The Social Responsibility of Corporate Management: A Classical Critique*

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ABSTRACT

Calls for "corporate social responsibility" are widespread, yet there is no consensus about what it means; this may be its charm. However, it is possible to distinguish the fiduciary obligations owed to shareholders as expressed by Milton Friedman from all other paradigms of corporate responsibility. Friedman maintains 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 within the rules of the game, which is to say, engages in open and free competition, without deception or fraud." All other paradigms argue that corporations have social responsibilities that extend beyond the pursuit of shareholder benefits to "stakeholders." The list of cited stakeholders is ill-defined and expanding, including non-human animals and non-sentient things. This paper defends the intellectual and ethical merits of fiduciary duties, and compares and contrasts it to the stakeholder paradigm. The fiduciary duty to firms' owners is the bedrock of capitalism, and capitalism will wither without it.

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> The term [corporate social responsibility] is a brilliant one; it means something, but not always the same thing to everybody. To some it conveys the idea of legal responsibility or liability; to others it means socially responsible behavior in an ethical sense; to still others the meaning transmitted is that of "responsible for," in a causal mode; many simply equate it with "charitable contributions"; some take it to mean socially "conscious" or "aware"; many of those who embrace it most fervently see it as a mere synonym for "legitimacy," in the context of "belonging" or being proper or valid; a few see it as a sort of fiduciary duty imposing higher standards of behavior on businessmen than on citizens at large. Even the antonyms, socially "irresponsible" and "nonresponsible," are subject to multiple interpretations. [D. Votaw and S.P. Sethi (1973, pp. 11-12), emphasis original]

I. Introduction

There is a stark contrast between the concept of "corporate social responsibility" and Milton Friedman's (1962) declaration of the social responsibility of business. Friedman's perspective is clear and unambiguous: "...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 within the rules of the game, which is to say, engages in open and free competition, without deception or fraud" (p. 133).[1] In contrast, "corporate social responsibility" is inherently vague and ambiguous, both in theory and in practice. Yet increasingly, contemporary scholars who write on corporate social responsibility and business ethics omit mentioning Friedman's position. Prominent among those who fail to cite Friedman are: Gerald F. Cavanagh, Dennis J. Moberg, and Manuel Velasquez (1981); Thomas N. Gladwin, James J. Kennelly, and Tara-Shelomith Krause (1995); Jeanne M. Logdon and Kristi Yuthas (1997); Ronald K. Mitchell, Bradley R. Agle, and Donna J. Wood (1997); Mark Starik (1995); Timothy Rowley (1997); Timothy L. Fort (1997); Nancy L. Mead, Robert M. Brown, and Dana J. Johnson (1997); and Jacquie L'Etang (1995). These and other authors on business ethics advise the managers of corporations to be responsive to an elastic list of “stakeholders” including (among others): customers, employees, suppliers of raw materials, the government, the community, the environment, assorted activist groups, and shareholders.

Advocates of the stakeholder approach generally maintain that, while the interests of shareholders should not be ignored, they are just one of many stakeholders; it is the common good of all stakeholders that is the hallmark of corporate social responsibility. Sandra Waddock (2002, pp. 10-15) is illustrative; she advocates corporate social responsibility beyond shareholders and speculates that the list of deserving stakeholders is so extensive that it may be necessary to dichotomize them into primary and secondary claimants.

As the epigraph to our paper indicates, the terminology of the social responsibilities of corporations makes it an extremely effective marketing tool because it is so ambiguous that it can be interpreted in almost any way to accomplish almost anything. In contrast, Friedman’s paradigm is clear and unambiguous. Yet, even a cursory examination of the literatures on business and managerial ethics shows an explosive growth over the past two decades. In spite of the proliferation of scholarship on ethics, there is an almost complete neglect of Friedman. This paper compares and contrasts Friedman’s paradigm with the growing literature on business ethics, and it addresses the following puzzle: If Friedman’s is the only intellectually defensible ethos, why are other ethos dominant in contemporary scholarship?

II. The Case for Friedman’s Paradigm

Incorporated businesses were created by governments to permit their owners to undertake enterprises that the state allows.[2] Corporations are legal fictions created by the state to engage

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[1] A more detailed presentation of Friedman’s (1962) perspective can be found in Friedman’s (1970) article.
[2] We explicitly recognize the existence of non-profit enterprises and exclude them from our analysis. Churches, universities, hospitals, and many other enterprises were founded to pursue goals other than profits. The executives

in lawful enterprises. Corporations have no existence beyond this legal fiction, and, unlike real people, can have neither responsibilities nor ethics. In assessing the social practices of any corporation, the focus must be on the agents of the firm meeting their prime responsibility: their fiduciary responsibility, within the legal strictures of society and without deception, to husband and increase the wealth that has been entrusted to them by shareholders. All other responsibilities of the firm's agents must be subordinated to this one. Above all, ethical agents must ask themselves: Have we met our fiduciary duties to the shareholders?

