Milton Friedman 50 Years Later

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Edited by:

Luigi Zingales, faculty director, Stigler Center
Jana Kasperkevic, managing editor, *ProMarket*
Asher Schechter, writer and editor, *ProMarket*

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for the Study of the Economy and the State

To mark the 50-year anniversary of Milton Friedman's influential *New York Times* piece on the social responsibility of business, we are publishing a series of articles on the shareholder-stakeholder debate. The 28-piece series first appeared on *ProMarket*.

We hope you enjoy reading this series as much as we enjoyed putting it together.

Luigi Zingales

TABLE OF CONTENTS

Introduction

1 Friedman's Principle, 50 Years Later
By Luigi Zingales

Modern Defense of Milton Friedman

4 The Enduring Wisdom of Milton Friedman
By Steven N. Kaplan

7 Shareholder Value and Social Responsibility Are Not At Odds
By Mary K. Bush

11 What Stakeholder Capitalism Can Learn From Milton Friedman
By Alex Edmans

Stakeholders

17 "50 Years Later, It's Time to Reassess": Raghuram Rajan on Milton Friedman and Maximizing Shareholder Value
By Raghuram Rajan

22 Beyond Friedman's Doctrine: The True Purpose of the Business Corporation
By Martin Lipton

26 The Illusory Promise of "Stakeholderism": Why Embracing Stakeholder Governance Would Fail Stakeholders
By Lucian Bebchuk, Roberto Tallarita

31 For Whom Corporate Leaders Bargained: What the Past Can Teach Us About the Questionable Promise of Implementing Stakeholder Capitalism Today
By Lucian Bebchuk, Kobi Kastiel, Roberto Tallarita

36 Diversifying Corporate Boards — the Best Way Toward a Balanced Shareholder/Stakeholder System of Corporate Governance
By John C. Coffee, Jr.

38 Corporations Are Governance Mechanisms, Not Shareholder Toys
By Margaret Blair

43 Bringing Ethics Back to Friedman's Call to Purpose for the Next 50 Years
By J.S. Nelson

47 It Is Time to Move on From Friedman's View of the Corporation
By Stefano Zamagni

When Shareholders Have Other Objectives

51 Shareholders Don't Always Want to Maximize Shareholder Value
By Oliver Hart

55 Serving Shareholders Doesn't Mean Putting Profit Above All Else
By Oliver Hart, Luigi Zingales

59 Market Forces Already Address ESG Issues and the Issues Raised by Stakeholder Capitalism
By Eugene F. Fama

65 The Purpose of Business is to Solve Problems of Society, Not to Cause Them
By Colin Mayer, Leo E. Strine, Jaap Winter

69 Does a CEO Have a Duty to Lobby?
By Luigi Zingales

73 Missing in Today's Shareholder Value Maximization Credo: The Shareholders
By Luca Enriques

78 Pursuing Stakeholder Capitalism Is an Impossible Task When Stakeholders Have Different Beliefs
By Marc Painter

82 Which Problems Should Companies Try to Solve?
By Sanjai Bhagat, R. Glenn Hubbard

88 A Challenge for Stakeholder Capitalism: Solving the Paradoxes of Voting
By John G. Matsusaka

92 The Real Effects of Environmental Activist Investing
By S. Lakshmi Naaraayanan, Kunal Sachdeva, Varun Sharma

98 Can Institutional Investors Solve Societal Issues When Governments Fail to Do So?
By Eyub Yegen

103 Strength in Numbers: Using Data to Track Diversity and Inclusion
By Marianne Bertrand, Caroline Grossman, Mekala Krishnan

Friedman Meets Stigler

114 There Is a Direct Line from Milton Friedman to Donald Trump's Assault on Democracy
By Martin Wolf

117 Milton Friedman and the Need For Justice
By Anat Admati

123 Corporations Are Already Plenty Powerful. Stakeholder Capitalism Could Make Them More So
By Karthik Ramanna

Conclusion

128 Friedman's Legacy: From Doctrine to Theorem
By Luigi Zingales

Friedman's Principle, 50 years Later

By Luigi Zingales

In the mid-1980s, Milton Friedman's view that the only social responsibility of business is to increase its profits became dominant in business and academia. Since the Great Financial Crisis, his views have increasingly been challenged. To mark the 50-year anniversary of Friedman's influential NYT piece, we are launching a series of articles on the shareholder-stakeholder debate.

Since the end of the 19th century, capitalism has been increasingly organized in the corporate form. Thus, the question of how corporations should be run is essential to shaping which type of capitalism we want.

The debate between a shareholder-centric perspective and a stakeholder-centric one dates back at least to the early 1930s, when Adolf Berle and E. Merrick Dodd argued these two positions in the *Harvard Law Review*. Yet, a crucial milestone in this debate has been set by Milton Friedman who, fifty years ago almost to the day, wrote in the *New York Times Magazine* that the only social responsibility of business is to increase its profits. Whether you love or hate his arguments, Friedman has set the terms of debate for the last 50 years.

Since the mid-1980s to the early 2000s, Friedman's position was dominant not only in academia, but also in the business world. In 1997, the Business Roundtable proclaimed that "the principal objective of a business enterprise is to generate economic returns to its owners," all but endorsing Friedman's position.

Since the Great Financial Crisis, Friedman's view has become increasingly unpopular. In the political arena, many prominent political figures, from Elizabeth Warren to Joe Biden, are calling for a stakeholder-centric corporation. In academia, the British Academy stated that "A corporation *must* have a set of clearly defined and aligned purposes—the goals it actively pursues and its contributions to societal goals or public interests (emphasis added)." Even in the business world, the Business Roundtable changed its position in 2019, proclaiming that "While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders."

Given the increasing challenges to Friedman's position, it is only fair that we use this anniversary to assess where we stand on this debate.

Before we open the debate, however, it is important that we agree on what Friedman said and what he did not. First of all, the *New York Times* piece should be read with chapter 8 of his 1962 book *Capitalism and Freedom*, which Friedman refers to in his article. In the book, Friedman makes clear that only in a competitive environment businesses have no social responsibility. "The participant in a competitive market has no appreciable power to alter the exchange, he is hardly visible as a separate entity, hence it is hard to argue he has any 'social responsibility.'" In contrast, "the monopolist is visible and has power. It is easy to argue that he should discharge his power not solely to further his own interest but to further socially desirable ends." So it is perfectly coherent with Friedman's view of the world to ask what is the social responsibility of digital monopolies like Google and Facebook.

Friedman espoused the contractarian view of the corporation—i.e., that corporations are just a nexus of contracts freely drawn by the various parties involved. According to this perspective, corporations are no different from a collection of individuals. Hence, they should not have any social responsibility different from that of individuals. It is important to emphasize, thus, that this does not mean "no responsibility." In fact, at the end of the *NYT* essay, Friedman makes clear that corporations have the social responsibility to play within the rules of the game, "which is to say, engage in open and free competition without de-

