severely limited the circumstances in which non-pecuniary factors could be considered at all, greatly reducing applicability of the test.

4 "Financial Factors."

5 "U.S. Department of Labor Releases Statement Regarding Enforcement of its Final Rules on ESG Investments, Proxy Voting by Employee Benefit Plans," U.S. Department of Labor, accessed September 9, 2021.

6 For an examination of U.S. fiduciary law, see generally Max M. Schanzenbach and Robert H. Sitkoff, "Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee," *Stanford Law Review* 72, no. 2 (February 2020); Freshfields, "A Legal Framework for Impact."

Historically, most funds marketed as "sustainable" or "responsible" relied on the blunt mechanism of screening out entire sectors that investors sought to avoid, such as alcohol, tobacco, oil and gas, or firearms. In recent years, a very different strategy, "ESG integration," has come to dominate the landscape.[117] Using the integration approach, an asset manager considers ESG issues only as a means to improve financial returns, not as a way to deliver on asset owners' environmental or social values.[118] ESG integration funds incorporate environmental, social, and governance issues only if they are "financially material," meaning that there is sufficient evidence to believe they present a financial risk to the company or portfolio.

One might be forgiven for wondering whether the "ESG integration" label is merely a marketing device—one with the potential to undermine the integrity of the entire ESG enterprise.[119] Many fund companies feed this skepticism by claiming that ESG integration is now an aspect of all of their actively managed funds and, in some cases, has been for years.[120] For example, JP Morgan Asset Management states: "We know that the way companies manage ESG risks and opportunities has consequences for their business results. Across our active investment processes, we incorporate financially material ESG factors in our research and decision making with a single objective: to deliver stronger risk-adjusted returns."[121] BlackRock similarly states that it uses ESG integration "across all our active portfolios in both public and private markets seeking to enhance risk-adjusted returns."[122]

> **"Effectively focusing the "S" on improving low-skill work will require that asset owners and fund managers move beyond assessments of corporate policies and commitments and look more closely at how companies make and spend their money."**

In fact, this may help to explain recent studies that find there isn't a clear difference between many ESG funds and conventional funds.[123] While some asset managers are undoubtedly rigorously pursuing ESG integration, others appear to be falling short of their promises. In April, the SEC issued a risk alert to fund providers after its own examination of ESG funds revealed that some did not deliver on the approaches outlined in their materials.[124] Some funds promised to follow international frameworks regarding ESG concerns but failed to do so in practice, SEC staff found. Other funds assured clients that they would hold only companies with high "E," "S," and "G" scores but instead used composite scores provided by third parties that obscured performance in the individual categories.[125]

Another consequence of the spread of the integration approach is that it focuses on issues that generate a documented record of financial harm to companies, such as consumer safety failures and pollution. Relying on pre-existing evidence of harm in this way tends to make funds reactive and less likely to engage with issues that are qualitative, diffuse, or otherwise difficult to measure, such as the quality and safety of outsourced jobs. It also means that when companies can effectively evade liability for the social harms they create, these funds may look the other way, regardless of how substantial the harms may be. For example, ESG integration likely would consider working conditions in apparel supply chains for consumer-oriented companies like Nike and Walmart, which in the past have been hit by boycotts after reports of labor abuse in their suppliers' factories. In contrast, ESG integration analysis might tolerate global construction companies that operate in the Middle East, where migrant labor abuses are rampant.[126] That's because these construction companies aren't consumer-facing, and worker mistreatment is less likely to affect the bottom line.

Even asset managers and funds that give greater weight to ESG objectives tend to do so in a way that is ill-suited to addressing the plight of low-skill workers. A fund that dutifully screens out companies that manufacture or sell certain controversial products is likely to miss companies causing significant harm to workers. Such a manager might plausibly claim to address social issues such as gun violence by avoiding investments in all firearm companies, but this blunt approach won't help improve the quality of outsourced jobs.