This question, while easily stated, is not easily answered. An ethical agent must pick and choose from the universe of possible actions that are legal and transparent. Because the consequences of the actions will unfold in the future, their consequences may not be fully anticipated at the time activities are undertaken. An example illustrates the problem: suppose a company has rights to trees that line the banks of a steep river valley. Logging will increase the risks of flooding downstream from the valley. If the area subject to flooding is owned by the firm, it will take into account all the potential damage its logging might cause downstream. If the land is not owned by the firm, logging the river valley may create substantial legal liabilities to the firm.[3] Notice that it is not a certainty that the downstream area will be flooded by the logging, only that the probabilities have increased. Nor is it certain that the firm will be held liable for the damage. If logging the area enhances short-run profits, managerial incomes will be justified and may be increased. The downside is the potential for litigation that will reduce the firm's (and the stockholder) wealth. Additionally there is a moral hazard if the damage that the

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of non-profit enterprises cannot be faulted for not trying to pursue maximum profits, because that is, by definition, not the goal of their enterprises.

[3] There are additional complications that may modify this analysis. If the costs of forming and enforcing contracts are sufficiently low, downstream landowners can negotiate a mutually agreeable contract with the timber firm that guarantees that the potential damage of logging will be no greater than if the timber firm were owned by the downstream landowners themselves. For more on this see the article by Ronald Coase (1960).

flood caused by excess logging is potentially greater than the wealth of the firm's; in this case an agent solely concerned with the welfare of the shareholders will not consider losses greater than the value of the firm.[4] What is an ethical manager/agent to do? We reiterate that the answers are neither straightforward, nor easy. Answers depend on forecasts of probabilities, total losses and gains associated with each action, and the assignment of liability. Different individuals will typically put different weights and values on the various outcomes and probabilities. But the point here is that this is a decision that the *individual* has to make.

We stress that, to be ethical, individuals acting on behalf of a corporation must do so without fraud or deception. This means that in the case of the river valley, if the timber company does log it and there is a disastrous flood, the executives who made the decision must admit that the flood was a consequence of their decisions. "With neither fraud nor deception" is a strict code of ethics that would resolve many, if not most, ethical dilemmas. Transparency in corporate decision-making allows the citizenry to address what they see as ethical issues. Again in the case of logging the river valley, ethical executives will provide information that allows an informed public to act. Individuals will differ in their assessments, and the fundamental assumption of democratic societies is that decisions made by ethical individuals will generally benefit society writ large.[5]

If an enterprise is sanctioned as lawful in a democratic society, in good conscience an individual may choose to work, or not work, for the enterprise. The choice will depend upon the individual's conception of right and wrong. Restating the point, a firm has no ethics because it is

[4] Recall that an ethical agent acts with neither fraud nor deception; if the potential hazards are much greater than the assets of the company, then an ethical agent should make this known. This information may have repercussions upon the institutional arrangements of society.

[5] In addition to this assumption are the rewards or punishments met out in the marketplace to firms with clean or tarnished reputations. Alan Greenspan articulated that, "…reputation or 'good will' is as much an asset as its [the firm's] physical plant and equipment" (1963, 1966; p. 118). From the same source, Greenspan stated: "Capitalism is

not a human being. The question of whether it is ethical for a person to work for a firm that produces, sells, or provide services to businesses that traffic in such things as alcohol, tobacco, narcotics, pornography, explosives, anesthesia, abortions, beef, pork, shellfish or divorce services is either a trivially simple question, or a question so complex that it cannot be answered. Trivially simple if by ethical we mean those activities allowed in society. To define ethical as anything else is to believe that the individual's judgment should be substituted for those of the legally anointed authorities of the state. This is the road to rebellion, anarchy, and ruin. An ethical person's conduct should not lead to disastrous consequences unless the consequences of not acting would be even worse.

We recognize that accepting the decision rule that it is ethical to engage in any enterprise that the state permits can lead to paradoxical outcomes. A firm providing limousine services from hotels in Las Vegas, Nevada to local bordellos is engaged in a legal business. A person may, or may not, wish to be employed by such a firm, but to argue that it is unethical to work for the firm is moral absolutism. However, across the state line in Utah such business activities are illegal. It would be unethical for an agent to employ the firm's resources in an activity that was illegal and exposes the firm to financial sanctions and its employees to both criminal and financial penalties.

Alternatively we regard the question of what is ethical for an agent of business as too complex to answer because it depends upon how the individual in question regards this employment. Individual ethics cannot be taken out of their historical and social context. Even a cursory knowledge of human societies and histories reveals startlingly wide divergences of what is considered ethical behavior. To argue that behaviors that are legal and sanctioned by society

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based on self-interest and self-esteem; it holds integrity and trustworthiness as cardinal virtues and makes them pay off in the marketplace, thus demanding that men survive by means of virtue, not vices" (p. 121).

because someone disagrees with them is moral absolutism. But in a democratic society, *individual freedom to determine what is right and just within the strictures of society can be the only moral absolute.*[6] The employees of legally constituted firms have an ethical obligation to their shareholders and societies to follow that absolute.