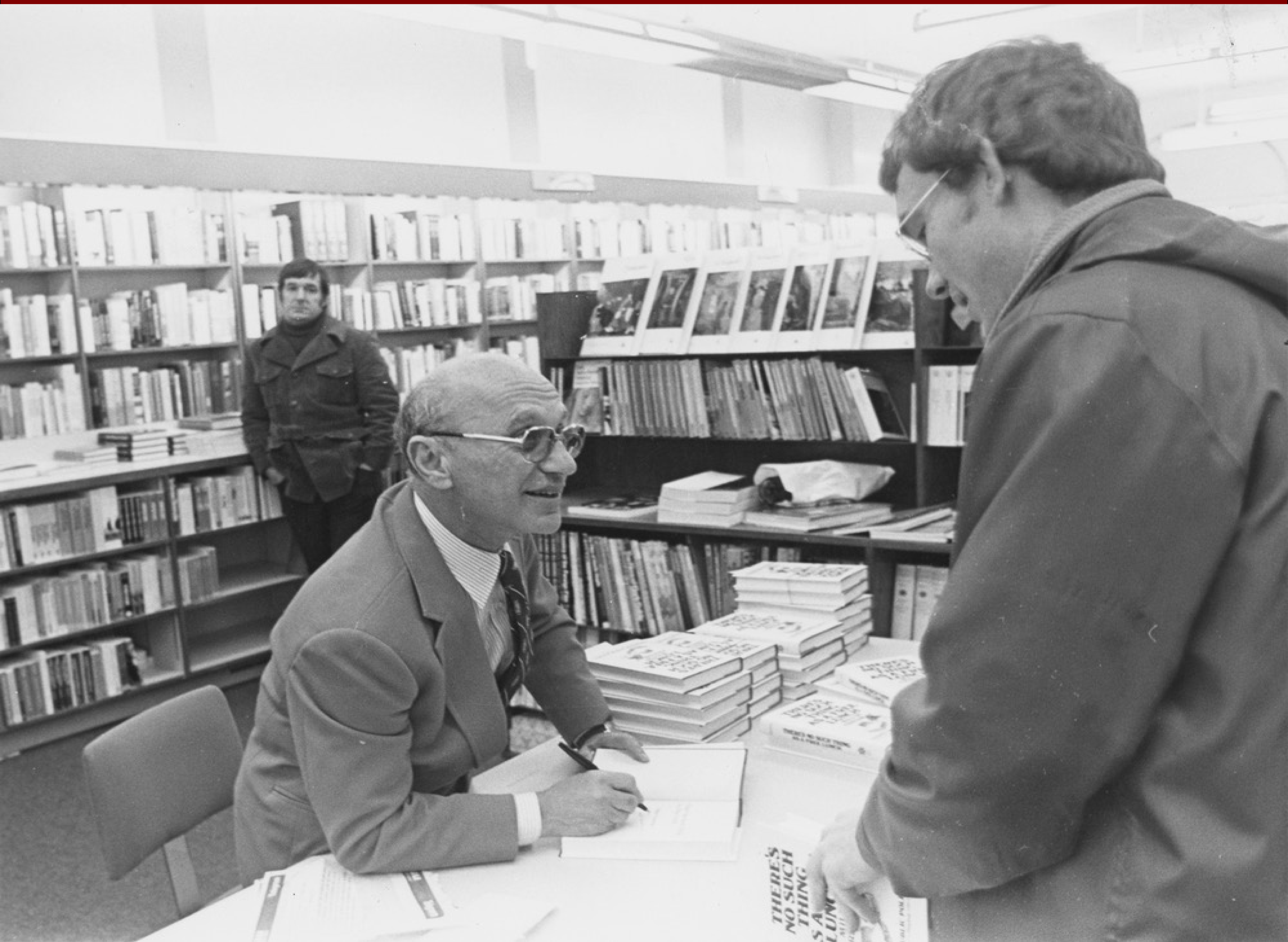
ception or fraud." Thus, Friedman believes that companies have not just a legal, but also a social responsibility to not collude, deceive, or defraud. This is a far cry from the "greed is good" version popularized by Gordon Gekko in the Oliver Stone movie *Wall Street*.

Friedman would not object to the goals contained in the 2019 Business Roundtable Report, from "delivering value to our customers" to "investing in our employees," from "dealing fairly and ethically with our suppliers" to "supporting the communities in which we work," to the extent that these goals are functional to "generating long-term value for shareholders." This is a straightforward application of the principle of "no taxation without representation." Any deviation from profit maximization is borne by the shareholders, who are the residual claimants. Thus, deviating from profit maximization is a form of taxation, which only the shareholders can impose on themselves. Otherwise, it is expropriation.

Thus, Friedman is not necessarily against the idea that individuals or businesses might pursue social objectives different than maximizing monetary returns. He is against the idea that these responsibilities or different objectives might be imposed on shareholders by other constituencies. If we accept a contractarian view of the corporation, it is very hard to disagree with this conclusion.

Luigi Zingales is the Robert C. Mc Cormack Distinguished Service Professor of Entrepreneurship and Finance at the University of Chicago - Booth School of Business. He is a Research Associate of the National Bureau of Economic Research, a Research Fellow of the Center for Economic Policy Research, and a Fellow of the European Corporate Governance Institute. His research interests span from corporate governance to financial development, from political economy to the economic effects of culture. He has published extensively in the major economics and financial journals. In 2003, Zingales received the Bernacer Prize for the best European young financial economist. In 2013 he has been named founding director of the Center for Economic Analysis of the PCAOB. In 2014 he served as President of the American Finance Association. He is co-author with Raghuram G. Rajan of "Saving Capitalism from the Capitalists" (2003) and author of "A Capitalism for the People: Recapturing the Lost Genius of American Prosperity" (2012). His latest book is "Europa o no" (2014).

Modern Defense of Milton Friedman



The Enduring Wisdom of Milton Friedman

By Steven N. Kaplan

Shareholder value maximization has been extremely successful globally in the way that matters most because, in many cases, maximizing shareholder value is in harmony with delivering for stakeholders.

Milton Friedman wrote his famous piece about corporate social responsibility 50 years ago. The wisdom of the piece has been influential, productive, and remains true today.

It is important to understand what Friedman actually said and meant: "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." I interpret "profits" to mean long-term shareholder value, which is the value of the company. That captures the fact that total shareholder value can increase if a company takes actions that reduce profits in the short-term, but increase them by more in the medium and longer-term. That is surely what Friedman meant.

Many observers, including the organizers of the Stigler Center's Political Economy of Finance Conference, believe that his view has been extremely influential. It has been implemented in the US and globally starting in the 1980s, encouraged by scholars like Michael Jensen (a Booth alum and my thesis advisor).[1] What has been the result of corporate shareholder value maximization mixed in with globalization? Let me cite Nicholas Kristof, of the *New York Times*, who wrote at the end of 2019 (and pre-pandemic): "For humanity over all, life just keeps getting better." People living in extreme poverty fell from 42 percent of the world's population in 1981 to below 10 percent today. That is 2 billion people who are no longer suffering extreme poverty. Absolute poverty declined substantially in the US, from 13 percent in 1980 to 3 percent today. And this is more or less what Friedman predicted. The pandemic will affect these numbers, but I am hopeful that the effect will be temporary.

So, I believe we should start from the premise that the goal of shareholder value maximization has been extremely successful globally in the way that matters most.

Shareholder value maximization has been successful because in many cases maximizing shareholder value is in harmony with delivering for stakeholders. Apple and Microsoft, for example, have delivered huge value not only to shareholders, but also to customers, employees, and suppliers around the world.

Today, some customers and employees care more that firms are responsible on environmental and social issues, so it can be value maximizing to respond. Friedman himself acknowledges: "It may well be in the long-run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government. That may make it easier to attract desirable employees, it may reduce the wage bill or lessen losses from pilferage and sabotage or have other worthwhile effects."

But, there are two major challenges with prioritizing stakeholders over shareholders. The first challenge is that there are always trade-offs. GM provided a great example last year when it proposed to close a plant producing gasoline cars in Michigan and to open one producing electric cars farther south.[2]

How do you choose? If you close the plant, you hurt the workers you fire and you hurt the community in Michigan. On the other hand, if you do not close the plant, you hurt the workers and community in the south and you hurt the environment. Would it matter if the closed plant is in Michigan or China? Would it matter if the new plant is in Texas or Mexico?