Yet another problem with these funds is that in choosing ESG-friendly stocks, asset managers commonly rely at least in part on ESG ratings sold by third-party analytical firms, which use proprietary and opaque methodologies. Users of these services often have little visibility into the subjective choices analysts make in determining which issues to consider, how to evaluate them, and how to weight them against one another. These variables can lead to radically different conclusions regarding the ESG performance of the same company.[127] One rating may consider Facebook an ESG leader because of its low carbon footprint, while another may give the company lower marks due to its stock structure, which affords founder, chairman, and chief executive Mark Zuckerberg virtually unchecked power. If the methodological choices underpinning such differences are clear, a variety of ratings can serve investors with different strategies and values. But too often the transparency of these ratings is wanting. Finally, as with ESG integration, such assessments typically consider only financially material issues and are likely to disfavor social considerations that are more difficult to measure. (Please see sidebar on page 18.)

‘Passive’ investing

Current ESG practices are further complicated by the growing popularity of “passive” investing. Passively managed mutual funds and ETFs are built on the premise that, over time, “active” fund managers—who pick stocks in an effort to outperform the overall market—will fail to achieve returns that justify the expense of their services. Popularized in the late 1970s by Vanguard founder Jack Bogle, passive funds are designed to track a particular index or segment of the market, such as the S&P 500.[128] They seek to achieve market-rate returns rather than the market-beating performance for which active managers strive. Because these funds require little-to-no stock picking, they require no research, and their management fees are extremely low. This combination of low fees and more predictable returns became wildly popular, and market analysts now estimate that worldwide, assets in passive funds will overtake those in active funds by 2026.[129]

The rise of passive strategies has several implications for ESG investing. Large asset owners and fund managers have two primary ways to reflect ESG considerations in their investment strategies. They can favor (or avoid) companies with strong (or weak) ESG practices when choosing where to invest and/or they can include ESG issues in the “stewardship” of their assets. Stewardship refers to how investors and fund managers engage with the companies whose stock they hold and how they vote their shares at annual meetings. More generally, investors and asset managers also can seek to influence public policy in ways that improve dominant ESG practices over time.

Since true passive fund managers do not pick stocks, they cannot favor or avoid companies based on their ESG performance. As a result, stewardship becomes the main way that these fund managers can pursue ESG goals. This requires overcoming several hurdles. First, most assets in passive funds are now managed by a handful of firms, with a particular concentration in BlackRock, Vanguard, and State Street. While this gives the trio great potential influence, their low fees mean that they have limited resources for engaging the vast universe of companies they hold. Consider Vanguard, which holds, on average, 5% of the shares in most large public companies. It votes at more than 13,000 annual meetings around the world but has only a 34-person stewardship team working on behalf of all its funds.[130]

Asset managers cope with this situation in a variety of ways. These include establishing firm-wide rather than fund-level voting guidance, relying on outside proxy and engagement advisory services, and developing automated systems to screen their holdings to narrow the range of companies that merit engagement.[131] These tactics again tend to steer asset managers toward areas where the interests of traditional and ESG funds overlap and on issues that are easy to observe and quantify—in other words, not on “S” issues such as job quality.[132]

With financial considerations and passive investing dominating the ESG landscape, it is no wonder that, as BlackRock recently proclaimed, “Climate is King.”[133] A full 68% of ESG-oriented ETFs focus on environmental issues.[134] The existential dangers of climate change are now obvious, as are the ramifications for myriad industries. From insurers offering flood and fire protection to farmers assessing crop viability, few sectors are immune to climate disruption. Environmental impacts are also comparatively easy to observe and study objectively, enabling companies and investors to test scenarios and determine the likely financial fallout more readily. A number of funds focused on climate change have even delivered on the promise of a “triple win”: giving companies like Tesla, the electric car pioneer, access to discounted capital; boosting value for their shareholders; and encouraging a race to develop next-generation green technologies.[135] An investor who unloaded oil and gas stocks a decade ago and bought into technology enjoyed big winnings.

But when it comes to the social category, things are more challenging. Social issues are more subjective, making the category itself a struggle to define. Should an ESG fund avoid social media companies with platforms allowing billions of people to express themselves while those same companies sell access to each user’s personal data? What about pharmaceutical companies that invent lifesaving medications but charge exorbitant prices? The list is seemingly endless. Even after relevant issues are selected, it may be unclear how to assess performance. At what point does a job become exploitative, for instance? Finally, social issues are both more difficult to measure and frequently require added costs to correct. Consider the issue of forced labor: Observing when and where it occurs within complex and opaque supply chains often is extremely difficult, as is drawing lines to all the businesses that may be responsible. Fixing the problem when you do find it will require paying for labor that was previously free or drastically discounted.

