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Commentary

Title:

"Is Profit Maximization or Social Responsibility the Morally Correct Goal of Business?" (Part 3)

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This article is the third in a four part series that is an extended comment on the moral principles of capitalism, famously addressed in a New York Times editorial by Milton Friedman who claimed that the "moral responsibility of business is to increase its profits."[1] In part two of this series on the social responsibility of business we concentrated on the impossibility of pursuing "social responsibility" (as opposed to pursuing profit), commonly understood. We found that the competitive pressure faced by most firms reduced profits to a normal level that are not sufficient to pay for social goods in addition to the market goods being produced by the firm. In part three of this series we will examine the danger of switching from the traditional fiduciary responsibility of managers to their stockholders to the stakeholder theory of management which permits the management of firms to pursue goals other than profit maximization for the owners of the firm.

Stakeholder vs Stockholder Theory of Corporate Responsibility.

Another major attack on the profit seeking norms of Capitalism by its critics is based on the Stakeholder Theory of Corporate Responsibility.[2] This theory, introduced in the mid 1980's by Edward Freeman, subverts the traditional view that the managers of a corporation have a fiduciary duty to manage the firm in the interests of stockholders, or owners of the corporation, by positing that corporate managers have an equal moral responsibility to manage the firm for the benefit of "stakeholders" of the company as well. According to Freeman, stakeholders are any group of people who are affect by the decisions of the corporation, such as workers, suppliers, customers, communities in which the company is located, etc. Theoretically, the stakeholder concept could be stretched to include the environment or society at large.

Friedman defends the traditional view that corporate managers or executives only owe a fiduciary duty to the stockholders on the principle that the managers are agents or employees of the stockholders. Corporate managers do not own the companies they manage and therefore are not authorized to spend corporate resources on their own personal goals. Friedman explicitly recognizes the right of anyone, including corporate managers, to spend their own money on any charitable project of their own choosing, but he rejects the idea that corporate managers have the right to spend other people's money, such as the stockholders, in this way.

The stakeholder view rejects the idea that managers of corporations owe a fiduciary duty to the stockholders only, but rather that they have ethical obligations to run the company for the benefit of everyone affected by the decisions of management. This theory has a surface plausibility, but it misunderstands the benefits of the traditional system where the corporate manager or executive runs the business for the exclusive benefit of the owner/stockholders.

Besides the traditional argument in favor of profit maximization for the firm's owner based on the principal/agent concept, there are strong efficiency arguments for the traditional view. The reason that incomes are so much higher in capitalist countries than in non-capitalist countries (such as the formerly communist countries of Eastern Europe and the Soviet Union, among others) is that capitalist institutions provide incentives, including profit maximization by firms, which lead to greater society-wide economic efficiency and a greater total output of goods and services. Since income is a direct byproduct of production, and production in capitalist systems is higher than in

[1] Milton Friedman, The Social Responsibility of Business Is to Increase Its Profits, New York Times, September 13, 1970, Section SM, Page 17, *https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html*.

[2] Freeman, R. E. 1984. *Strategic Management: A Stakeholder Approach*. Boston: Pitman.

non-capitalist systems, the incomes in capitalist countries are higher than incomes in non-capitalist countries.[3]

Profit maximization in firms leads directly to higher productivity for society and therefore higher incomes for the vast majority of people. The connection of profit making to incomes is due to the residual claimant status of those profits. Profit making firms are legally structured so that the owners of the firms may only take their profits out of the firm's revenues after all other contractual claimants have been paid. This means that everyone who does business with the firm, including the workers, gets paid before the owner does. Since the owner gets what is left over after everyone else is paid, the profit to the owner could be either positive or negative. In the following example we see two possible outcomes for a firm and its owner.

Table 1.