For Friedman, the choice is clear—do what maximizes shareholder value of the overall company. When you deviate from that and consider the other stakeholders, Friedman asks: "If businessmen do have a social responsibility other than making maximum profits for stockholders, how are they to know what it is?"

And, how does the board evaluate the CEO? Without shareholder primacy, it is very easy for the CEO to say, "I did a good job."

The CEO can say, "I kept the old plant and employees! The employees and community are happy. I am a great success!"

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1 *Nicholas Lemann devoted an entire book to this, Transaction Man: The Rise of the Deal and the Decline of the American Dream.*

2 *Greg Mankiw used a version of this example in his column for the New York Times, July 24, 2020.*

Or the CEO can say, "I built the new plant. The environment is happy. The new community is happy. I am a great success!"

You see the problem. The CEO can do almost anything and claim to be creating value.

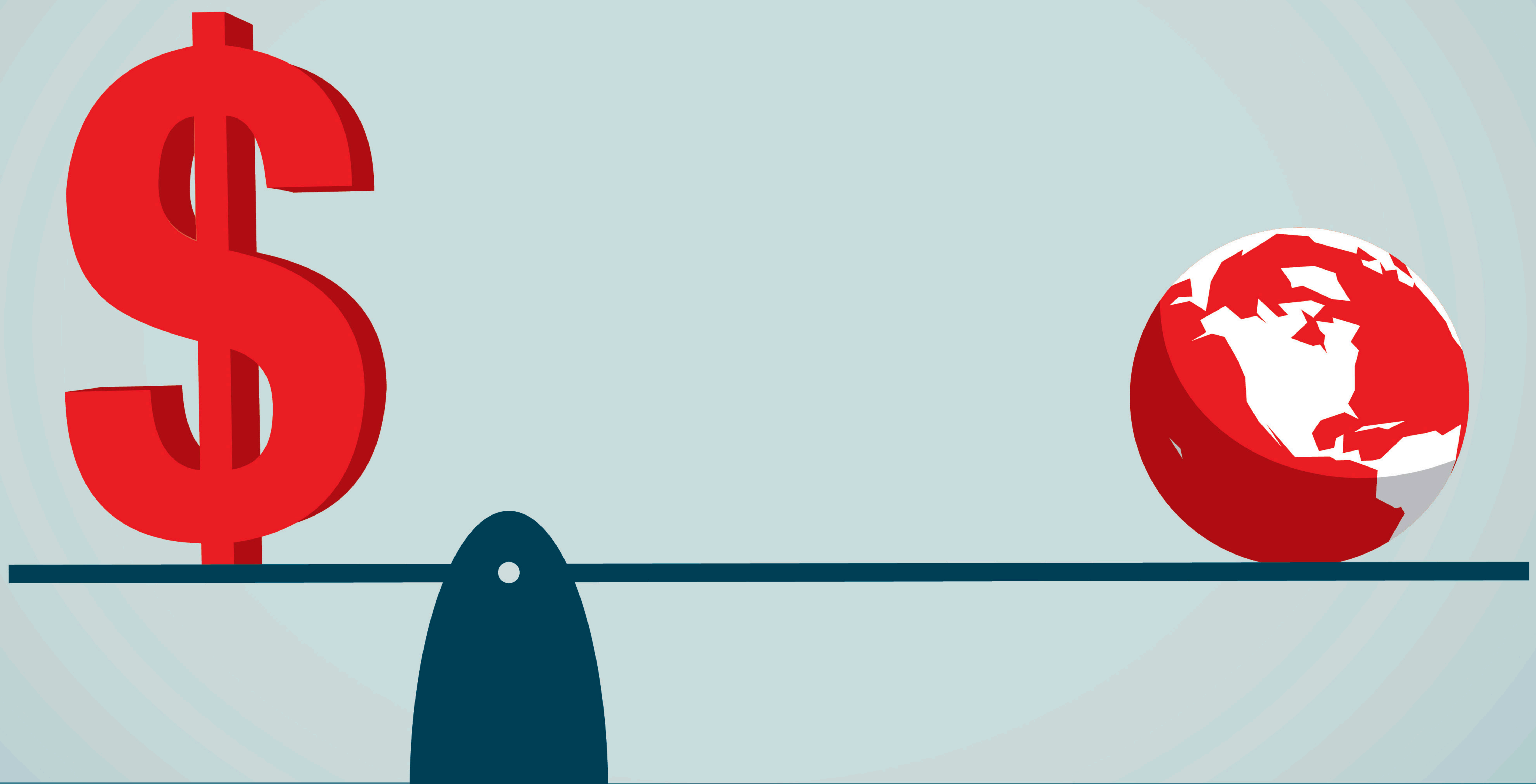
The second major challenge with delivering for stakeholders instead of shareholders is competition and investment. Many models, including Hart and Zingales, ignore investments and understate the effect of competition. Companies compete against shareholder value maximizers. Value maximizing competitors will operate and invest efficiently. When a company prioritizes other stakeholders and does not maximize shareholder value, the company is likely to invest less/operate worse. A good example of this is the US auto companies in the 1960s and 1970s. They treated their unions and employees as partners/stakeholders. They were devastated by Japanese competitors.

And Friedman is prescient and wise in one additional way. Last year, the Business Roundtable, comprised of the CEOs of many of the largest US companies, issued its ill-advised Statement of Purpose that concluded: "Each of our stakeholders is essential. We commit to deliver value to all of them." Friedman brings up a vital concern about dividing loyalties in this way. "If businessmen are civil servants rather than the employees of their stockholders, then in a democracy they will sooner or later be chosen by the public techniques of election and appointment. And long before this occurs, their decision-making power will have been taken away from them."

Right on cue, Senator Elizabeth Warren and other politicians responded. Warren wrote: "For information about the tangible actions you intend to take to implement the principles … I expect that you will endorse and wholeheartedly support the reforms laid out in the Accountable Capitalism Act to meet the principles you endorse."

To conclude, Friedman was and is right. A world in which businesses maximize shareholder value has been immensely productive and successful over the last 50 years. Accordingly, business should continue to maximize shareholder value as long as it stays within the rules of the game. Any other goal incentivizes disorder, disinvestment, government interference, and, ultimately, decline.

Steven Neil Kaplan is the Neubauer Family Professor of Entrepreneurship and Finance at the University of Chicago Booth School of Business. He conducts research on issues in private equity, venture capital, entrepreneurial finance, corporate governance and corporate finance. He has published papers in a number of academic and business journals. He has testified to the U.S. Senate Finance Committee and the U.S. House Financial Services Committee about his research. Kaplan is a research associate at the National Bureau of Economic Research and an associate editor of the Journal of Financial Economics. Kaplan teaches advanced MBA and executive courses in entrepreneurial finance and private equity, corporate finance, corporate governance, and wealth management. BusinessWeek named him one of the top 12 business school teachers in the country. Professor Kaplan has been a member of the Chicago Booth faculty since 1988 and co-founded the entrepreneurship program at Booth.



Shareholder Value and Social Responsibility Are Not At Odds

By Mary K. Bush

Being socially responsible can, and frequently does, make good business sense. There are plenty of opportunities for companies to do well by doing good.

The core of capitalism—the freedom to engage in entrepreneurial activities, to trade goods and services, and make profits for shareholders—in and of itself, is socially responsible. It is so because enterprises and the profits they generate bring many benefits to society including jobs and training, revenues for suppliers, R&D investment for innovation, among others. All potentially produce social and economic returns for individuals and businesses beyond the walls of the company. That is socially responsible.

