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The Failure of Friedman's Argument

One of the most influential contributions to the theory of corporate responsibility is Milton Friedman's "The Social Responsibility of Business is to Increase Its Profits." This argument, often summarized as "business is business," effectively argued that businesses should focus on maximizing profits for their shareholders. However, over time, the flaws in this argument have been exposed, and it is now widely recognized that businesses have a broader responsibility beyond mere profit maximization.

Friedman's View

An attraction of this picture of the corporation is that it is simple, clear, and appealing; it is like a well-constructed image of an all-purpose engine that can operate under a wide variety of conditions. It is easy to see why this view is so attractive to so many people. The idea of a single-minded focus on profits can be comforting in a world where uncertainty and complexity are the norm. However, as Douglas Birch argues, this view is inadequate and fails to capture the full range of responsibilities that businesses have.

The Appeal

The appeal of Friedman's argument is that it provides a clear and straightforward framework for understanding the role of businesses. However, as Birch points out, this view fails to acknowledge the complexities of modern business and society. Businesses are not just profit-maximizing entities; they are also part of a larger ecosystem that includes stakeholders such as customers, employees, suppliers, and the communities in which they operate.

Douglas Birch

Birch argues that Friedman's view is too narrow and fails to take into account the social responsibilities of businesses. He suggests that businesses have a responsibility to contribute to the well-being of society and to act in ways that are ethical and sustainable. This view is consistent with the principles of corporate social responsibility (CSR), which has become increasingly important in recent years.

In conclusion, while Friedman's argument may be appealing, it is insufficient to capture the full range of responsibilities that businesses have. A more comprehensive approach, one that recognizes the social responsibilities of businesses, is necessary to ensure that businesses contribute positively to society and the environment.

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live simply makes money and does not become involved in trying to alleviate the social problems of the community.

One way of justifying the view that the businessperson is an agent is based on property rights and free market capitalism. One of the principles of free market capitalism is that each person has the right to control his or her private productive property and reap the benefits of it. Free individuals participating in the market implicitly agree to respect other's private productive property. The stockholder provides capital to the corporation to use. The capital remains the property of the stockholder in the sense that he or she should be able to direct how it will be used and to receive the returns from its use. The stockholder claims that their capital will be used to produce maximum return. Their agents, the corporate executives, use the capital to carry out the directive.

Since the executives have been entrusted with the owners' property, they must do with it as the owners direct and are responsible for providing maximum return on the stockholders' investment. Considering executives as agents ensures that the stockholders will control their private productive property and reap the benefits of it. The agency theory can be justified by declaring that executives must be regarded as agents if we want to protect property rights and the free market system. The "doctrine of social responsibility" would subvert freedom by allowing executives to disregard the directive of the owners and to take the control of their private productive property away from them.

Three counterarguments to this argument are discussed in the remaining parts of this article.

THE "COST/HYPOCRISY" COUNTERARGUMENT

The first counterargument focuses on the fourth premise in Friedman's argument. Fulfilling "social responsibilities" would make money for the owners or would be hypocritical and deceptive. This premise is flawed. First, there are cases in which an executive can fulfill a social responsibility and without losing money for the stockholders. Thus, at some degree, executives can fulfill social responsibilities while remaining responsible agents. Second, consider Friedman's claim that if money is made while fulfilling a social objective and rationalized in this way, it is hypocritical and deceptive and therefore unethical. Friedman is wrong on both counts. A corporation can fulfill a social responsibility ethically. The conscious motive for performing the actions does not prevent the benefits from fulfilling social responsibilities, and corporations do not necessarily derive the public when they fulfill social responsibilities.