The ethical thing for the firm's agents is to create wealth for the firm's shareholders by meeting public demands for the goods or services they produce. Furthermore, classical economics makes the case that the pursuit of wealth in open markets promotes the public interest:

> Every individual... generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. ... [a businessperson] by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.
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> Adam Smith (1776; 1937, p. 423)

In a free and open marketplace customers buy only after being persuaded that a product's value is sufficient to justify its price. People are persuaded to become customers in four ways: (1) by offering better "mousetraps" at attractive prices; (2) by offering equivalent "mousetraps" at lower prices or more conveniently; (3) by offering products that substitute for "mousetraps"; or (4) by operating outside the law to cut costs, or defraud the consumer.[7] With the exception of the last (anticipated in Friedman's paradigm), Adam Smith's invisible hand serves the public interest *because of* the pursuit of profit by self-interested businesspeople in three distinct ways.

First and foremost, the mice afflicted customers benefit from either better traps, less expensive traps, or trap substitutes. Second, the "suppliers" of mice control products benefit because they have higher incomes than they would have had otherwise. The "suppliers" include

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[6] The "strictures of society" allow the state to compromise the individual's freedom. In a functioning society there must be some constraints upon individuals, but it is the genius of the American Constitution and society that leaves most ethical issues to individual resolution.

[7] Using the example of mousetraps to illustrate the workings of open market capitalism traces to Sarah S.B. Yule, who in 1889, crediting Emerson for the idea, put it into print as follows: "If a man write a better book, preach a

shareholders, employees and the suppliers of other inputs. All of these members of society are better off. Third, even people who are not bothered by mice benefit from improved mice control. They benefit in at least four ways: (1) A better trap kills more mice and/or is safer for the consumer to use. Fewer mice will lower the spread of mice borne pathogens that afflict humanity. (2) Safer traps mean fewer injuries, which is welfare enhancing by itself, and economize upon scarce medical products and services. (3) Less expensive traps will benefit those unperturbed by mice because it forces their competitors to adopt more economical methods. Fewer resources are used in the production of mice control, and the freed resources will be employed elsewhere. (4) In the case of competitive substitutes, society benefits because the substitutes are either: (a) less costly to produce than traps (and allow resources to go elsewhere), and/or (b) more effective at killing mice (contributing to public health), and/or (c) safer than existing products, economizing on the use of health care resources.

The "mousetrap" metaphor represents the myriad of ways that profit seeking serves the public interest.[8] Because demanders and suppliers of legally sanctioned products are members of society voluntarily transacting, we expect that the public interest has been served by each exchange. If we accept the notion that serving the public interest is the *sine qua non* of "social responsibility," then it follows logically that legal profit seeking (with neither fraud nor

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better sermon, or make a better mousetrap than his neighbor, though he build his house in the woods, the world will make a beaten path to his door." (in *Best Quotations*, 1945, p. 161)

[8] We have explicitly not addressed the welfare of mice (nor that of the pathogenic organisms they spread) in the development of this metaphor. This is not facetious; various animal rights groups advocate an "ethical" treatment of non-human species. Testing the envelope of corporate social responsibility, Mark Starik (1995) looks forward to the day when stakeholder status can be extended to "non-human" species (the title of Starik's article is worth emphasizing: "Should Trees Have Managerial Standing? Toward Stakeholder Status for Non-Human Nature"). We believe their view is untenable because they implicitly use human values to address non-human welfare. If we refuse to accept that "man is the measure of all things" (an anthropocentric view of the world), then how do we know what a different species regards as a welfare enhancing change, and how do we resolve conflicts between species?

deception) is “socially responsible.” Consequently, ethical corporate agents are being socially responsible in their efforts to fulfill their fiduciary obligations to the shareholders.

III. The Case Against the Stakeholder Paradigm

A. The Stakeholder Paradigm May Be Superfluous

The elasticity of the list of stakeholders and the unspecified amount owed to each makes the doctrine of corporate responsibility to stakeholders pale in comparison to Friedman’s paradigm of single-minded responsibility of management to shareholders. There is just one interpretation of the stakeholder paradigm that we find to be as intellectually defensible, and that is when the list of stakeholders includes *only* shareholders. In this case, the difference between the paradigms is defined away. Advocates of corporate social responsibility to shareholders are conflicted; they are hard pressed to deny the reasonableness of Friedman’s paradigm, but generally think that the corporation should “do something” beyond pursuing pecuniary profit. This sometimes makes it difficult to tell exactly what it is that advocates of the shareholder paradigm really intend. The obscurity is illustrated in the following:

> The solution lies in business practices that reflect and respect the competing claims for all stakeholder groups. No longer simply a matter of publicity or philanthropy, socially responsible business practices affect all aspects of business operations and contribute significantly to corporate productivity and profitability.
> (*Website of Business for Social Responsibility*)[9]

Certainly a firm’s interactions with customers, employees, input suppliers, government, activists, and so on may affect profitability. Ethical executives should consider this as part of their fiduciary duties to shareholders. If the stakeholder paradigm is the same as Friedman’s then there is no conflict between the search for profits and other goals.