With renewed emphasis on social responsibility, some see Milton Friedman's dedication to increasing profits for shareholders as being at odds with social responsibility. I don't see it that way at all. I think that friction between profits for shareholders and social responsibility arises, in many cases, when individual freedom is, in some way, compromised. Capitalism and individual freedom are joined at the hip. Friedman saw it that way and so do I. A weakened or severed link between the two frequently causes the friction.

As the Reagan-appointed US representative on the IMF Board, I had a timely and unforgettable oppor-

tunity to promote free markets, both through advice and lending facilities specifically designed to incorporate free market policies into the economies of African and Latin American IMF borrowers.

Witnessing many countries repeatedly in financial crisis, it became clear to me that economic growth and prosperity were stunted by government ownership of productive assets, restrictions on capital movement and business formation, and high business taxes. I thought that a new joint IMF/World Bank lending facility, structured to support privatizations and other free market reforms, would help engender growth and financial stability. Hence, we created the Structural Adjustment Facility. The results included increased business formation and economic growth along with poverty reduction and middle-class growth—all socially and economically responsible outcomes. Becoming known as Ms. Free Market made me proud. It was capitalism that drove these much-desired outcomes.

Now, though, we hear the clarion call for social responsibility. The call comes from many places including shareholders themselves. BlackRock, Vanguard, State Street, and other holders of large swaths of corporate equity are prominent promoters of stakeholder capitalism. So are many other individual and institutional investors.

Would they be sounding the call if they did not think that there is value-creating potential in stakeholder capitalism? I don't think so. I believe that they are signaling to the executive teams that manage companies that social responsibility, integrated with the business strategy and practiced smartly, has the potential to create value. They are signaling that, if companies do not conduct business in a socially responsible way, there is clear potential for weakened prospects for value enhancement and even for value destruction. The managers' duties, then, are to figure out how to merge stakeholder and shareholder interests for the good of the enterprise.

That which is for the good of the enterprise can also be good for communities, for society, and that which is harmful to communities and society can also be harmful to the enterprise, to its people. In situations where a company operates in a way that harms communities, it is more than likely compromising individual freedom of the people that comprise those communities, including its own employees.

A clear example of this is a company that dumps waste into the oceans or whose production processes pollute the air. Who is harmed? The people who breathe that air or use the ocean for leisure or even commercial fishing stand to be harmed. That may well include some of the company's employees. Those employees and their neighbors have what I would deem to be a natural right to the clean water and air that has been encroached upon by the company. Their freedom to breathe clean air and share in unpolluted waters have been diminished by a company neglectful of its social responsibility.

Is the company harmed? There are two ways that are obvious. One is that the health of its own employees could be at risk. What does that imply for medical costs for the company, for the loss of productive time for employees, for the cost of regulatory scrutiny or fines? Is there a negative impact on profits and therefore on shareholders? Likely, yes.

The second obvious harm is to the company's reputation. Will customers and investors punish the company for its negligence in protecting the environment? If so, shareholders will suffer.

Another area of social responsibility receiving long-overdue attention is that of attracting a workforce, up through the executive ranks, that is selected from a broad universe of available talent with an even hand.

In other words, a diverse workforce is the issue. Other than a moral sense of fairness, what's the business imperative here? What is it that enables the company to be socially responsible on diversity while also increasing profits? McKinsey, Deloitte, and others have studied the fortunes of companies that have diverse executive teams and/or boards and compared them to companies that rank lower on the diversity scale.

A 2018 study by McKinsey found that top quartile companies for ethnic/cultural diversity on their executive teams were 33 percent more likely to have industry-leading profitability. Top quartile companies for gender diversity on their executive teams were 21 percent more likely to outperform on profitability. Diverse boards of directors were also correlated with better performance. McKinsey concluded that these are statistically significant correlations. They were careful not to claim causality. However, the level of correlation is much too significant to be ignored.

Enhanced innovation and a heightened ability to spot, and therefore, reduce risks were highlighted in Deloitte's review of companies with significant levels of diversity.

When shareholders invest, they expect the company's management to assemble the best talent and the best teams of people to produce products, services, and financial results that will help assure excellent returns on their investment. Common sense tells me that, to assemble such teams, companies must select from a broad pool of talent—not a pool where some are left out because of gender or ethnicity—whether intentionally or in an *unconscious* manner.

If management does not select from the broadest pool of talent, it may well be denying the company access to individuals who are likely to make contributions that will enhance shareholder value. Moreover, for groups of people excluded from the talent pool, their *freedom of access to opportunities* is denied. I know this kind of denial of individual freedom personally as I grew up in Birmingham, Alabama at a time when Blacks and women in corporate America were a rarity and graduated from Chicago Booth at a time when the corporate world and Wall Street were just beginning to open their doors to both. The McKinsey and Deloitte studies point to the wisdom of inclusive executive teams and to the profit and shareholder value enhancement that frequently ensues.

McKinsey and Deloitte were able to quantify the value of diverse executive teams. But, not every socially responsible action can be easily quantified. Take, for instance, a company that had to furlough or reduce work hours for certain employees during the financial crisis and Great Recession and, again, during the Covid-19 pandemic. At a company that I know well, for a significant number of employees, hours of work were below that which required continued payment by the company for health insurance. Nevertheless, the company continued to provide health insurance for those employees. The cost for this socially responsible benefit could be calculated. However, calculating the benefits to the company and to the shareholders is another story. One would have to figure out the long-term value of the retained loyalty of those employees, of their propensity to go the extra mile for the company and its customers because the company showed that it valued them as employees and as human beings in tough times.

Several companies are offering training for young people in underserved communities who might not have had access to the best education. That has a cost which will come out of current period profits. But, as with other investments, the payoff comes over the medium to longer term as those trainees become productive employees. In my view, most rational investors consider the medium and long term when assessing investments made by management. Profit increases for shareholders, to which Friedman gave

primacy, may well not be the case in the year in which the cost of training is incurred. But the payoff for shareholders may well be significant in the out-years. Since this is the way that most investments are evaluated, I somehow doubt that Friedman would object.

There are plenty of opportunities for companies to *do well by doing good*. Some companies are great at attending to stakeholders while making attractive returns for shareholders. Others have barely dipped their toes in the water. Being socially responsible can, and frequently does, make good business sense. Owners and investors will continue to push companies in this direction and capitalism will, therefore, reveal more of its heart and soul.

The Honorable Mary K. Bush is internationally recognized for her expertise in global financial markets, banking and corporate governance. She has served three Presidents as U.S. Director on the IMF Board, head of the Federal Home Loan Bank System and Board member of Sallie Mae. At the IMF, she led the creation of an IMF/World Bank multi-billion-dollar facility that propelled developing nations toward free markets for capital, trade, investment and entrepreneurship - - all of which resulted in greater economic growth and prosperity. As head of the Federal Loan Home Bank System, her leadership resulted in preserving the health of the 12 Federal Home Loan Banks even as they allocated resources to the Savings and Loan bailout and other Congressional mandates. As head of International Finance at Fannie Mae and at Bankers Trust, she led ground-breaking transactions with institutional investors and Fortune 500 companies internationally. She was Chairman of a bipartisan Congressional Commission on transforming U.S. foreign aid to give greater emphasis to investment and human resource development. She was also a member of the U.S. Treasury Committee on the Audit Profession. Ms. Bush was one of NACD's top 100 Directors in 2012, has served on more than a dozen corporate boards and has chaired or served on the following committees – Governance, Audit, Finance, Pension & Investment and Risk. Current boards include Bloom Energy, Discover Financial Services, ManTech International and T. Rowe Price Group. Former Boards include Marriot International, United Airlines, TEXACO. She is Chairman of Capital Partners for Education, a not-for-profit that mentors low-income youth through high school and college. Education: M.B.A. in Finance from the University of Chicago and B.A. in Economics, Phi Beta Kappa, Magna Cum Laude, from Fisk University.