An example can help make previous points clearer. One way that corporations help fulfill social responsibilities is in their charitable activities. It is possible that by connecting a charitable act to an advertising campaign, the corporation could produce a net gain even if the corporation owns a number of retail stores in a small city. Imagine also that the city's public parks are in poor shape owing to lack of public funding. The people of the city want to revitalize the parks because they provide recreational opportunities. The corporation might initiate a campaign in which it donated a percentage of the profit from each sale to a fund for revitalizing the parks. By using an advertising campaign to show the public that buying their products helps revitalize the parks, the corporation might increase sales and thereby make more money. It would be fulfilling a voluntarily accepted social responsibility. As the executive's action in doing this would be in line with the stockholders' directive to make as much money as possible.

There is nothing inherently hypocritical or deceptive about this. The corporation would not be trying to hide the fact that it is making a net profit. Even if it did not say so directly, the public would know that the business hopes to increase sales with its campaign. More and more corporations are beginning to market their contributions as a marketing tool.

EXECUTIVES WHO PARTICIPATE IN SUCH PROGRAMS ARE HELPING FULFILL SOCIAL RESPONSIBILITIES, AND THEY ARE ALSO BEING SUCCESSFUL AGENTS.

Another way that a corporation can ethically fulfill a social responsibility and make money at it is to produce a product or provide a service that helps achieve a social objective. A business that makes moisturized wheelchair helps achieve the social objective of fully integrating the hand-icapped society. Another corporation manufactures smokestack scrubbers and helps reduce pollution. A third company provides nursing care for the elderly and helps fulfill the social responsibility of caring for aging senior citizens. It would be ridiculous to charge these companies with being hypocrites or with doing something approaching fraud. Executives of such companies would be helping fulfill social responsibilities without violating their proper role as agents.

Friedman's "agency argument" lacks force in all cases because the executive can ethically fulfill a social responsibility and still be a responsible agent. Instead of declining to fulfill any social responsibility, the executive must look at opportunities to fulfill social responsibilities while making a profit. If the overall net return is expected to be positive, then the agent should use the opportunity without trying to defraud the public concerning the profitability of the action. If helping to fulfill a social responsibility will increase the corporation's own profit, returning the profits to the stockholders, then the responsible agent should refrain from that action. Even accepting Friedman's concept of the executive as agent, we find him wrong in saying an agent would fail his social responsibilities.

However, the agent should help fulfill a social responsibility only when doing so leads ethically to a net return for the corporation and the stockholders.

THE COUNTERARGUMENT OF OWNER DIRECTIVES

The second counterargument concerns premise three: "The owners of a business direct its agents to make as much money as possible while conforming to the laws and ethical customs of society. Friedman ignores this part of the stockholders' directive and misrepresents the test of it. The part of the directive Friedman ignores is the last clause of premise three, which adds "while conforming to the laws and ethical customs of society." This clause is significant: it means that an executive should not break a law or violate an ethical custom in order to make as much money as possible. An executive's highest responsibility ought to be obeying the law and acting in accordance with ethical custom. The responsibility to make as much money as possible ought to be secondary to this. Moreover, the primary "social responsibility" of business is not to increase its profits, but to obey the law and act in accordance with ethical custom. It is apparent how a business is to obey the law if the laws are clear and unambiguous, but how a corporation is to be fact ethically may require some elaboration. This will mean, among other things, that corporate officials should have integrity, be truthful, and keep their promises, and that the corporation should do no obvious and avoidable harm. Therefore, being honest and truthful with the public and the government, keeping promises to the public and the government, and doing no obvious and avoidable harm can be said to "social responsibility" of business.

Also of particular interest in regard to social responsibility is the question whether U.S. businesses ought, according to Friedman's view, to donate to charity. Recall that Friedman does not believe that executives should conform to law and "ethical customs." In the United States, it is part of the ethical custom that those with an abundance of wealth are expected to give to charity. The individual like Dicken is usually expected to do this, and if he fails to give to charity, is condemned as unethical. Corporations with an abundance of wealth ought to give to charity also, or they can be condemned as unethical. The problem here is what constitutes an abundance of wealth for a corporation. This parallels the question of how wealthy an individual has to be before we consider him or her for not giving to charity. The line cannot be drawn precisely, but this does not prevent us from making any judgments at all. While I would feel justified in condemning any "fortune 500" company not giving to charity, others may draw the line elsewhere. In any case, the wealthiest corporations are the ones better able to give to charity, and thus are obligated to be helping to fulfill social responsibilities. Friedman fails to see that the third premise of the "agency argument" mandates that corporations have and ought to fulfill social responsibilities, and are not free to ignore them.