Because management is in a better position to understand the benefits from its charitable activities than shareholders (or other outside observers), it will not always be clear whether managers have been faithful to their shareholders or have squandered shareholder wealth. Whether the corporate activities incurred under the rubric of social responsibility are, or are not, in the best interest of shareholders will depend upon the circumstances that the firm faces. Donations to local cultural charities may be an effective way of recruiting and retaining employees with pretax dollars, or the result of unethical executives using shareholder resources to enhance their own avocations or pleasures. In Rochester, New York, the Eastman Kodak Corporation is well known for its charitable donations in support of the *local* symphony hall and orchestra. Outsiders find it difficult to tell whether or not these donations are in the best interests of Kodak's shareholders. Kodak's ability to recruit talented employees may be improved, and/or the monetary salaries of its current and potential employees may be decreased by community amenities.[10] Kodak's human resource experts are better informed about the importance of these amenities than the typical shareholder. If Kodak's executives give donations believing that they will increase shareholders' wealth, the managers are behaving ethically. If they are not considering shareholder wealth, but are motivated by other considerations, then they are guilty of neglecting their fiduciary duty to the shareholders and are acting unethically.[11]

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[9] Website at http://www.bsr.org/Meta/About/index.cfm, February 15, 2002.

[10] An anonymous referee suggested adding: "or the local populace may be so appreciative of Kodak's subsidizing of their symphony that they agree to tax abatements for Kodak's plant expansion." This may or may not be consistent with the Friedman ethos. Consider the following: suppose that Kodak is given a $1 million tax abatement in return for having contributed $1 million to the symphony and suppose that Kodak gains nothing else in terms of being able to pay lower wages, etc. The question arises as to whether the populace would have been willing to have their collective taxes raised by $1 million to fund the symphony in the absence of Kodak's beneficence. If not, then the political system has merely been used to deceive the public. Remember that Friedman's ethos requires that actions be free of fraud or deception; as a corollary to that, ethical behaviors in the *public sector* should also be free of both fraud and deception.

[11] Recent revelations about the actions of Tyco International Ltd.'s former CEO, L. Dennis Kozlowski, suggest a breach of fiduciary duty. Mark Maremont and Laurie Cohen (*Wall Street Journal*, August 7, 2002) report: "But he [Mr. Kozlowski] was also very generous with Tyco's money, donating tens of millions of corporate dollars to charities he favored—often getting credit in his name rather than Tyco's. A private school attended by his daughter got $1.7 million in Tyco money for its Kozlowski Athletic Center, while his alma mater, New Jersey's Seton Hall University, received a $5 million Tyco pledge for Kozlowski Hall." Mr. Kozlowski is currently charged with tax evasion in New York, and is under private investigation for abuses by Tyco's board of directors.

B. The Stakeholder Paradigm May Lead to Corruption and Chaos

To argue that a corporation has an ethical responsibility to behave in a manner not conducive to its owners financial well being is both logically and conceptually inconsistent.[12] First, the business was created for the purpose of increasing its shareholders' wealth. The state sanctioned the enterprise by granting it a corporate charter. It is logically inconsistent to claim that an artificial creation of the state (i.e., the corporation) is more prescient in assessing social responsibilities than the state's legally appointed representatives who were instrumental in the creation of the firm. Second, by undertaking actions that are not consistent with increasing shareholder value opens a venue for individuals to divert wealth from shareholders to others. This is the road to managerial corruption and/or chaos.

1) Managerial Corruption

Consider the implications of restricting "socially responsible" to mean activities that meet either of the following conditions: 1) the agents engage in public sector activities that do not enhance corporate profitability; or 2) the agents make disingenuous or naive claims about "socially responsible"actions that result in enhanced corporate profitability. In the first case, diverting the firm's resources to purely altruistic activities (that in fact offers no payoff to the firm) that are identified as "socially responsible" is unethical because it violates the fiduciary obligation owed to the shareholders. This is a misappropriation of shareholder resources.[13] There are at least two further problems in "socially responsible" corporate acts of charity. First, the altruistic label attached to "social responsible activities" mutes the outrage that would

[12] If the action proposed as "ethical" enhances shareholder wealth, then there is no conflict between self interest and the advocated "ethical" behavior. Corporate critics occasionally say that short sighted managers are unable to see what is truly in the firm's best interest. If this is the case the critics should either inform the shareholders, or establish their own firm and do well by doing good.

