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Striking A Balance: Horizontal Shareholding Versus Consumer Welfare

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ABSTRACT

Corporate ownership plays a substantial role in the U.S. economy. Through a variety of practices, it fosters economic growth and innovation. However, not all of these practices are truly beneficial for the U.S. economy and, in fact, actually result in negative consequences. Horizontal shareholding, also known as common ownership, is one of them. This paper will provide empirical evidence of its detriments and serve as a call to action for U.S. lawmakers to address these adversities through specific avenues. Furthermore, economic context will be provided to understand the meaning of said adversities in the U.S. economy and why they must be overcome. Horizontal shareholding has also been proven to be a consequence of diversification. So, it is reasonable to believe that hindering common ownership would harm the investment security that is created from this practice. This creates a dilemma of whether horizontal shareholding should actually be inhibited. This paper will discuss solutions for lawmakers to sustain the pros of both sides while confronting the cons. These solutions will serve as the impetus for a more fair and just economy that protects both consumers as well as producers, thereby creating a better society as a whole.

Keywords: Competition, Consumerism, Diversification, Horizontal shareholding, Market concentration

Introduction

Corporate ownership is the fuel that propels the engine of America's national economy. It fosters economic growth and innovation through job creation, capital formation, and government tax revenue accumulation (Manyika et al., 2021). But like all fuel, corporate ownership carries the risk of sparking fire and turmoil. Throughout the last few decades, large asset-management corporations have shifted towards horizontal shareholding (also known as common ownership), a monopolistic practice that detriments the economy, and a practice that should be inhibited by U.S. nation's lawmakers. Horizontal shareholding is defined by George S. Dallas, the policy

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director at International Corporate Governance Network (ICGN), as being "a term that reflects the investment practice of many institutional investors to hold investment positions in more than one company competing in the same sector" (Dallas, 2018). This allows said investors to diversify their portfolios, thereby reducing risk, and while this practice may have some benefits, it is important to acknowledge and combat the deficiencies as well. Looking through a positive light, it can be seen that this practice benefits the portfolio owners (by spreading risk), along with the competing businesses that are being invested in: capital produced from the owners purchasing shares provides these companies with the necessary funding they need to pursue strategic initiatives. On the other hand, it considerably harms American consumerism and disempowers workers, suppliers, and society altogether. Weighing in both the positive and negative effects of horizontal shareholding leads to the question: should lawmakers inhibit horizontal shareholding by corporations in the U.S.?

Economic Context

In order to effectively answer this question, we must first examine common misconceptions along with the economic framework that governs our society today. It is a common belief that in the economic landscape, companies and corporations operate solely for profit, and while this is true to an extent, it is not the whole story. In a recent empirical study, Matthew Backus and his colleagues argue the "common ownership hypothesis", which was initially articulated by Rotemberg in 1984. This hypothesis suggests that when large institutional investors own shares in competing companies, these companies might not only prioritize the maximization of profits but also the interests of their common shareholders. This ends up having an impact on consumer welfare and market competition (Backus, p. 273). Additionally, their research has shown "a significant increase in markups and a decline in labor share and investment since the 1980s, raising questions about the broader macroeconomic implications of common ownership" (Backus, p. 274). Therefore, horizontal shareholding should be hindered through the action of lawmakers due to its detrimental effects on consumers in commercial industries. George S. Dallas found that investors encourage anticompetitive business practices that benefit the companies and investors involved at the expense of consumers. These harmful effects were measured by Dallas in the airline industry. He used empirical data to find that common ownership resulted in the cost of airline tickets being inflated for consumers by 3%-7% relative to regular competitive pricing (Dallas, 2018). Furthermore, Martin C. Schmalz, from the University of Michigan, claims that in the airline industry, the common ownership of airship carriers that compete against one another is more likely to decrease market competition. With decreased competition and companies not being incentivized to provide competitive prices, consumers end up losing money, and with that, power. Together, these studies utilize a

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combination of numerical data and empirical research to highlight the adverse effects of horizontal shareholding on the people, and the economy as a whole.

Counter Argument

Through a different light, horizontal shareholding can be seen as only the result of diversification, where corporations hold positions in competing companies with the intention of managing risk, not of monopolistic behaviors. Dallas acknowledges that a high degree of portfolio diversification largely portrays the modern financial theory: diversification of corporate holdings to reduce portfolio risk as a matter of fiduciary prudence (actions made by the principles of responsible management of resources). Meaning while common ownership might have the unintended consequences of anti-competitive business practices, it is intended to be the diversification of corporate ownership to reduce risk. Additionally, while the liabilities of common ownership might appear to have an easy fix through immediate legal action from lawmakers, these liabilities may only be the byproduct of the advantages that this practice offers. For example, institutional investors are placing a greater focus on long-term, sustainable value creation to provide their beneficiaries with stable returns. As a result, this approach does not include the distortion of industry competition, as this would oppose the "growing focus on broader social and environmental factors as investment and stewardship considerations" (Dallas, 2018). In essence, while anticompetitive effects might surface from horizontal shareholding, enforcing laws against this practice could impair institutional investments, creating a dilemma in the U.S. economy.