The second problem with this premise is that there is something odd about the idea that the stockholders actually provide a directive to the
executives. The current stockholders as a group do not usually direct the executives to do anything. The mission of a corporation has been set by board members, stockholders, the CEO, and senior executives before most current stockholders ever purchase the company’s stock. The board of directors is supposed to represent the stockholders’ ongoing interests, but whether they really do so is an open question. The current stockholders do have the right to vote on their share, but small stockholders do not expect to direct the corporation to do anything since they know that their holdings are insignificantly small compared with the total amount of outstanding stock. Most of them merely send in their proxies for management to vote or do not even bother to return their proxies. From the directors, stockholders, such as mutual funds, insurance companies, and pension funds, often hold large blocks of stock and could exert influence over management, but usually they also vote with management or do not vote their shares at all.10 Thus, most stockholders fail to exert even their limited influence over management, in the form of voting their shares, to offer any directive to the executives. This being the case, one questions whether the actual directive of the stockholder is to make as much money as possible.

It is also doubtful whether the implied directive of the stockholders is generally to make as much money as possible. Most stockholders only want a stable return on their investment, i.e., competitive with what they would get if they invested elsewhere. Potential stockholders who want to make as much money as possible tend to buy a speculative growth stock or the stock of a takeover candidate. Thus, Friedman has misrepresented the implied directive of the stockholders.

Maximizing the return to the stockholders would actually not be the long-term interest of a corporation since it would reduce the amount of money that the business could use for improvement and expansion. Corporate management usually claims that it owes the stockholders only a fair or equitable return on their investments. Management will try to prevent the dividend return from being too small, the stock from failing to appreciate, or the price—earnings ratio from being too high because these events may cause the shareholders to withdraw their money. Management will not, however, return as much money as possible to the stockholders. The appropriate return of the stockholders should keep earned in the corporation’s stock, while leaving plenty of corporate cash for improvement and expansion.

Consider a firm with pretax profits equal to three. Few corporations ask their stockholders for an explicit directive concerning social responsibility. Without a direct sampling of opinion, is the corporation entitled to assume that the stockholders only want more money and never do anything socially responsible? I believe this is unjustified. Would not many stockholders, if asked, direct the corporation to act responsibly to some minor degree even if it cost money? They might not be willing to sacrifice the part of their dividends, but most would likely be willing to give up a small portion of it. By being willing to give away anything, the owners would be demonstrating that their directive is not as utilitarian. Friedman believes as well that, in some cases, the owners or executives of a corporation would be more willing to give away money than Friedman suggests. Many corporations are involved in charitable activities with the support of the majority stockholders. These majority stockholders believe that the corporations should show some degree of social responsibility. The agency theory is crucial to Friedman’s position since it ensures that the stockholders’ directives to the executives will outweigh any other responsibilities the business person might have. Thus, Friedman thinks that the executive’s responsibility to make as much money as possible within legal and ethical guidelines is paramount.

Friedman’s only stated reason why we should consider the agency problem is that the executive is spending an employer’s money. This reason, however, does not compel us to see the executive as an agent. Some employees’ responsibilities are determined by a written contract. The task primary responsibility is carrying out the directive of the owners, while the contractual employee may have a variety of responsibilities and obligations specified by contract. The contractual employee’s primary responsibility may also be determined by the contract, and it could be related to employees, suppliers, customers, or even the local community. That a contractual employee is not an agent in the sense of “agent” that we have been using. These contractual employees, however, may spend their employers’ money without fulfilling their responsibilities. If contractual employees are not agents and yet still spend their employers’ money, then Friedman’s observation that executives spend their employers’ money does not follow from his argument.