What Stakeholder Capitalism Can Learn From Milton Friedman

By Alex Edmans

Instead of ridiculing the Friedman doctrine and proclaiming its death, advocates of stakeholder capitalism and responsible investing, like me, can learn a lot from it.

In 1958, Nobel Laureates Franco Modigliani and Merton Miller controversially claimed that, under certain assumptions, the value of a firm is independent of its capital structure.

Their article was a landmark at the time. Executives were fretting about how to fine-tune their capital structure, paying fat fees to bankers and consultants to advise them. Modigliani and Miller pointed out that they were wasting their time—CEOs should instead concentrate on the operational side of the business.

The key words, of course, are "under certain assumptions." These assumptions, such as no taxes or bankruptcy costs, clearly don't hold in the real world. Yet, even in 2020, the Modigliani-Miller theorem is a cornerstone of MBA finance classes around the world. The theorem is valuable not because capital structure is actually irrelevant, but because it highlights the only reasons why it can be relevant. A company should only base its capital structure on violations of the assumptions such as taxes and bankruptcy costs—and not other arguments such as "debt is cheap and equity is expensive." Modigliani and Miller's article was a landmark at the time; it remains a landmark today, and has been cited over 26,000 times.

In 1970, Nobel Laureate Milton Friedman controversially claimed that, under certain assumptions, a CEO should focus entirely on maximizing profit and not on serving society.

His article was a landmark at the time. But, unlike Modigliani-Miller, today it's an object of scorn and ridicule. It's been cited over 20,000 times, yet most of these citations are to highlight how broken shareholder capitalism is. 3,000 of those citations have come in the past year, as the stakeholder capitalism movement has gathered momentum. To declare that you reject the Friedman doctrine has become almost a requirement for acceptance into polite society.

But advocates of stakeholder capitalism, like me, can learn a lot from Milton Friedman by using his article in a similar way to Modigliani-Miller. Friedman highlighted the assumptions under which "the social responsibility of business is to increase its profits." If—and only if— those assumptions are violated, is there a case for moving away from shareholder value.

The first step to learning from it is to understand what Friedman actually said. While this may seem a truism, Friedman's article is widely misquoted and misunderstood. Indeed, thousands of people may have cited it without reading past the title. They think they don't need to, because the title already makes his stance clear: companies should maximize profits by price-gouging customers, underpaying workers, and polluting the environment.

By presenting Friedman as a narrow-minded caricature, critics of capitalism can then push their own theory of how it should operate, and it's not difficult to argue that theirs is superior when the alternative has been presented as a straw man.

But Friedman never advocated that companies exploit stakeholders. He argued that it is legitimate for a company to focus on increasing profits because the only way it can do so, at least in the long term, is if it treats stakeholders seriously. He wrote, "It may well be in the long-run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government. That may make it easier to attract desirable employees."

Thus, while last year's Business Roundtable statement was heralded as "the end of Friedmanism," it's fully consistent with it. Any company maximizing shareholder value needs to "commit to delivering value to our customers … investing in our employees … dealing fairly and ethically with our suppliers … [and] supporting the communities in which we work."

Indeed, critics of shareholder value attack it for being short-termist, but this makes no sense because shareholder value is an inherently long-term concept. Shareholder value is the present value of all future cash flows that a company generates. That's not just abstract theory—it holds in practice. Some of the world's most valuable companies are tech firms whose market valuations are orders of magnitude higher

than what their short-term profits imply.

But there are at least three important assumptions in the Friedman doctrine. These assumptions don't always hold in the real world, thus yielding a case for stakeholder capitalism. Yet just like Modigliani-Miller, Friedman is a useful starting point, because only if these assumptions are violated should we move away from explicit profit maximization.

One key assumption Friedman makes is that a company has no comparative advantage in socially responsible actions. $1 spent on a social initiative creates the same value as $1 spent by anyone else. This assumption holds for many initiatives, such as donating to charity: A company could instead pay higher dividends to investors or wages to employees, or charge lower prices to customers, and they could donate it to the charity of their choice. So Friedman did recognize that individuals have social responsibilities beyond profits. He argued that the social responsibility of business is to increase profits because doing so gives individuals—investors, employees, and customers—maximum flexibility to choose which social responsibilities they wish to fulfill. It's not the CEOs' prerogative to take this decision away from them and support their own pet social cause.

This has profound implications, because many companies—and even governments—believe that stakeholder capitalism involves corporate philanthropy. India requires large companies to spend 2 percent of their profits on CSR initiatives; many firms around the world make similar pledges voluntarily. But if you're a drinks company, your expertise is making drinks —not choosing which charitable causes are most worthy.

Friedman's doctrine states that companies should only invest in social causes if they can generate more value than anyone else, and there are many activities that satisfy this "principle of comparative advantage." Coca-Cola has developed expertise in logistics to distribute its drinks all over the world, including the onerous last mile to a rural village. So its Project Last Mile leverages this expertise to distribute medicines throughout several African countries. It delivers medicines, rather than books, as the former must be kept cool—and, as a drinks company, Coca-Cola has a particular comparative advantage in refrigerated transportation.

But others don't. Companies donating money to Black Lives Matter in the light of George Floyd's tragic death would have been wise to heed the Friedman doctrine. They should have instead invested their money in recruiting under-represented minorities at all levels, stamping out discrimination in their promotion and evaluation processes, and ensuring that their culture encourages a diversity of thinking—actions that only they can control, which means they have a comparative advantage in doing so.

A second key assumption in Friedman's article is that governments are well-functioning. Friedman states an important caveat to his claim: "there is one and only one social responsibility of business … to increase its profits *so long as it stays within the rules of the game.*" [emphasis added]

The government sets the rules of the game: it has "the responsibility to impose taxes and determine expenditures for such 'social' purposes as controlling pollution or training the hard-core unemployed." Some voters want high minimum wages and carbon taxes; others don't. Politicians set regulations at the level that best represents the aggregate preferences of the electorate—or else they can be voted out. In contrast, a CEO who pursues social causes "is in effect imposing taxes, on the one hand, and deciding how the tax proceeds shall be spent, on the other." She may pursue her own preferences, not sharehold-

ers' or society's.

However, regulation is imperfect, and this is another reason why businesses should have a social responsibility. Regulation is most effective at addressing measurable issues such as wages and carbon emissions. However, it's much harder to regulate qualitative issues such as providing employees with meaningful work and skill development. Thus, a company could go above and beyond in the working conditions it provides. But the Friedman principle remains useful because there are situations in which regulation is generally effective. If a firm wishes to pay above the minimum wage, even though market forces don't dictate this, it needs to have good arguments for why the government has set it wrongly.

The third key assumption is the most important, and is the reason why I am an advocate for stakeholder capitalism. This assumption is often overlooked as it's only implicit in Friedman's article.

When he argues that profit-focused companies will invest in stakeholders, Friedman is assuming that they can calculate the impact that such investments have on profit. Calculation works for some investments: When contemplating a new factory, a CEO can forecast how many widgets it will produce and how much it can sell them for. Subtracting the cost gives her the Net Present Value (NPV)—the investment's impact on shareholder value. While the real world is risky, NPV is able to handle risk. The CEO can do a "sensitivity analysis," where she plugs in different assumptions, and see how the conclusion changes.

But the implicit assumption in Friedman is that there's no uncertainty. A risky problem can be analyzed, if you have a rough idea of its parameters and can do a sensitivity analysis around them. With uncertainty, you have no idea what the parameters are.