Making good on ESG’s social promise

Thankfully, a growing number of U.S. institutional investors now view improving the social category as their top priority.[136] Investors can begin by organizing their efforts around ensuring that low-skill work is legal, safe, and adequately compensated. But ESG investing will be an effective tool for achieving these aims only if fund managers and data providers squarely address the missing “S.”

Effectively focusing the “S” on improving low-wage work will require that asset owners and fund managers move beyond assessments of corporate policies and commitments, and look more closely at how companies make and spend their money. While investors, of course, should applaud disciplined corporate spending, too often they celebrate labor cost-cutting without giving sufficient thought to the reason and social consequences. This issue has become more pronounced in recent decades as outsourcing shifted many workers outside the view of asset owners and managers,

‘Sustainable Investing’: A Close Look at the Top ESG ETF

ESG funds marketed as “sustainable” investments typically seek to balance investors’ financial objectives with their social and environmental values. To understand the limits of common approaches, it is helpful to look more closely at the most popular ESG exchange-traded fund: BlackRock’s iShares ESG Aware USA ETF. With $22.4 billion in assets under management—more than four times as large as Vanguard’s top ETF—iShares ESG Aware USA dwarfs its competition.[1] The fund’s homepage promises that it not only will hold companies with more favorable ESG practices but also target a risk-and-return profile similar to those of traditional U.S. market indices. An assessment of the fund’s methodology, however, reveals that these returns are likely achieved in part due to the negligible ESG requirements that companies need to meet for inclusion.

As is common among ESG funds, the top five holdings of ESG Aware USA are technology companies: Apple, Microsoft, Amazon, Alphabet, and Facebook. Beyond those, the ETF has positions in a number of companies that ESG-focused investors may be surprised to see, including fossil fuels producer ExxonMobil, ride-share provider Uber, defense contractor Raytheon Technologies, and the controversial data firm Palantir.[2]

As with its other ESG ETFs, BlackRock relies on MSCI, a global investment company and ESG data provider, to construct the index of companies in which ESG Aware USA invests. Beginning with the 623 mid- and large-caps companies in its traditional U.S. index, MSCI first screens out companies that derive substantial revenue from five products: civilian firearms; controversial weapons, such as landmines or chemical weapons; petroleum extracted from oil sands; thermal coal; and tobacco.[3]

MSCI then considers how the remaining companies rank according to two of its proprietary ESG assessments. The first is a composite ESG rating that MSCI determines using an undisclosed set of industry-specific metrics. The criteria by which these metrics are selected are not public. After selecting the key issues for a given company, MSCI says that it relies on thousands of data points to determine where along its seven-point scale the company sits.[4] Those awarded a CCC or B are considered “laggards”; BB, BBB, or A are “average”; and AA or AAA are “leaders.” Only companies that do not have any score at all because they have failed to disclose the necessary data are excluded from the iShares ESG Aware ETF.

MSCI next considers each company’s “controversy score,” which can range from 0 (worst) to 10 (best), based on the number of public controversies—such as community demonstrations or lawsuits—a company has experienced recently related to ESG issues. Again, MSCI provides very little information regarding the methodology or sources it uses to evaluate controversies, so it is difficult to assess the significance of these scores. Still, it is notable that the iShares ESG Aware ETF excludes only companies that receive a zero—in other words, the absolute worst score. According to UK-based asset manager Aviva Investors, as of early 2021, just 28 companies worldwide have received this score.[5]

Finally, MSCI weights the remaining pool of companies to maximize exposure to those with higher ESG scores. But this weighting is subject to the ETF maintaining risk and return characteristics similar to that of traditional funds.

In short, even though BlackRock labels this ETF as a “sustainable” fund, in reality, achieving an equivalent risk-return profile to more traditional funds is the paramount goal. As a result, other than the preliminary negative screens for controversial products, this fund is unlikely to differ much from more conventional offerings.