Real Impact

Now, hampering horizontal shareholding may seem to restrict many beneficial business practices and create colossal problems in the U.S. economy. But the truth is, the impact of common ownership dominating the market is actually much worse. In a *Nasdaq* article, Phil Mackintosh finds that "retail investors own 77% of the market capitalization in total via stocks (held directly), mutual and pension funds." This means that when consumers have to pay inflated prices (due to the anti-competitiveness of markets dominated by horizontal shareholders), they will have less money to invest in the stock market themselves, meaning that since they own 77% of the market, the economy, in its entirety, will suffer (Mackintosh, 2020). After understanding the economic framework and discussing the effects of inhibiting versus allowing horizontal shareholding, we can return to the question of whether lawmakers should impede common ownership through the legal obstruction of this practice.

The Economy as a Whole

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To understand whether lawmakers should take this action, the economy must be analyzed as a whole. This is the point at which the three "incompatible" economic objectives come into play: portfolio diversification, shareholder representation, and competition. José Azar, an assistant professor at the University of Navarra, argues that it is impossible to achieve the three preceding objectives simultaneously. The reason being that in an economy where everyone holds the market portfolio, all companies have the same shareholders, and if firms act in the interest of these shareholders, the equilibrium outcome becomes that of an economy-wide monopoly (Azar, p. 263). As a result, regardless of whether lawmakers take action or not, it is impossible to achieve all objectives. However, among these objectives, competition is the most crucial, as it "is a powerful tool for improving the functioning of transactions by making sure that in each case the transactors are the best possible partners and that transactions take place on the best possible terms" (Rubin, p. 880). Additionally, competition prevents monopolies, thereby maintaining justice for not only consumers but businesses as well. Thus, it should be a priority to retain competitiveness in the U.S. economy, and horizontal shareholding must be hampered through action by lawmakers in order to do so.

Market Concentration

Moreover, market concentration, as defined by the Organization for Economic Co-operation and Development (OECD), "measures the extent to which market shares are concentrated between a small number of firms. It is often taken as a proxy for the intensity of competition" ("Market concentration"). And as established before, market competition is ruined by horizontal shareholding. The OECD goes on to assert that recent years have seen a rise in concentration, which serves as evidence that the level of market competition is falling, and that the expansion of large firms with high market shares is inflating profits. This undermines innovation and productivity and increases financial inequality ("Market concentration"). To be specific, common ownership in the U.S. airline industry suggests increases in market concentration that are 10 times larger than what is "presumed likely to enhance market power by antitrust authorities" (Jose Azar et al., p. 1513). On top of that, new research from Marshall Steinbaum and Maurice E. Stucke has found that "in highly concentrated markets, individuals have limited choice and little power to pick their price, quality, or provider for the goods and services they need; workers are met with powerful employers and have little agency to shop around or bargain for competitive wages and benefits; and suppliers can't reach the market without paying powerful intermediaries or succumbing to acquisition" (Steinbaum et al., p. 595). Furthermore, the relationship between price inflation and market concentration is evident and can be analyzed across different industries. Figure 1 displays the prices and contribution margins (which equals selling price minus variable costs) of a variety of medical procedures in concentrated and competitive markets. It is clear that there is a significant difference in the prices of those