Consider the deliberately simple decision of whether to provide colleagues with a free gym. The cost is easy to estimate but the benefits are not. Will the gym attract and retain workers, and what's their value to the firm? How many lost days due to sickness will the gym prevent, and how much would they have cost the company? How many interactions between colleagues in different departments will the gym foster? These questions are almost impossible to answer. There's not even a baseline around which to conduct a sensitivity analysis. So you can't calculate the NPV of the gym, and without it, you can't justify the gym under shareholder capitalism.

Arguing that "increasing profits" will lead a company to invest in stakeholders is only true if profits can be forecast with some degree of accuracy. For particularly uncertain investments, they can't. Thus, NPV would lead a company to forsake many investments in its employees, and also other stakeholders, ultimately destroying shareholder value. The mindset of maximizing profits may actually lead to companies failing to do so.

That's where stakeholder capitalism comes in. A company with explicit stakeholder objectives makes investments for intrinsic reasons—to deliver value to such stakeholders— rather than to instrumentally increase profits. This leads it to make many investments that are ultimately profitable, but could not be justified by a financial calculation. A company might build a gym simply because it cares about employee health. By doing so, it will recruit, retain, and motivate great workers, likely increasing profits as a by-product, even if this increase couldn't be quantified at the outset.

Importantly, this argument means that it may be in a company's own interest to adopt social objectives. Such objectives aren't simply worthy or fluffy, but good business sense—the guide to decision making in

a world of uncertainty. For example, one of my own studies finds that companies that treat their workers well outperformed their peers by 2.3-3.8 percent per year over a 28-year period, or 89-184 percent compounded. However, it's highly unlikely that CEOs could forecast that stock return uplift when deciding to invest in employee satisfaction.

Now, such social objectives can't be unfettered or a free-for-all. If a company moves away from NPV, it needs alternative criteria to decide whether to take an investment. In a recent book, I propose three. One is the "principle of multiplication," that $1 invested in a stakeholder must create more than $1 to that stakeholder. The second is the aforementioned "principle of comparative advantage," that $1 creates more value than someone else could by investing in that stakeholder. The third is the "principle of materiality," that the stakeholder(s) the activity benefits must be material to the enterprise.

My proposed criteria aren't necessarily the last word. But any advocate of stakeholder capitalism can't attack Friedman's rule—of appraising projects based on shareholder value—without proposing an alternative.

Overall, just as capital structure is not irrelevant for firm value, I believe that a company's explicit goal should not be to maximize profit. However, by highlighting the assumptions required for his claim to hold, Friedman shows us that a company should only depart from intentional profit maximization where these assumptions are violated: the company has a comparative advantage, there is regulatory failure, or instrumental decision making is difficult. This is true in some cases, but not others such as charitable donations.

Moreover, this framework is relevant not only for business leaders but also investors. Savers are piling into ESG funds, but many such funds are channeling this capital to companies that support social causes in a box-ticking manner, not questioning whether the Friedman assumptions hold. Rather than ridiculing the Friedman doctrine and proclaiming its death, advocates of responsible business and responsible investing can use it to guide us.

Alex Edmans is a Professor of Finance at London Business School and Academic Director of the Centre for Corporate Governance. He also serves as Managing Editor of the Review of Finance and Associate Editor of the Journal of Financial Economics, and is a Fellow of the Centre for Economic Policy Research and the European Corporate Governance Institute. Alex's research interests are in corporate finance, responsible business, and behavioral finance. He has spoken at the World Economic Forum in Davos, testified in the UK Parliament, and given the TED talk What to Trust in a Post-Truth World and the TEDx talk The Social Responsibility of Business with a combined 2 million views. Alex's book, Grow the Pie: How Great Companies Deliver Both Purpose and Profit, headed the Financial Times Business Books of the Month for March 2020 and was named to the FT's Summer Books of 2020.

Stakeholders

50 Years Later, It’s Time to Reassess

By Raghuram Rajan

The biggest problem with shareholder value maximization is that it completely turns a tin ear to politics. The alternative is to maximize the value of long-term financial and non-financial investors in the firm—shareholders, of course, but also long-term debt holders, long-term suppliers, workers whose sweat equity is embedded in the firm, etc. It is important for the corporate board to make clear who these investors are, whose interests it will elevate above other stakeholders.

Editor's note: The following is based on a talk Raghuram Rajan gave during the Stigler Center's 2020 Political Economy of Finance conference.

Every social problem we had before the pandemic has been exacerbated by it. We have rising inequality in many places. Many frontline workers are low-income, while better-paid people like us stay at home and work remotely.

There are many left-behind communities which have been hit hard. Many of the poorer countries in the world—Peru, India, Bangladesh—were hit by the pandemic. And we see the effects of climate change in the terrible pictures of red skies that we see from California.

We have paralyzed governments that can't really seem to get their act together. In this kind of environment, there's enormous pressure on corporations to do more than make a good widget, to move away from what Milton Friedman argued.

To some extent, the Business Roundtable in 2019 anticipated these pressures and came up with a statement that said, "Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country."

Who could disagree with the statement? There was an interesting piece in the *Financial Times*, where the daughter of Shell's CEO asked him, "You're such a good corporation. Why don't you sell out everything and give all your money to Greenpeace?"

According to the Business Roundtable statement, Shell's adherence to the statement would be assured if Shell sold out its assets and gave all the realized money to Greenpeace—after all, Greenpeace is a stakeholder. What prevents that? Is the statement anything more than completely vapid? Unless a statement recognizes there are trade-offs and tells corporate management how to make those trade-offs, it's vacuous. If everyone is essential or important, no one is.

The Business Roundtable statement is a nod to everyone and in that way, a nod to no one. There is a study by Wharton Professor Tyler Wry which seems to suggest this in fact the case. I haven't been able to find the paper, so take this with a pinch of salt, but the headline finding cited in *The Atlantic* is that those who signed the Business Roundtable statement, in the first few weeks of the pandemic, were almost 20 percent more prone to announce layoffs or furloughs. They were less likely to donate to relief efforts, less likely to offer customer discounts, less likely to shift production to pandemic-related goods. In summary, signing the statement had zero pro-stakeholder effect.

In some sense, when Milton Friedman wrote 50 years ago, it was as if he was addressing this latest statement by the Business Roundtable. He said: "The businessmen believe they are defending free enterprise when they declaim that business is not concerned 'merely' with profit but also with promoting desirable social' ends; that business has a 'social conscience' and takes seriously its responsibilities for providing

employment, eliminating discrimination, avoiding pollution and whatever else may be the catchwords of the contemporary crop of reformers." Then he says this is pure undiluted socialism, leading to his famous statement, "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"—that is, it obeys the law.

To put that statement in context, Friedman was reacting to the Johnson administration exhorting corporations to stop raising prices in an attempt to combat inflation. Johnson thought that this was a national duty of corporations, and Friedman was doubly—or triply—incensed by this. First, the Chicago School believes prices are important, and he felt that tampering with prices would create more distortions. Also, given his theory of how inflation emerged, he thought price restraint by corporations would do nothing to combat inflation, because inflation was driven by the macro policies of the Johnson administration, which he disagreed with. In effect, corporations were being pressed to remedy the deficiencies of the government.

That was what he was reacting to. He believed that decisions driven by politics rather than the market were socialism, hence his statement.

Now it's 50 years later, and it's time to reassess. I would argue that Friedman has a point. He makes sense, but to a first approximation. We have to elaborate further to get closer to what is appropriate.

I will go through the argument in favor of Friedman and then move to the cons immediately after.