1 “ETF Finder,” ETF Screener & Database, ETF.com, accessed September 9, 2021.
2 “iShares ESG Aware MSCI USA ETF,” BlackRock, accessed September 9, 2021.
3 “MSCI USA Index (USD),” MSCI, accessed September 9, 2021.
4 “What if ESG disclosures become standardized?,” MSCI, accessed September 9, 2021; “MSCI Extended ESG Focus Indexes Methodology,” MSCI (February 2020).
5 “Living in the past: Why are controversy scores so controversial?,” Aviva Investors, accessed September 9, 2021.

and even corporate executives. ESG investing ought to provide asset managers with a means for scrutinizing labor cost-cutting in a more nuanced way. But doing so will require creativity and experimentation in the assessment of social risks and performance.

A logical first step would be for asset managers to deepen their stewardship practices. More emphasis on stewardship would mesh well with the continued popularity of passive investing strategies. Large, passive fund managers now have considerable influence over the companies in their portfolios, and, because they typically track an entire market sector, their performance is more closely tied to long-term systemic risks.[137] The worsening quality of low-wage work presents one such threat to market stability. In the U.S., a strategy focused on stewardship also is more compatible with the fiduciary duties of large asset owners, such as pension funds, since it allows investors to retain a well-diversified portfolio.[138] More active stewardship can also help to identify where important data are missing and surface best practices among industry leaders to inform evolving policies—such as mandatory disclosure—and future engagement.

To date, asset owners and managers have favored ESG integration and industry screening over more active stewardship, but this is beginning to change.[139] In the past few years, major players, including Japan's Government Pension Investment Fund, California's public pension funds, BlackRock, and State Street have committed to using their voices and votes to advance ESG issues.[140] The effect has been noteworthy. During the 2021 annual general meeting season, shareholder resolutions focused on environmental and social issues received record levels of support.[141] Resolutions seeking greater transparency on climate change, diversity, and political spending were particularly popular, as were efforts focused on limiting CEO pay.[142] BlackRock voted against 255 directors as a result of climate concerns in 2021, including the head of the audit committee at Berkshire Hathaway, up from only 55 negative votes in 2020.[143] Analysts for financial institutions are raising questions regarding ESG issues more frequently on quarterly earnings calls, again mostly related to climate change.[144] And, in June 2021, Engine No. 1 followed up on its successful campaign against Exxon by introducing a new ETF that uses the ticker symbol VOTE and focuses entirely on more active stewardship. The ETF holds the 500 largest public companies in the U.S. and promises to use voting and engagement "to harness the power of investors…to create good jobs, reverse climate change, fight gender and racial injustice, and build an economy that is sustainable, inclusive, and prosperous."[145] By the end of August 2021, the ETF had attracted more than $184 million.[146]

These are promising steps forward. But when it comes to "S" considerations, stewardship efforts are faltering in familiar ways. Engagement on social factors is once again coalescing around what is easiest to measure, rather than most relevant to long-term risk-adjusted returns and social improvements. There has been some progress on increasing the number of women and people of color on corporate boards and among direct workforces. But on the issue of income inequality, investors and asset managers have focused almost exclusively on reining in CEO compensation.[147] While board diversity and executive pay are important issues, neither addresses the growing economic hardship among low-wage workers, which the pandemic has made so evident and is fueling social backlash around the world.

To address this gap, the NYU Stern Center for Business and Human Rights has begun to develop a framework of industry-agnostic metrics that stewardship teams can use to identify companies among their holdings that are most likely to rely on poor-quality or illegal low-wage work. Following a wide-ranging review of empirical studies, we have identified 25 metrics that we plan to test and refine. While each metric on its own is highly imperfect, taken together, they should identify companies whose outsourcing operations are at higher risk of fostering labor abuse.

Our framework is distinct from common approaches to evaluating treatment of workers in two important ways. First, it takes a more comprehensive view of the jobs on which companies rely. Most existing analysis of job quality focuses exclusively on direct employees. But our framework casts a wider net, looking at data on a firm's total outsourced workforce, including not only global supply chains but also domestic outsourcing to third-party firms, local manufacturers, and independent contractors. While much of this information is still spotty, we believe that this approach will nonetheless provide a more accurate and complete assessment of labor risk and deter companies from seeking greater flexibility and cost savings at the expense of workers who remain outside the scope of traditional investor analysis. It also will highlight areas where more and better data are needed.