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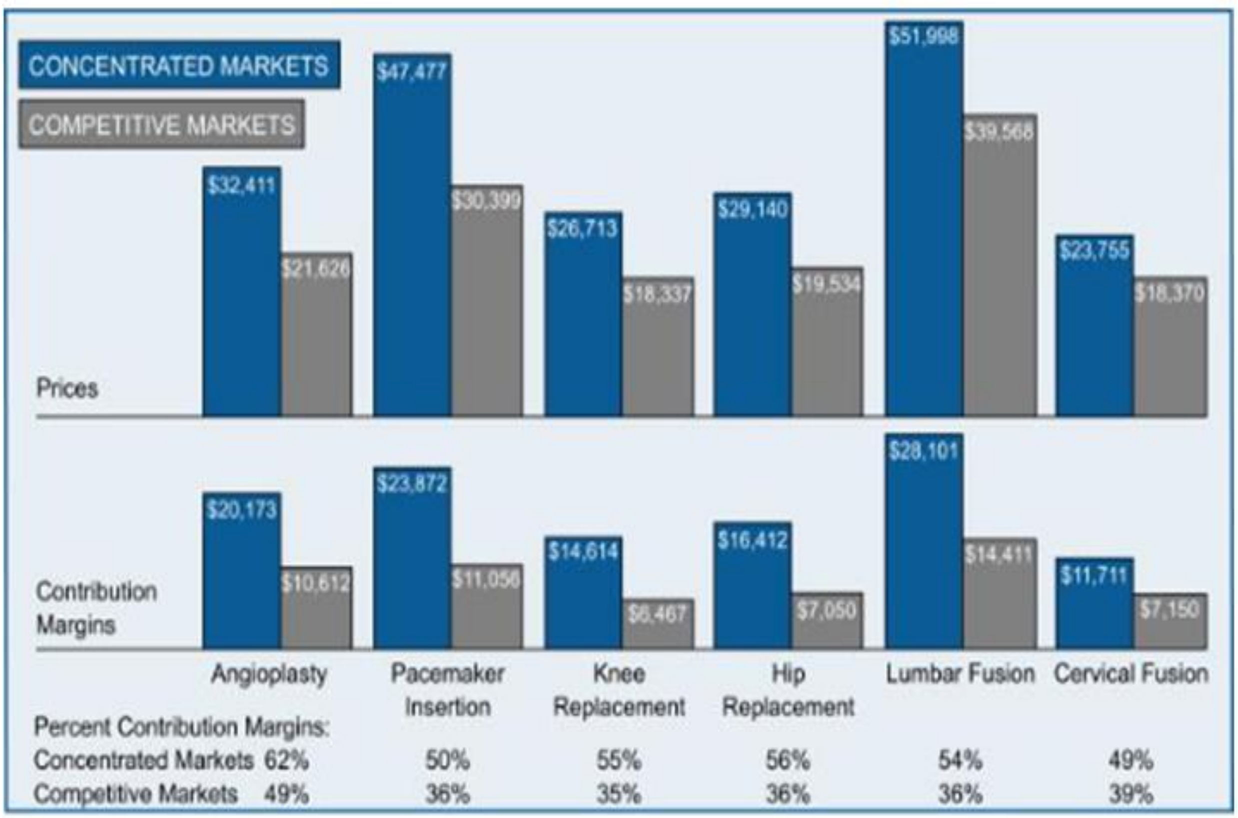
procedures in these markets, with higher prices being seen in concentrated markets. In addition, Figure 2 plots data points of the average Solar Home System (SHS) price versus market concentration and finds the line of best fit. This line is upwards sloping, illustrating a positive relationship between concentration and prices. Meaning that as market concentration increases, prices do as well. Together, both figures provide concrete evidence of the correlation between increased concentration and increased prices. In context, a rise in prices results in a fall in the purchasing power of consumers (Floyd, 2024). Therefore, we can establish a direct relationship between market concentration and a decrease in consumer purchasing power. Moreover, since market concentration is correlated with measuring competition, and competition is obstructed by horizontal shareholding, there is also a relationship between market concentration and horizontal shareholding. By integrating both relationships we find that horizontal shareholding exacerbates the issue of declining consumer purchasing power.

Figure 1: Prices in Concentrated versus Competitive Markets in the Medical Industry



Source: Chapter 24 - Market Consolidation and Alignment from The Transformation of Academic Health Centers (2015)

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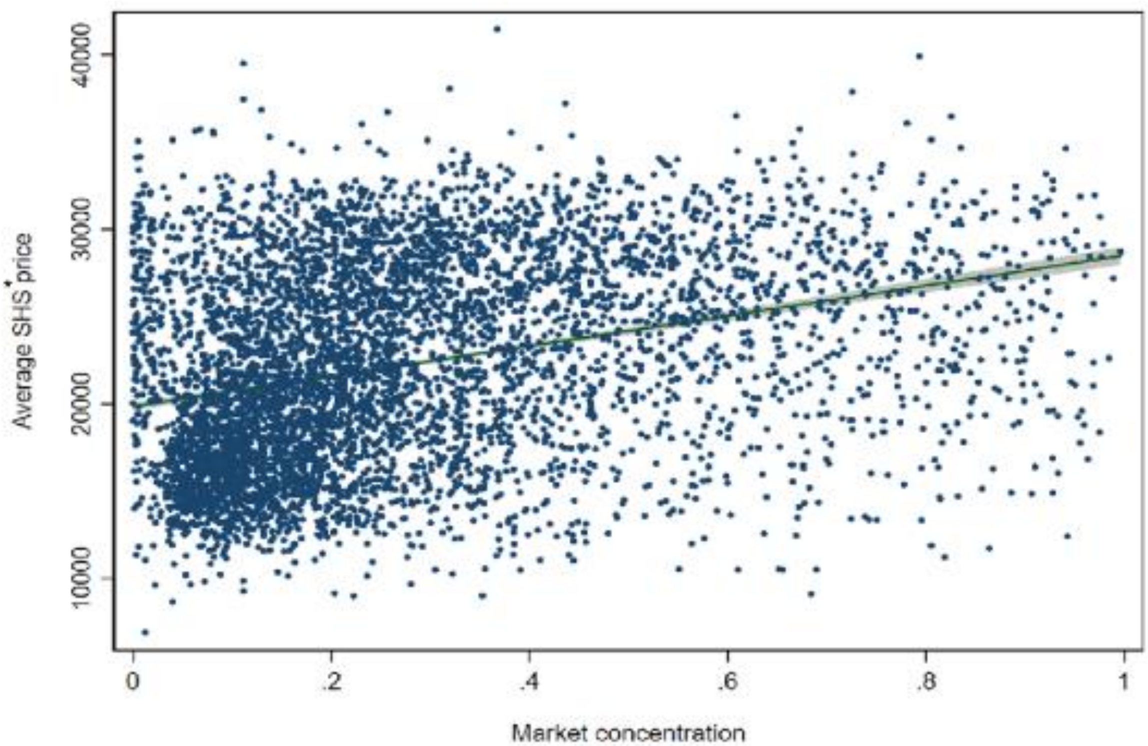
Figure 2: Average Solar Home System Price versus Market Concentration