[13] Whether this is theft or misfeasance is a legal issue. We have used the term "misappropriation" because it is a less value-laden term than "theft."

otherwise be forthcoming when charlatans advancing the "socially responsible" themes *du jour* simply to enrich themselves and their cohorts.[14] Second, the altruistic activity advocated may promote the public interest less than if the firm's resources had been used simply to pursue profits; this was the point of our mousetrap metaphor. Any comparison of the net change in public welfare must take into account: a) the lost benefits to the general public that the pursuit of profits spawns, b) the lost benefits to the shareholders, and c) offsetting these would be the benefits from the "socially responsible" acts.

If the firm's agents are disingenuous and falsely claim to be acting altruistically this is, by any reasonable definition, unethical. They are acting deceitfully. Furthermore if the firm's guiding agents are naive and believe that they are "altruistically" promoting the public interest, this provides an opening for corruption. The underlings who implement policies and people acting in behalf of government or non-governmental "socially responsible" firms opportunities may engage in activities that favor special interests (corruption) with the justification that they are serving socially responsible public interests. It must be recognized that doing business with "a wink and a nod" exposes the firm to a morass of entanglements between its agents and public sector bureaucrats that are inevitably ethically suspect.

Take the example of the timber company in the narrow river valley. Suppose that its agents meet with bureaucrats employed by an agency that is designed to protect the environment. If the firm thought that potential liabilities would preclude it from logging the valley, its agents

[14] The Reverend Jesse Jackson and the Rainbow/PUSH organization have been accused in the news media of threatening firms with boycotts over alleged racial injustices unless the firms in question favor Jackson or his confederates with special treatments that are labeled "socially responsible" actions. According to a CNSNEWS.com story reported on Jan. 31, 2002, Enron was a contributor. The story makes two interrelated challenges to the image of Reverend Jackson as a champion of the public interest: 1) Rev. Jackson was "accompanying a busload of former Enron employees to Washington so they could complain to Congress about the loss of their retirement funds" at the time of his "admission" that Enron was a contributor; and 2) "Jackson [is] opposed to returning contributions he received from Enron." If accurate, this story provides a vivid illustration of the kind of entanglements that are borne of the doctrine of "social responsibility."

may try to extract benefits in the form of regulations that assist it or harm its competitors for following the course of action that it would have taken anyway, the profit enhancing action of not logging. The cover of "social responsibility" provides justification for the firm getting benefits it would not have received, and for the bureaucrats claiming that their work has provided public benefits. It is a win-win solution for the firm, its agents and the bureaucrats, but it is a net loss to the public interest.[15]

Advocates of the doctrine of corporate social responsibility appear to be blind to the ethical quagmire it creates. Kenneth Andrews's work is illustrative. He maintains that there are only two possible directions open for the evolution of the relationship between the corporations and society:

> Our national experience with government regulation should tell us that necessary as is regulation it cannot possibly design the ideal relationship between the corporation and society. If corporate power is to be regulated more by public law than by private conscience, a large part of our national energy will have to be spent keeping watch over corporate behavior, ferreting out problems, designing and revising laws to deal with them, and enforcing those laws even as they become obsolete. Furthermore such a development [path] would stifle the entrepreneurial initiative on which our economic system is based.
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> …
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> The alternative [path] to much greater but still inadequate intervention by the state in economic affairs is for businessmen to assume responsibility early as a matter of conscience rather than accept it late as a matter of law. The principal justification for leaving corporate power relatively unchecked is the emergence of the doctrine of social responsibility. This doctrine is **the only alternative** we have to an unworkable extension of the role of government in our economic system. [Emphasis added, p. 138]

Explicit in Andrews' doctrine of corporate social responsibility is participation in public affairs. Andrews asserts that "government control" can be counted on to constrain "the dangers and problems of corporate participation in public affairs." (p. 138). But Andrews' trust in

[15] This is illustrated in footnote 9.

"government control" is incompatible with his mistrust of "government regulation" along the path where "corporate power is to be controlled more by public law than by private conscience." The idea that government, corporations, and organized labor can, and should, cooperate for the betterment of society has a long pedigree. It can be seen in the early Christian church's distrust of individualism, and in its more recent (and discredited) manifestation in the political doctrines of fascism.[16]

2) Managerial Chaos

If shareholder interests lose their primacy, then Pandora's Box opens. How are corporate duties to shareholders evaluated against duties to other stakeholders? How are conflicts between and among stakeholders resolved? These questions are both unanswerable and give management unbridled discretion that will too frequently result in either absolute chaos or criminality. We have already dealt with corruption; we now illustrate the inconsistencies inherent in the stakeholder paradigm.