Second, in assessing outsourcing practices, our framework does not rely on corporate policies or audits, neither of which have proven to be revealing indicators of harmful corporate labor practices nor accurate predictors of operational or reputational risks related to labor abuse.[148] Instead, our framework looks at three intersecting corporate attributes that are more central to companies' earnings strategies: (1) the presence of incentives to cut costs aggressively, (2) a company's bargaining power when contracting for outsourced work, and (3) heavy reliance on outsourced workers whose circumstances make them especially vulnerable to exploitation.

For instance, our framework will look at metrics such as the degree to which a company is owned by "transient shareholders"—investors who tend to hold small positions in companies and sell their stock readily when earnings decline—or how sensitive a company's stock price is to missing its earnings estimates. These are both attributes that empirical studies have found induce managers to cut costs excessively when their earnings are lower than anticipated.[149] When paired with metrics that evaluate the degree to which a company relies on vulnerable outsourced workers and derives its cost savings from this workforce, this framework can help flag companies that are at greater risk of relying on exploitative low-wage work. For more examples and explanation of our metrics, see the appendix on page 22.

To understand the effectiveness of this framework, we will need to test and refine both the metrics and the relationships among them. This will include assessing whether the metrics are leading or lagging—in other words whether they predict future problems or simply confirm a company's recent trajectory on a given issue. They will also need to be adjusted and benchmarked to account for expected differences across industries, firm size, and growth stage. Unlike the academic studies from which we have derived many of these metrics, we will not attempt to establish a causal relationship between any specific metric or the overall framework and inadequate wages or working conditions. Rather, we see the metrics as together providing a more accurate risk screen for outsourcing practices that entail chronic labor abuse. When testing the framework, we will look for evidence that it consistently identifies companies that merit engagement on labor practices and provides insights that would help a stewardship team develop a roadmap for how to do so. We will also explore whether the framework helps to identify companies likely to have greater earnings volatility or higher risk for operational disruptions and controversies related to outsourced work.

A considerable upside of our analytical model is that, once finalized, it should allow asset owners and fund managers to start looking more deeply at potential drivers of poor-quality, low-wage work right away, using information that is already publicly available. For instance, this framework could be used to scan a fund's holdings and identify companies whose earnings growth merit deeper scrutiny. This could be as simple as asking a few follow-up questions when a firm that is heavily reliant on vulnerable outsourced workers announces savings due to cheaper or faster production. Simply asking what accounts for the claimed improvements and how the firm is mitigating the risk to workers would be a significant start.

Consider, for example, Apple's widely celebrated 36% margin on its product sales in the second quarter of 2021.[150] Currently the most valuable company in the world as measured by market capitalization, Apple has long been hailed for its supply chain efficiency.[151] But reports of grueling hours, unsafe working conditions, underpayment of wages, and even child labor in Apple's supply chain suggest that at least part of the company's impressive margins are the result of poor labor practices at its suppliers' factories.[152] While Apple has devoted considerable resources over recent years to rectifying these issues, the problems persist.

Former Apple employees and labor rights groups say the company's desire for cost savings and quick production times have caused its management to overlook abuses in the past.[153] For instance, in 2012, when Apple discovered that some of its top Chinese suppliers were relying on students, some still teenagers, as temporary workers for production of its hardware, the company initially decided to ban the practice.[154] But these temporary student workers are typically paid less than standard workers and aren't eligible for benefits like social insurance or severance pay. They also allow suppliers to rapidly scale production capacity up and down, paying only for the exact hours needed. After some of Apple's suppliers said that they could not deliver the same production terms without the students, Apple opted instead to cap the amount of student workers to conform with local law.[155]

In the years that followed, the Financial Times and local labor rights NGOs accused Apple of relying on illegal amounts of these and other temporary workers and mandatory student overtime to deliver both the iPhone and Apple Watch.[156] Apple maintains that it closely monitors its factories and will terminate relationships with suppliers that have repeated violations.[157] But this is unlikely to fix the problem if Apple's cost and production demands simply require a larger temporary workforce than is legally allowed.