* SHS is short for Solar Home System

Source: The impact of supply structure on solar home system installations in rural off-grid areas (2021)

New Standard to Preserve Competition

To solve the problem of highly concentrated markets, Steinbaum and Stucke have proposed that agencies and courts should use the preservation of competitive market structures as the primary goal of federal antitrust laws. Specifically, structures that will protect both consumers and producers, ensure opportunities for competitors, and disperse private power. Unfortunately, the configuration of the federal judicial system and the time and expenses to undo the damages of the deviations by the Supreme Court in economic theory discourages the legal adoption of this standard (Steinbaum and Stucke, p. 618). Despite this, the new standard will result in numerous benefits, far outweighing the cons: establishment of a clearer set of indicia for determining whether a firm has market power, more accurate monopolization policies, reinforcement of the Sherman Act, measurement of equal protection of federal antitrust law among supplier-distributor networks, price effects, privacy protection, quality, variety, services, and innovation (Steinbaum and Stucke, p. 602-616). The legal adoption of this new standard, despite its

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resource-intensiveness, will produce advantages that will benefit not only the economy but society as a whole.

Action from Firms

The adjustments mentioned above fall under the responsibility of the government. We can now focus on exploring how corporations themselves can maintain the diversification of their investments while also averting horizontal shareholding and increased market concentration. One option is for firms to give up voting rights in the shares that they claim to purchase solely for investment (Elhauge, pg. 1314). This can be exemplified in the court case United States v. Tracinda Inv. Corp. The defendant Tracinda Investment Corporation, which was owned by Kirk Kerkorian, became a majority stockholder of Metro-Goldwyn-Mayer (MGM). Kerkorian utilized Tracinda's tender offer to acquire Columbia Pictures Industries. The plaintiff (U. S. Dept. of Justice) attempted to obstruct the transaction by claiming that the tender offer violated the Clayton Act. However, they eventually amended their complaint to demand the divestment of the Columbia stock. The trial concluded with the court's findings and conclusion, which were in the defendants' favor and against the plaintiff. Because Tracinda Investment Corporation had restricted voting rights over the acquired stock, the transaction was permitted (Morton and Hovenkamp, p. 2043). Alternatively, corporations can “avoid any risk of liability funds by changing how they index” (Elhauge, pg. 1316). Specifically, by becoming indexed across different industries rather than across the competitors in one industry. This reduction in concentration correlates with a reduction in price as well: prices in the Bay Area were measured to be about 12-15 percent lower than those in concentrated markets (Bresnahan and Reiss, p. 1005).

Conclusion

While horizontal shareholding may be the consequence of diversification (a practice that benefits the economy by securing investments), it has a multitude of adverse effects, and should be hampered by U.S. lawmakers. And what’s more, lawmakers do not have to make this decision by weighing the pros and cons of each side. Instead, it is possible to reap the advantages of both. Through the legal actualization of strategies like the adoption of Steinbaum and Stucke’s new standard to preserve competition, the relinquishment of institutional investment stock voting rights, and a change in the methodology of corporate diversification can the detriments of horizontal shareholding truly be ameliorated. Furthermore, with these measures, corporations will still be able to diversify portfolios and secure their investments, thereby protecting those of the people as well (retirement funds, for example). Apart from investments, consumers will see financial benefits with the dilution of concentrated markets. Overall, there are various avenues for reform, and it should be prioritized by lawmakers to pursue them.

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