Suppose a drug company discovers a cure for a disease that causes a slow and painful death in those it strikes. How should the interests of shareholders be weighed against the victims of the disease, and how much should the employees receive? We can say that we should be "fair" to all these groups but that is identical to saying "we have no idea how we should treat these disparate stakeholders." If the wealth of shareholders is not paramount, who should get the drug? Should it be the youngest (those with the most years left to live), those with the most

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[16] The early church's antagonism towards profit seeking is evident in St. Thomas Aquinas, writing *circa* 1260, he stated: "… to sell dearer or to buy cheaper than a thing is worth is itself unjust and unlawful." (reproduced in Kapp and Kapp, 1949, p. 8) Martin Luther (1524) echoes the distrust of the individual: "That is a very rogue's eye of greed which sees only one's neighbors need, not to relieve it but to make the most of it, and grow rich on one's neighbor's losses. All such people are manifest thieves, robbers, and usurers. … Now I have said above that the rule that a man may sell his goods as dear as he will is false and unchristian." (in Kapp and Kapp, p. 26) In general, the early church's antagonism to profit was probably because of its interpretation of the New Testament as being hostile to private property, wealth, and the pursuit of economic goods. Much of the literature of the early church fathers

dependents, people who contribute most to advances in the medical sciences, people who are the most beloved by society (celebrities), or who? The list of worthy recipients for the drug is virtually endless. And this is just one aspect of the stakeholder paradigm. Another list can be made on how much to reward each employee, another on the eleemosynary institutions that should be supported from any unassigned profits derived from the drugs, and another list of the future illnesses to be researched. These lists are limited only by imagination of the putative stakeholders and/or their advocates, and the patience of the reader.[17]

Despite the difficulties in implementing the stakeholder paradigm beyond shareholders, this paradigm is dominant in contemporary scholarship on business ethics. This raises an obvious question: Why is the stakeholder paradigm of corporate social responsibility so pervasive? It is not its intellectual clarity, quite the contrary, the paradigm is intellectually incomprehensible.

IV. An Explanation for the Popularity of Stakeholder Paradigm

Neither cabal nor conspiracy is required to explain the predominance of the stakeholder paradigm. Its success is a result of a circularly reinforcing amalgam of three elements: individual self-interest, moral conviction, and the reification of the corporation. Kenneth Andrews (1972) provides a particularly concise illustration of the importance of these elements to the case for extending corporate responsibility is beyond shareholders. In his attack on Friedman's position, Andrews argues that:

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and the Protestant reformers was devoted to delineating between sinful and non-sinful economic activities. At best, the pursuit of economic gain was considered suspect. See, Harry Landreth (1976, p. 17).

[17] An anonymous referee raised the question as to whether human organs should, like drugs, be allocated by free market pricing. But blood is an organ of the body and people currently do buy and sell plasma; other organs whose sale is prohibited in the United States (kidneys, livers, hearts, lungs, etc.) are currently supplied at a zero price by "organ donors." Yet there is a strong likelihood that introducing such remuneration under a market or quasi-market system would be beneficial. The law of supply suggests that more organs would be forthcoming if "donors" received monetary compensation. Evidence indicating that the supply of organs is positively impacted by monetary incentives is the existence of an illegal or black market in them.

> ... in effect that present-day corporate executives are increasingly the kind of people who cannot be expected to confine themselves to pursue economic activity while ignoring its social consequences, means merely that managers will concern themselves and their companies with social problems because they find it stimulating to do so. ... [these managers] realize that a large 'private' corporation is a public institution and that its management is conducted under the guidance of implicit moral values constituting a corporate conscience. (p. 140)

Andrews begins with self-interest; it is *personally* "stimulating" to executives who direct business resources toward addressing "social problems." Next morality and corporate reification are combined: "...management is conducted under the guidance of implicit *moral values* constituting a *corporate conscience*." Incredibly, Andrews writes as if businesses were moral beings with consciences.

How has this fusion of nebulous morality, reification, and beliefs become dominant? We answer this question by way of an example. Consider the situation of hypothetical executives employed by firms producing personal hygiene products. In their lives away from work these executives find beauty and fulfillment in the arts.[18] They find their work in producing, marketing and improving personal hygiene products somewhat less fulfilling than their artistic avocations. If executives believe that they should be ethical, then they will be committed to certain moral duties. Fulfilling their moral duties gives them satisfaction, and failing to do induces disquiet. If the executives adhere to Friedman's paradigm, morality will direct them to engage in activities at work that focus on increasing shareholder wealth. This may not make the job as stimulating as it might be if their time and the firm's resources could be spent on the arts. But if they were to allocate firm resources to the arts this would unsettle them because their

[18] Obviously we are using the "arts" as a hypothetical example the executives' outside interest. Because executives are heterogeneous and have diverse interests, and because we do not know exactly what outside of their jobs might provide them with greater personal fulfillment than work (sports, helping orphaned children, helping battered women, etc.). We have chosen the "arts" as a "catch all" for these interests. While the nuances of the example would obviously change if executives were pursuing some other outside interest, the underlying nature of our argument would remain exactly the same. We do not wish anyone to believe that we are trivializing the plight of

behavior would conflict with their ethics. Is there any way that executives can have the firm support the arts and still consider themselves moral? Yes, simply modify their existing ethos to include in it the duty of the corporation to work for the betterment of society. The desire of executives for greater fulfillment at work, *sans* moral dissonance, creates a market demand for an ethos of corporate responsibility that encompasses not only shareholders, but also other members of society. Meeting this demand is not trivial because the ethos must be respectable, give managers greater discretion, and have a patina of credibility, otherwise it is not, by definition, an acceptable ethos. The substantial personal wealth of executives and their discretionary powers over corporate budgets and spending increases the likelihood that they will be successful in their search for a viable alternative ethos.