By asking questions—regarding Apple's purchasing practices, including whether it knows and discloses the key characteristics of its suppliers' workforces and whether workers have permanent or contingent contracts—stewardship teams could signal to the company that its shareholders are concerned with the quality of jobs that underpin its success while also gaining a better sense of the degree to which Apple's earnings are dependent on problematic or illegal practices.

Stewardship teams similarly could use the Center's framework to track and engage with companies regarding planned workforce changes. FedEx offers an instructive example. In 2000, the company announced plans to launch a new ground division staffed for the first time entirely by contractors.[158] The move allowed FedEx to save on taxes, fringe benefits, healthcare, and retirement costs associated with direct employees, but was out-of-step with others in the industry at the time. UPS, for instance, relied predominantly on unionized employees for its deliveries.[159] Had investors pressed for more detail on how FedEx planned to ensure that the new outsourced workforce received adequate pay and a certain minimum number of hours, the company might have structured fairer contracts with its drivers.

It also might have avoided a series of lawsuits alleging that it had unlawfully misclassified employees as outside contractors. FedEx ultimately settled the suits for a total of more than $460 million.[160] At the time, the company emphasized that it had shifted away from employing independent contractors directly and instead relied on third-party businesses to oversee its ground division drivers, in effect washing its hands of the problem.[161] However, the ground division again came under fire recently when drivers alleged that the new scheme was merely a pretense to shield FedEx from responsibility and that the company was in fact still effectively their employer.[162] So far, FedEx has agreed to settle claims with 101 New Jersey drivers for a total of $2.5 million.[163] Another suit brought on the same grounds by drivers in Pennsylvania is pending.[164]

Uber and Lyft have since similarly had to pay multimillion dollar settlements related to driver misclassification.[165] On top of the settlements, the ride-share companies reportedly shelled out a total of $205 million to lobbyists for successfully obtaining an exemption from a 2020 California voter proposition that would have required them to treat their drivers as employees.[166] A host of other states and the European Union are now in various stages of trying to force ride-share providers and other gig companies to treat workers as full-fledged employees. By tracking such employment trends more closely, stewardship teams could anticipate regulatory and legal surprises and help identify best practices for ensuring that corporate gains from the gig-worker model are more equitably shared with those workers.

The attempted takeover of Unilever in 2017 by Kraft Heinz illustrates how our approach might work in the context of a merger. At the time, Unilever, under the leadership of CEO Paul Polman, was among the most visible stakeholder-oriented corporations in the world. It premised its earnings strategy primarily on growing revenues through expansion into new markets rather than increasing margins by means of downward cost pressure on suppliers, as was common among some of its peers.[167] Kraft Heinz had been acquired five years earlier by 3G Capital, a Brazilian private equity firm known for a strategy that entailed "austere budgeting."[168] The firm's credo looked skeptically on innovative models, stating: "Innovations that create value are useful, but copying what works is more practical."[169] Under 3G Capital's management, Kraft Heinz had grown its margins to 28%, well above the industry average and Unilever's 14.8% margins.[170] With 3G at the helm, Kraft Heinz had seen its stock price increase by 26%.[171] Seeing Unilever's below-average margins and market power, 3G Capital—backed by the legendary financier Warren Buffett—saw the potential to apply a similar playbook to boost Unilever's earnings.[172]

News of the planned takeover bid leaked, however, giving Polman time to shore up support among his board and shareholders.[173] This ultimately led Kraft Heinz to withdraw its bid, but it seems to have left Polman shaken nonetheless. Shortly after the episode, Polman pressed shareholders to move Unilever's headquarters from London to Rotterdam, in part because the Netherlands grants executives greater power in the event of a hostile takeover bid.[174] Shareholders firmly resisted the move, and the disagreement ultimately led to Polman's resignation. And yet, it seems that he was right to reject Kraft Heinz's bid. While the acquisition may have temporarily increased Unilever's earnings, it almost certainly would have done so to the detriment of low-wage farmers and suppliers in Unilever's supply chain. And it seems sticking to their guns served Unilever just fine. In the years since, Unilever has consistently performed at the top of its industry, outperforming Kraft Heinz among other rivals.[175]