Earlier in the article, I explained how agency theory could be justified by property rights and free market capitalism. Friedman would certainly endorse that justification. Modern capitalism, however, does not rest in harmony with the free market model. Thus, we cannot use the free market justification to declare that businesspeople are agents of their principals. If Friedman believes that we should structure the employer–employee relationship as a free market capitalistic, then he could argue that businesspeople ought to be agents, but this would be a difficult argument to make forceful. The limitations and the problems connected to free market capitalism are too great.

There is also a common-law justification for the agency theory. One might argue that businesspeople are agents since the legal system says the businessperson is an agent. This is, however, a distinction from the agent/principal model as the proper description of the employer–employee relationship. The courts are declaring that employees cannot direct their employers to act in ways that violate the employees’ legitimate interests or the interests of the public. The legal system is protecting employees who “blow the whistle” on their employers or refuse to perform actions in violation of law or public policy, or who are discharged, or disciplined by employers who are acting unfairly or in bad faith.11 These decisions constrain the kind of directives employers can give employees and may lead to the complete rejection of agency theory.

owners if the stockholders do not also seem to reject the agency model in favor of viewing employment as contractual even when no written contract be-
Another problem is that the agency theory could lead to an extremely simplistic and dangerous notion of corporate responsibility. If the executive's responsibility is merely to maximize the return for the stockholders, then it must be concluded, as Friedman seems to do, that the corporation's only or overriding responsibility is to maximize net profits. This notion could lead the corporation to maximum irresponsibility, profitlessly. Companies might do no more than what is required by law to bear the externality costs created by their operations. Since the laws generally require corporations to bear only a small portion of their externalities, the idea of a large burden on government to bear these costs, or to defer the costs for future generations, is a period of an enormous federal budget deficit, it should be clear why the first alternative is problematic. The impending environmental crisis caused by atmospheric pollution or "greenhouse gases" illustrates the danger of deferring externalities for future generations to deal with. The more we defer dealing with such externalities, the greater the ultimate cost. Corporations that accept the idea of corporate social responsibility, including the responsibility to do so obvious and avoidable harm, will be more inclined to bear the burden of some percentage of their externalities. Thus, rejecting the agency model offers a benefit to society. This may be an unconvincing reason for some businesspeople, but not to those who appreciate the degree to which healthy business relies on a healthy society. A society that accepts the classic justification of capitalism, that it is supposed to maximize public benefit.

The previous part of this essay argued that there are no compelling reasons to reject the agent/principal model as the correct description of employer–employee relations, and that there are at least two reasons to reject it. The "agency argument" rests on an oversimplified and inaccurate view of the executive. It also leads to a view of corporate responsibility that could be dangerous to society in the long run. This should lead us to repudiate premise one: that an executive has no responsibility of the business. Therefore, we cannot reject Friedman's argument completely. Friedman fails to establish his conclusion that executives should never fulfill social responsibilities since he offers no compelling reasons why we should accept the agent/principal model of the employer–employee relation.

The issue of corporate social responsibility is a complex one. When we expect corporations to assume social responsibilities, we are asking them to bear costs that may have some degree of impact on their operations. A solution must be found that allows corporations to remain profitable and to fulfill their social responsibilities. At the same time, we should look more seriously at arguments that claim that among the social responsibilities of corporations and their officials are being honest, and being responsible to the public and government, keeping promises to the public and government, not being obvious and avoiding harm. This last responsibility might include the responsibility to bear a larger part of the cost of alleviating problems caused by their own activities.