Academics, pundits, and consultants (frequently combined into one) have successfully constructed an ethos, the corporate stakeholder paradigm, that meets demands for an ethical paradigm more elastic than that of fiduciary responsibility to shareholders. Academics are among the foremost suppliers of alternative ethical standards for four reasons. (1) Their status as educators and scholars in institutions of higher learning is reassuring to executives who are in the market for an alternative to the shareholder ethos. (2) Traditionally part of the academic workload is to write position papers and present workshops. The creation of a stakeholder ethos may be simply a by-product of these activities. (3) Academics are experts in their chosen disciplines and it is a relatively small step for them to write and lecture about the ethics surrounding their fields. This allows them to have an inordinate amount of influence upon the mindset of their students, the business leaders of the future. (4) The institutions that hire the faculties who successfully champion this ethos are, *ceteris paribus*, the ones that can expect the

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orphans or battered women by the use of the term "arts" as a "catch-all" category. We use it solely as generic term for all "socially responsible" non-profit pursuits.

largest corporate contributions to their endowments and foundations. In the ethos of corporate social responsibility, academic institutions are considered stakeholders that have an ethical claim upon the firm's resources. Faculty members who champion the view that academia is an institutional stakeholder that corporations have a duty to support are more likely to attract business philanthropy than faculties who eschew the stakeholder doctrine. Financial support makes stakeholder advocates more attractive to academic administrators than faculty members who contend that the only ethical responsibility that managers have as managers are to preserve and increase shareholder wealth without fraud or deception.

This is a straightforward explanation for the success of the stakeholder doctrine. The intellectual consistency and clarity of Friedman's ethos have been vanquished by the self-interest of university administrators and faculty members. Circular reinforcement explains why the doctrine of corporate responsibility survives and thrives.[19] There are no cynical motivations behind the purveyors of the notion of corporate social responsibility to stakeholders. Quiet the contrary, the most successful propagators of belief systems are themselves "true believers;" first because frauds or charlatans are not immune to exposure, and secondly because less pecuniary compensation will be required by true believers in return for "spreading the word." Finally, because the Friedman paradigm does not appeal to university administrators or to professional management, it has been neither studied nor extended.[20]

V. Transparency, Incentives and Shareholders' Interests

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[19] Because an idea survives makes it evolutionarily successful, but that does not mean it is desirable. Evolution is not a normative concept, it only states that those things that are relatively well adapted to their environment will survive and spread. Desirability is a normative concept. For example, rape may have provided the rapist with an evolutionary advantage in the ancestral environment, but no civilized human advocates it. The success of faculty members who hold with the stakeholder ethos in currying the beneficence of university administrations and business executives does not make this ethos desirable. For more on undesirable evolutionary adaptations see Helena Cronin (1991).

[20] This reflects the assessment of Milton Friedman (2002), who in personal correspondence wrote that: "Perhaps your article will give schools of business another paper they can use to reinforce mine."

"*Man is as God made him, and frequently worse*."

Cervantes

Implementing the fiduciary duties owed to shareholders presents practical difficulties. Friedman does not explore the practical issues that frustrate fiduciary obligations in a world of costly information and uncertainty. However there is a substantial literature that offers guidance on these issues; in a classic publication, Berle and Means (1932) contend that an important cost of big business arises from the separation of ownership and control. The separation of corporate ownership and management is referred to as the "principle-agent" problem, where managers are the agents who are supposedly bound (both legally and morally) to act on behalf of the shareholder principals. Berle and Means argue that small shareholders have few incentives to monitor the actions of management. This allows unethical managers to exploit their informational advantage to promote their interests at the expense of the stockholders. The principal-agent literature illuminates the design of incentives for making agents faithful to their principals when agents are better informed and have different goals than their principals.[21]

The literature concentrates on three methods of motivating agents to act on behalf of their principals. First and foremost is transparency; this means opening the corporation's decision-making and insider information to public scrutiny wherever feasible. Ethical executives must husband shareholder wealth and not divulge trade secrets or other proprietary information.[22] Typically trade secrets do not include financial information, consequently any sequestration of financial data is ethically suspect. The provision of financial data allows equity markets to assess managerial performance and the possibility that a takeover and/or a change in

[21] Ross (1973) presents an early formal principal-agent model. For a recent survey of the literature see Chapter 14 of Mas-Colell, Whinston, and Green (1995).

[22] See Richard A. Posner (1983, p. 242) for a good discussion (with references to the literature) of the importance of secrecy to innovation.

management would increase the value of the firm.[23] Timely information about firms can serve the public interest well, whether it reveals financial peccadilloes or dangers to the flood plain.