As these examples demonstrate, there are numerous ways in which stewardship teams can begin to engage more deeply with companies about the declining quality of low-wage work. While these examples are drawn from well-known companies likely to be on the radar of stewardship teams already, similar dynamics are undoubtedly at play among less closely scrutinized firms. Over time, engaging a wider swath of companies more consistently and more deeply on how they manage the labor risks associated with common earnings strategies would help improve jobs for people of all skill levels. It would also give both investors and firms greater insight into which practices have more impact on job quality throughout global value chains and what information regarding their diffuse and fragmented workforces companies ought to be tracking and disclosing.

The Covid-19 pandemic has highlighted both the extraordinary, innovative potential of capitalism—as seen in the rapid development of safe, effective vaccines and widespread adaptation to remote working—but also the significant imbalance in how economic gains are currently divided. This growing inequality, and the rising precariousness of low-wage workers, now threatens the stability of the broader global economic system. Rising demand for ESG investment products during this moment of crisis suggests that many people would like to see their money invested in a way that helps to mitigate the imbalance, but current approaches to ESG will not meet this need. Now is the time to find new ways to improve the health, safety, and well-being of low-wage workers, many of whom helped get us through the initial stages of the pandemic. Investors and asset managers can play a critical role in motivating companies to promote better labor conditions around the world.

"Engaging a wider swath of companies more consistently and more deeply on how they manage the labor risks associated with common earnings strategies would help improve jobs for people of all skill levels."

Appendix:
A New Approach to Assessing Labor Risk

Overview of our analytical approach

The framework of metrics explained below is intended to help identify companies with outsourcing practices that create greater risk of labor abuse. These metrics are currently hypotheses that we intend to back test and refine. Given the poor quality of workforce data that is now publicly available, the framework examines three intersecting corporate attributes that together make it more likely that a company is deriving cost savings at least in part from persistently poor-quality or illegal low-wage work. These attributes are: (1) the presence of incentives to cut costs aggressively, (2) a company's pronounced or growing bargaining power when contracting for outsourced work, and (3) heavy reliance on outsourced workers whose circumstances make them especially vulnerable to exploitation.

Of the sample metrics for each of these attributes, some are specific to a given company, while others relate to a company's industry or the places where a company operates. Each metric is imperfect on its own, but taken together, they should provide a more accurate assessment of labor risk than looking at a company's policies or the volume of factory audits it undertakes. We anticipate that some metrics will be leading and others lagging indicators of labor risk. Some will need to be weighted more than others, and most will have to be analyzed in the context of expected differences across industries, company size, and growth stage. These metrics are intended as a foundation for further exploration and discussion with asset owners and managers, as well as academic experts.

Attribute 1: Heightened incentives to engage in aggressive cost cutting

Hypothesis

Firms with larger incentives to cut costs are more likely to place strong downward pressure on the suppliers and independent contractors to which they outsource lower-skill, low-wage work.

Sample Metrics

- Percentage of total shares outstanding held by "transient owners," meaning investors who hold small stakes and trade quickly on an earnings drop
- "Earnings response coefficient," which is a measure of how sensitive a company's share price is to its earnings targets
- Use of share purchases to meet earnings estimates
- A company with:

  (1) Declining cost of goods sold or cost of sales (COGS)* as a percentage of overall sales

  (2) Stable or increasing selling, general and administrative (SG&A)* costs as a percentage of overall sales

  (3) Stable or declining number of employees as a percentage of overall sales

*These are accounting metrics that include labor costs. COGS typically covers the costs directly tied to the delivery of goods or services, such as labor, materials, and distribution. SG&A typically covers overhead expenses more generally, including most direct employee salaries.