First, on the economic front, economists would tell you that shareholders are residual claimants. They capture the present discounted value (as some of our alums know) of long-term profits. So if you think of everyone else who contributes to the firm as fixed claimants, maximizing long-term shareholder value maximizes the value of the corporation to society. Now, that clearly means that we don't run the firm into the ground for the benefit of shareholders. We do all the good things that people want us to do: we are nice to workers because workers are essential to the firm, make investments where appropriate, including long-term investments as in pharmaceutical research. It's not about making every decision in the short-term in favor of shareholders—that may run the firm into the ground. It's about the long term because the share price captures the long term.

As we go through the modern era, we have to question the statement a little. Shareholders are not always the residual claimants. Anybody who knows about the conflict between debt holders and shareholders knows that as a firm gets closer to distress, the residual claimants are really the debt holders, rather than shareholders. Continuing to make decisions in favor of shareholders at that time could actually reduce the value of the firm.

But more importantly, there are others who have made long term investments in the firm. In any human capital intensive firm, workers have made tremendous investments in the firm. And often, they become partners in the firm—sometimes they are explicit shareholders, sometimes they are implicit shareholders since their "sweat equity" is not formally recognized. Thinking about the firm in this way, about those who have made long-term investments, implies that it is not always appropriate to choose shareholders over these other claimants. Sometimes, both are residual claimants, and the board will have to choose one over the other, not always favoring the shareholder.

Another pro of Milton Friedman's statement is that relative to the vacuous statement by the Business Roundtable, it may be relatively easy to monitor management when it has a well-defined goal such as shareholder value maximization. If I'm told basically to be good to anybody, how do I prevent management from giving away the firm to Greenpeace? Not clear. With shareholder value maximization—much more clear. Again, one can dispute this supposed clarity, because courts have often refused to intervene in the decisions of management. Their view is that what constitutes shareholder value maximization is not absolutely clear, and therefore we defer to corporations and allow them to use their business judgment. This argument in favor of Milton Friedman can also be overstated.

A third argument that is often emphasized is that when management focuses on maximizing shareholder value, it creates value for shareholders, who can then decide what they want to spend on. In other words, it's not management that decides on corporate social responsibility, giving to charity, or giving to their favorite football team. Their job is to maximize the share value, and then the shareholders take that money and spend it—it's their wealth, they are the bosses of the managers, they should decide whether they want to give it to charity or to their favorite political parties. That is, again, a powerful argument.

Recently, Oliver Hart and Luigi Zingales have argued that even that is a little problematic. Consider Walmart's shareholders. Walmart sells guns—or used to sell guns—and that creates crime. If guns create crime, what Milton Friedman would say is: Let Walmart sell all the guns it can to generate profits, those profits will go to shareholders, and they can spend that money on fighting the NRA or compensating the victims of gun crimes. Hart and Zingales would say: Well, isn't it a shorter route, given that shareholders have this preference, to just stop selling guns and not first sell guns and then prevent the crime that results from that, which may be much costlier and much more expensive?

Similarly, there are situations where workers have preferences that conflict with shareholder value maximization. A most recent example is Google's employees, who basically went against Google's involvement in Pentagon-supported programs that used artificial intelligence and video imagery to target drone strikes. They said: This is bad, this is evil, we don't want to be part of it. And essentially, Google went in favor of its employees, believing that they were more important than shareholders.

Finally, Milton Friedman thought that there was a political argument for shareholder value maximization, which keeps the role of the government and the role of the corporation separate. He thought that was important because he felt that corporate social responsibility was a backdoor way for special interests to push what they could not get through Parliament and therefore make rules for the firm which they could not make through legislation. In some sense, this is a very important argument because it says that sometimes, these pressures can be anti-democratic rather than pro-democratic—that because you're frustrated in Congress or in Parliament, you might try to push that stuff through the backdoor by directly targeting corporations.

The reality is that not every political pressure comes through Parliament. It is naive, in some sense, and this is the con to this argument, to believe that the only way that corporations should be affected politically is by action through legislation. There will be pressure groups that will build up, especially if the corporation is consumer facing, in order to change the way the corporation behaves. There will be pressure groups even within the firm, as we just saw with Google's employees, that change what the firm does. So it is somewhat naive to believe these interest groups won't actually affect the firm. Corporations will have to take that into account.

And that leads to what I think is the deepest problem with Milton Friedman: shareholder value maximization means completely turning a tin ear to politics. It sounds sinister. It sounds pro-rich. It sounds evil, even if it may be the right thing to do for society under many circumstances.

So what's the alternative? I would argue that it's clear what the alternative is, and firms have been doing it for a long time. Not every firm, of course, but many. The alternative, in my view, is to maximize the value of long-term investors in the firm. This is different from the Business Roundtable statement, in that you can identify who these long-term stakeholders are. If you are a firm with a lot of impulse customers, they're not your long-term investors—they come in and buy as they wish. If, however, you have long-term employees, they are long-term investors because their sweat equity is embedded in the firm. Similarly, shareholders, long-term debt holders, long-term suppliers, these are long-term stakeholders. A firm could say, when forced to choose between two stakeholders: I will choose the action that enhances the overall value of these stakeholders. In the case of Google, it valued its employees more than it valued that contract with the Department of Defense.

This has actual bite. You can identify your key stakeholders and state that. What is important is that once you say that, those stakeholders feel their interests are going to be taken more into account, and therefore will act accordingly. What this does is in the long run is maximizing shareholder value. For example, if a firm says: I'm going to be more trusting toward my workers and work on their behalf, they respond by choosing that firm over others. That firm attracts more talent, they demand less pay because they trust the firm to not squeeze them in bad times, and they respond by going the extra mile for it.

The problem is that like shareholder value maximization, this idea of maximizing the value of long-term investors is very sterile. It needs a more politically-appropriate appellation, for example, maximizing societal value. But the details matter: Who does the corporation consider to be the important, relevant parts of society? That differs for each corporation, and that's really what the corporation should make explicit. Ultimately, a corporation sinks or swims on whether it makes a desirable widget, but in order to do this sustainably, it has to weigh the interests of a broader set of stakeholders than just the shareholders. Corporate boards should take pride in the investors they stand for. Being nice to everyone is, however, infeasible, meaningless, and simply deflection. That is what I take away from Milton Friedman.

Raghuram Rajan is the Katherine Dusak Miller Distinguished Service Professor of Finance at Chicago Booth. He was the 23rd Governor of the Reserve Bank of India between September 2013 and September 2016. Between 2003 and 2006, Dr. Rajan was the Chief Economist and Director of Research at the International Monetary Fund. He is the author of The Third Pillar (Penguin Random House 2019).

Beyond Friedman's Doctrine:

The True Purpose of the Business Corporation

By Martin Lipton

The pandemic and the renewed focus on inequality and injustice arising in the wake of the death of George Floyd have accelerated the conversation on what the purpose of corporations should be. The result has been a necessary process of reflection about the role that corporations play in creating and distributing economic prosperity and a need to articulate a new purpose for firms, one that better balances between value and values.

From a practical standpoint, the most significant part of the 1970 Milton Friedman essay in the *New York Times* was the headline: *The Social Responsibility of Business Is to Increase its Profits*. For a half-century, that phrase has been used to summarize the essay, and alongside Friedman's similar views in a 1962 treatise, also used in support of "shareholder primacy" as the bedrock of American capitalism. "Shareholder primacy" and "Friedman doctrine" became interchangeable.

The Friedman doctrine was a precursor to, and became a doctrinal foundation for an era of short-termism, hostile takeovers, extortion by corporate raiders, junk bond financing and the erosion of protections for employees, the environment and society generally, all in support of increasing corporate profits

and maximizing value for shareholders.

This concept of capitalism took hold in business schools and boardrooms, became ascendant in the eighties and continued as Wall Street gospel until 2008, when the perils of short-termism were vividly illuminated by the financial crisis, and the long-term economic and societal harms of shareholder primacy became increasingly urgent and impossible to ignore.