The second method that the literature examines for alleviating principal-agent problems is to align the interests of management with those of the shareholders. Typically this involves either an equity position by management in the firm, or managerial stock options. These too have their difficulties,[24] but here again transparency may ease or resolve some of these issues.

The final remedy prescribed by the literature is a vigorous market for corporate control. If management is not being faithful to the interests of owners, this presents an opportunity for other investors to profit by taking over the firm and removing current management. In support of this Jensen (1988) finds that equity prices rise by more than thirty percent when a hostile takeover replaces management.[25] Regarding socially responsible management, it is difficult for outsiders to understand the total effect of corporate donations on a firm's value. If there is transparent reporting of corporate donations, then the costs are observable, but the benefits may be less obvious. Corporate activities that generate profits (and these may include "charitable"

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[23] It is always tempting to address contemporaneous events in an academic paper, and we have fallen to that temptation, albeit in a footnote. According to the *Indianapolis Star* (02/17/02, pages D1 and D5), the executives of Enron Corporation hid their true level of indebtedness from shareholders and the public generally. This deception helps to explain why the price of Enron stock became overinflated (hitting a high of $90.75 during the year 2000) and quickly imploded (to less than $.70 in 2002) as the true financial profile of the company became clear to investors. If the information in this newspaper article is correct, the executives of Enron Corporation certainly violated the part of the Friedman ethos that requires that there be neither "fraud" nor "deception." If Enron's accounts had been transparent and had its executives followed the Friedman ethos, then its stock price most likely would neither have soared nor imploded.

[24] Ownership reduces the moral hazards associated with the principal-agent problem, but does not eliminate them. Stock options have these problems and more: See Robert Samuelson (2002).

[25] In response to increased activity in the market for corporate control some managers have adopted poison pills, provisions designed to thwart takeovers. Jensen finds that poison pills lower shareholder wealth. Poison pills are frequently used in firms where the management has a small equity position. Poison pills can also protect managers who follow policies ("socially responsible") that reduce their firm's value to its shareholders form being replaced.

donations) will not be reduced by increased competition or a more active market for corporate control.[26]

This cursory review of the resolution to principal-agent problems underscores the utility of transparency. The inspection of executive actions is a significant inducement for management to act with neither fraud nor deceit. Relying upon managerial good will may be sufficient in some circumstances, but transparency alleviates the necessity. Like all resources, good will is scarce; efficient firms economize upon its usage.

VI. Conclusions

In 1942, Joseph Schumpeter doubted that capitalism would survive. Schumpeter envisioned capitalism as an engine of economic growth that would eventually prove *too* successful. He argued that the creation of wealth under capitalism would give rise to beliefs that would challenge the ethical basis of capitalism, ultimately leading to its replacement by socialism. The success of capitalism and the demise of overtly socialist regimes and doctrines in the recent past contradicts Schumpeter's vision; currently few of capitalism's critics want to replace it with socialism. Instead of supplanting capitalism, the critics now propose to modify and "improve" it. This is the rationale behind the stakeholder and corporate social responsibility movements that are put forward to attenuate managerial obligations to shareholders.

The fiduciary duty that ethical executives owe to shareholders is at the heart of Friedman's paradigm, and is fundamental to capitalism. By producing better mousetraps the

[26] From 1986 corporate donations declined from 2.36% of pretax profits to 1.1% of pretax profits in 1997. (Conference Board, 1999 p. 8). The decline of corporate philanthropy has been blamed on a more active market for corporate control. "The frequency of corporate mergers will undoubtedly accelerate the contributions decline." (Muirhead, 1999) "… even the most successful company giving programs are not immune to the effects of such financial adversities as mergers and acquisitions, budget cuts, global competition, and the nation's changing economy." (Council on Foundations, p. iii) This suggests that a large amount of corporate donations were not in the interest of shareholders, or else they would not have been affected by competition. Conversely, the continued existence of corporate philanthropy implies that either there is an imperfect market for corporate control, or that some philanthropy creates value for shareholders.

wealth of society increases. This simple observation is the utilitarian defense of capitalism, and we cannot have capitalism without capitalists. The doctrine of corporate social responsibility to stakeholders removes capitalists from center stage and, although meant as an "improvement," its actual effects are profoundly corrosive to the practical and ethical foundations of capitalism. The "improvements" that attenuate the duty of managers to shareholders also: (1) reduce the incentives to increase the wealth of society; (2) give ambiguous guidance to what an ethical manager should do; and (3) exacerbate the principle-agent problem between shareholders and management by creating virtually unlimited opportunities for ethically suspect situations and outright corruption.

This paper is an attempt to defend the intellectual and ethical merits of shareholder primacy, and to point out the inadequacies of the proposed alternatives. Free market capitalism has done more to alleviate human misery than all other methods of organizing resources combined. If we have succeeded in its defense, it is because its merits are manifest; if we have failed, it is because we were inadequate to the task.

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