Rationale

There is a rich body of academic research examining when firms are most likely to cut costs in ways that benefit near-term earnings but are detrimental to the longer-term interests of the firm and its stakeholders. Many of the factors commonly associated with more aggressive cost-cutting relate to the rising power of institutional investors and the pronounced cost-cutting focus of traditional "activist" investors explained in the main body of this report. To capture these dynamics, our framework will assess the number of transient shareholders, as defined by University of Pennsylvania accounting scholar Brian Bushee. These shareholders tend to buy small stakes in companies and sell them quickly on an earnings decline, thereby putting pressure on corporate managers to avoid earnings declines and stock selloffs.

Our suggestion of analyzing a company's earnings response coefficient reflects research pointing to when the use of certain factors—most notably, earnings per share—in determining CEO pay is most likely to result in "real earnings management." These studies focus on when managers are more likely to implement sub-optimal operational changes to meet earnings targets. To determine whether a company may implement sub-optimal operational changes, such as cutting labor costs in an unsustainable fashion in order to meet earnings targets, our framework will assess three things: how sensitive its share price is to meeting its earnings targets, whether the company is highly consistent and precise in meeting these targets, and whether management tends to repurchase shares in order to meet EPS targets.

Attribute 1: continued

To assess the degree to which general cost-cutting incentives lead to reduced labor costs in particular, we will also evaluate the two accounting metrics mentioned above: SG&A expenses and COGS. While neither focuses exclusively on labor costs, they nonetheless give investors a place to start in evaluating a company's labor expenses over time. Typically, expenses related to a company's direct workforce appear in the SG&A line (among other overhead costs), while outsourced labor will appear mostly in COGS. These two measures are likely to differ substantially by industry and even by company. But tracking how they change at a given company over time, along with changes to the number of direct employees, may indicate whether earnings are derived substantially from labor cost savings; and if they do, whether those savings come from reducing its direct workforce or obtaining lower prices for its outsourced labor.

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Attribute 2: Large or increasing power imbalances in purchasing relationships with suppliers and contractors

Hypothesis

Companies that have greater power in their negotiating relationships are more likely to shift costs and risks on to suppliers and contractors in ways that reduce outsourced workers' wages and job quality.

Sample metrics:

- Market concentration, assessed using the Herfindahl–Hirschman Index at level 3 of the North American Industry Classification System (NAICS)
- Turnover rate over a five-year period of an industry's top five companies, as measured by profits and by market value
- Merger with another company in same NAICS level 3 industry within past 24 months
- Rate of change in accounts payable turnover, a measure of how long companies take to pay for their outsourced goods and services

Rationale

Recent empirical research finds that increased market concentration is associated with reduced supplier margins and a lower share of revenue going to labor. Studies have also found that declining margins at the supplier level result in reduced worker wages.

Given these findings, our framework pairs companies' cost-cutting incentives and practices with indicators of market concentration and bargaining power. This attribute includes both industry-level and company-level metrics. At the industry level, we examine how many major buyers there are and whether those powerful companies retain their privileged positions over time. At the company level, we examine when recent mergers have likely concentrated bargaining power further, a potential leading indicator, since this has been shown to correspond with subsequent declines in supplier margins and lower worker wages. Finally, the framework looks at evidence of whether companies are able to negotiate one-sided payment terms by examining how long it takes a company to pay for the goods and services it receives. Longer payment terms are likely associated with greater bargaining power.

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Attribute 3: Exposure to vulnerable workers

Hypothesis

Companies that operate in, or source key products or services from, countries with weak regulation and labor protections are more likely to have exploitative or illegal labor practices in their outsourced functions. The same is true of companies whose outsourced workers typically are not covered by existing labor protections, such as migrants, contract workers, and informal day laborers.

Sample metrics

- Number of significant supply relationships—meaning top three quartiles by cost to the company or over 5% of total supply spend—in countries that score poorly on one or more of the following: the World Justice Project ranking, International Trade Union Confederation Global Rights Index, and/or MSCI country risk assessment
- Number of significant supply relationships in countries with substantial low-skill migrant populations or informal workforces

Rationale

The final set of indicators arise predominantly from studies of forced labor and other extreme forms of labor abuse. Given the limited data on outsourced work, these findings are more often based on case studies, which consistently find that workers who fall outside of traditional labor protections, particularly migrants and contingent workers, as well as workers in lower-income countries with more limited labor laws and enforcement capabilities, are most vulnerable to abuse.

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