Janice's Construction Company	**Projected**	**Outcome A**	**Outcome B**
Revenue	$10	$10	$10
Cost	$8	$11	$7
Profit = Revenue – Cost	$2	– $1	$3

Janice owns and operates a construction company. In Figure 1 above, we see her projected (or anticipated) revenue, costs, and profits, each stated in thousands of dollars. For example, from the first column of numbers, suppose she wins a contract from a homeowner to install a deck for $10,000 and projects a profit of $2,000 after paying her expected expenses of $8,000. Her expenses include labor, materials, and equipment needed to finish the project. If the job is completed as anticipated she will earn a profit of $2,000. The figure also includes two potential outcomes, A and B. Outcome A transpires due to Janice being disorganized and failing to have the materials delivered on time. Her construction crew shows up but there are no materials to work with. This delay boosts costs to $11,000, leaving a negative profit (or loss) of $1,000. Outcome B is due to Janice having great organizational and management skills where there is no wasted effort on the job site. In this case, from the same revenue, the profit is now $3,000. According to the capitalist principle that the owner gets the residual, Janice earns either a loss if she is incompetent or a larger than expected profit if she is especially competent. This "carrot and stick" approach to profit and loss focuses the attention of the owner on the efficient management of the firm. If the firm is large enough to have hired managers running things, profit leads owners to paying rewards to good managers and losses lead owners to disciplining or firing poor managers.

If our society chooses to modify this traditional method of paying owners and executives through profit, and instead requires corporate executives to focus on a myriad of other stakeholders' needs, the disciplining power of profit and loss is diminished. Now suppose that Janice is a hired executive manager of a large corporation with the values in Figure 1 above stated in millions of dollars. Consider Outcome A which results in a $1 million loss. Ordinarily this outcome would put tremendous pressure on Janice to do better or get replaced by an executive that can do the job efficiently. But, if she can claim that the loss was not due to her incompetence but rather to her allocating resources to other stakeholder interests as morality dictates, she may remain in command even if truly incompetent. Weakening the link between owner and manager by

[3] For a fuller treatment of the connection between production and income see Acemoglu, Laibson and List, *Economics*, Pearson Publishing, 2015, ppg. 431 and 432.

inserting other responsibilities other than profit maximization for the owner will lead to system wide inefficiencies and thereby lower incomes for all.

It is obvious that increasing the efficiency of firms will increase the incomes of owners and managers of firms, but how does the focus on maximizing the profitability of the firm redound to the benefit of workers and others? Assuming we are dealing with competitive markets (all arguments in favor of capitalism rely on markets being competitive), the increased efficiency of firms is not fully captured by the owners. Paradoxically, the pursuit of profit in a competitive market will in the long run lead to firms earning only a normal rate of return with most of the benefits of increased efficiency being captured by either workers in the form of higher wages or by consumers of the firm in the form of lower prices.

Workers earn higher wages, not because businesses are charitable, but because the increase in productivity leads firms to expand and hire more workers. This increase in demand leads to higher wages as firms compete for workers. This is clearly visible in our economy right now where most retail firms and fast-food firms have hiring signs at their places of business advertising wages significantly above the legal minimum wage. The demand for workers in a vibrant economy outstrips supply at the previous wage level and boosts those wages to a higher level. So, part of the benefit of the new technology gets passed on to workers due to competitive markets for labor.

An increase in productivity also benefits consumers through a similar market process. As long as there are multiple firms competing in the industry (and in the markets for construction services and trucking, considered here and in part two of this series, there are thousands of firms and low barriers to entry) we will see a "price war" break out among those firms as they compete for business. Firms are in a position to lower their prices without losing money since the new technology has made them more efficient and therefore more profitable. The firms don't share their profits with customers out of kindness, but rather because they all want to expand their businesses. In order to do that they must take customers from their competitors. In the process of winning a customer away from another firm the winning firm usually has to offer a lower price, and other firms in the industry are forced to follow suit to hold their customers. This leads to a general reduction in the price of goods in industries that are becoming more efficient due to new technologies.

When all is said and done, a new technology will lead to a temporary increase in profits which will be dissipated over time in the form of higher wages and lower prices. If this is the case, Stakeholder Theory, if implemented conscientiously, could actually damage the interest of workers and other stakeholders rather than help them by reducing the ability and desire of firms to become more efficient. Because of the Law of Unintended Consequences, the imposition of "social responsibility' in an oversimplified way can lead to more harm than good. Imposing a moral construct on business is not as straightforward as it seems.