Another social responsibility worth discussing is that many American businesses ought to be responsible for making donations to charities. This article represents a necessary first step, calling for the question of an important argument against executives helping to fulfill social responsibilities. Readers who accept my contentions concerning agency theory will see that we can delete Friedman's "agency argument" from the corporation–government relationship. We should, however, discard Friedman's insight that the stockholders (and I would add the rest of the public) expect corporations to obey the law and act ethically. This is the foundation from which future discussions on corporate social responsibility ought to proceed. Readers who are unconvinced by my arguments connected to discarding the agency theory ought still to see that based on Friedman's position the primary "social responsibility of business is obeying the law and acting ethically."

NOTES
2. Two recent examples are John McCall, "An Analysis of the Free-Market View of Responsibility," in Neural Economics and John McCall (eds.), "Guerrelle," "The Social Philosophy of Business Ethics (Belmont, CA: Wadsworth, 1986); and Thomas Mallon, "A Critique of Milton Friedman's Essay, "Social Responsibility of Business Is to Increase Its Profits," "Journal of Business Ethics 5, 1986. McCall states that Friedman's "social" and "productive" arguments are weak. However, the executive can achieve social objectives by imposing taxes on their principals. Mullan criticizes Friedman's comments on agency rest on the tax matter. Executives look to their agents because they impose a tax on their principals, and the exercise of corporate social responsibility is unfair because it creates costs without returns.
3. See McCall's previously mentioned commentary.
5. Ibid., 124.
7. Loc. cit. I think that Friedman's arguments about doing in the long-term interest of the corporation and calling it "fulfilling social responsibilities" is a problem, and I feel that the foundations of a free society is at stake. Also, the use of the word "corporation" here is misleading.
8. As Friedman clearly points out, this argument would not apply to corporations established for an eleemosynary purpose, e.g., a hospital or a school. In corporations like these, the manager would still be an agent, but his or her primary objective would be rendering a certain service.
10. Friedman also mentions the executive spending the customers' or employees' money by fulfilling social responsibilities is unfair because it creates costs without returns. However, in most cases there could be no objection to this since it would not conflict with the directive of the principals. Only if mining the price to customers, delaying an employee raise, or lowering the employees' salaries affected the return to the stockholders would this lead to the agent's being held irresponsible.
11. I am not claiming to provide the directive of ethical custom to corporations by loosening how ethical custom applies to individuals.
12. An interesting point is that mutual funds, insurance companies, and pension funds are also "owned" by their shareholders. Thus, these shareholders would act as executives is that Friedman must want us to guide our application of ethical custom to corporations by loosening how ethical custom applies to individuals.
CHAPTER TWO

ETHICAL THEORY AND THE FREE MARKET

Introduction

In Chapter One we examined a free market view of business ethics as expressed by Milton Friedman in "Social Responsibility of Business." In that article, Friedman offers both moral advice to business managers and recommendations for public policy toward business. Briefly, Friedman tells us that business managers ought to make only those decisions that will maximize profits and that society ought to be arranged in such a way that business is given maximum freedom to pursue its goal of profit maximization. In this chapter we examine two arguments that have been used to justify this free market view in a manner that is philosophically more satisfactory than the defense offered by Friedman.

Utilitarianism

The first of these philosophical arguments tells us that the free market is justified because such a system will lead to better overall consequences for a society. To understand fully how this view is defended, we need to look in some detail at the ethical theory called utilitarianism.

Utilitarianism is an ethical theory that, roughly speaking, directs us to seek the "greatest good for the greatest number," or to "maximize the overall good." Thus, utilitarianism involves two components: an account of what is "good" for individuals and a rule for judging all acts in terms of this good. So, is utilitarians, we judge an act (for example, a business manager's decision to maximize profits) by the consequences produced by that act. If the result of the act is to maximize the good, then the act is ethically right; if this does not occur, then the act is ethically wrong.

From this description, we can see that utilitarians distinguish two types of value: intrinsic value and instrumental value. The "good," that against which all other things are measured, is something that is valued for its own sake: It can be said to have intrinsic value. All other things are judged to have value not in