Since then, acceptance of and reliance on the Friedman doctrine has been widely eroded, as a growing consensus of business leaders, economists, investors, lawyers, policymakers, and important parts of the academic community have embraced stakeholder capitalism as the key to sustainable, broad-based, long-term American prosperity. This is illustrated by the World Economic Forum's request that I prepare a new paradigm for corporate governance, which it published in 2016, its issuance of the 2020 Davos Manifesto embracing stakeholder and ESG (environment, social, and governance) principles, and the 2019 abandonment of shareholder primacy and adoption of stakeholder governance by the Business Roundtable. So, too, has corporate purpose and stakeholder and ESG governance been embraced by index fund managers BlackRock, State Street, Vanguard, and other major investors.

It should be noted that some well-known business people, economists, and lawyers reject stakeholder governance and adhere to the Friedman doctrine. Also, in commemoration of the 50th anniversary of the essay, four prominent senior fellows of the Hoover Institute—George P. Shultz, Michael J. Boskin, John F. Cogan, and John B. Taylor—published an article in the *Hoover Digest*, the title of which aptly summarizes their opinion: *Cheated by Collectivism: Businesses do good by benefitting their shareholders, not pursuing a phantom of "social responsibility."*

In an article titled *The Illusory Promise of Stakeholder Governance*, Lucian Bebchuk and Roberto Tallarita of the Harvard Law School called the Business Roundtable embrace of stakeholder governance naïve and marshaled a litany of empirical, historical, and human greed arguments in derogation of stakeholder governance. As might be expected, compelling arguments rejecting the Bebchuk arguments soon appeared. Alison Taylor and Dina Medland, in an article titled *The Illusion of Reasoning,* sum up the arguments for stakeholder governance and against preserving Milton Friedman's fifty-year-old doctrine:

> *"In fact, simplistic prioritisation of shareholder interests ceased to be an option some time ago. Shareholders today are not a monolithic interest bloc, and business leaders have some choices about which owners they seek to attract. Many shareholders today argue enthusiastically for longer time horizons and more substantive measurement of environmental, social and governance issues.*
>
> *More broadly, the value of intangible assets such as reputation, innovation and network effects now constitute 61 percent of the value of the S&P500. Return on investment takes longer, and is harder to measure. Any attempt to navigate successfully through this new environment is inherently "contestable," too. It is the idea that a focus on shareholder value negates any need to consider complex trade-offs that is naïve and unrealistic, not the BRT statement."*

In addition to these reasons for rejecting the Friedman doctrine, the fundamental structure of the corporate world has changed dramatically since the 1960s. Today, the three index fund managers control on average in the aggregate about 20 percent of the shares of the listed corporations. Together with ten other asset managers, they have voting control of most corporations. Also, Friedman assumed that sharehold-

ers wanted primacy and had no concern for the other stakeholders. Clearly, that is not the situation today. Stakeholder and ESG governance and sustainable long-term investment are embraced today by the holders of a clear majority of the shares of most corporations.

Recent events—notably the pandemic, its disparate impact on various segments of society, and the focus on inequality and injustice arising in the wake of the death of George Floyd—have accelerated the conversation on corporate purpose and the debate about stakeholder governance. The result has been substantial, salutary reflection about the role that corporations play in creating and distributing economic prosperity and the nexus between value and values.

For my part, I have supported stakeholder governance for over 40 years—first, to empower boards of directors to reject opportunistic takeover bids by corporate raiders, and later to combat short-termism and ensure that directors maintain the flexibility to invest for sustainable long-term growth and innovation. I continue to advise corporations and their boards that—consistent with Delaware law—they may exercise their business judgment to manage for the benefit of the corporation and all of its stakeholders over the long term. That it is the corporation, qua corporation, that commands the fiduciary duty of its board of directors.

In looking beyond the disruption caused by the pandemic, boards and corporate leaders have an opportunity to rebuild with the clarity and conviction that come from articulating a corporate purpose. This purpose should be anchored in a holistic understanding of the key drivers of their business, the ways in which those drivers shape and are shaped by values, and the interdependencies of multiple stakeholders who are essential to the long-term success of the business.

This opportunity leads me to reiterate and refine a simple formulation of corporate purpose and objective, as follows:

> *The purpose of a corporation is to conduct a lawful, ethical, profitable and sustainable business in order to ensure its success and grow its value over the long term. This requires consideration of all the stakeholders that are critical to its success (shareholders, employees, customers, suppliers and communities), as determined by the corporation and its board of directors using their business judgment and with regular engagement with shareholders, who are essential partners in supporting the corporation's pursuit of its purpose. Fulfilling this purpose in such manner is fully consistent with the fiduciary duties of the board of directors and the stewardship obligations of shareholders.*

This statement of corporate purpose is broad enough to apply to every business entity, but at the same time supplies clear guideposts for action and engagement. The basic objective of sustainable profitability recognizes that the purpose of for-profit corporations includes creation of value for investors. The requirement of lawful and ethical conduct ensures generally recognized standards of corporate social compliance.

Going further, the broader mandate to take into account all corporate stakeholders, including communities, is not limited to local communities, but comprises society and the economy at large and directs boards to exercise their business judgment within the scope of this broader responsibility. The requirement of regular shareholder engagement acknowledges accountability to investors, but also the shared responsibility of shareholders for responsible long-term corporate stewardship. Essentially, this is The

New Paradigm for corporate governance issued in 2016 by the World Economic Forum.

Fulfilling this concept of purpose will require different approaches for each corporation depending on its industry, history, regulatory environment, governance, and other factors. I expect that board committees—focusing on stakeholders, ESG issues, and the stewardship obligations of shareholders—will be useful or even necessary for some companies. But for all the differences among companies, there is an important unifying commonality: corporate action, taken against the backdrop of this formulation of corporate purpose, will be fully protected by the business judgment rule, so long as decisions are made by non-conflicted directors acting upon careful consideration and deliberation.

Executed in this way, stakeholder governance will be a better driver of long-term value creation and broad-based prosperity than the shareholder primacy model. Directors and managers have the responsibility of exercising their business judgment in acting for the corporate entity that they represent, balancing its rights and obligations and taking into account both risks and opportunities over the long term, in regular consultation with shareholders. Directors will not be forced to narrow their focus and act as if any one interest trumps all others, with potentially destructive consequences, but will instead have latitude to make decisions that reasonably balance the interests of all constituencies in a manner that will promote the sustainable, long-term business success of the corporation as a whole.

Most important of all, The New Paradigm will obviate the need for legislation regulating corporations and institutional investors and asset managers that would quickly lead to state corporatism. For a fuller discussion of avoiding legislation and saving American capitalism, see my 2019 essay, *It's Time to Adopt the New Paradigm*.

Martin Lipton, a founding partner of Wachtell, Lipton, Rosen & Katz, specializes in advising major corporations on mergers and acquisitions and matters affecting corporate policy and strategy. Lipton is a Trustee of New York University (Chairman 1998-2015), a Trustee of the New York University School of Law (Chairman 1988-1998), a Trustee of the NYU Langone Medical Center, an emeritus member of the Council of the American Law Institute, a member of the Board of Advisors of the Institute of Judicial Administration and an Honorary Chair of The American College of Governance Counsel. Lipton is a member of the Executive Committee of the Partnership for New York City and served as its Co-Chair (2004-2006). Lipton has a B.S. in Economics from the Wharton School of the University of Pennsylvania and an LL.B. from the New York University School of Law. He is an Adjunct Professor of Law, New York University School of Law, a member of the American Academy of Arts & Sciences, and a Chevalier de la Légion d'Honneur. Mr. Lipton is an Emeritus Chairman of Prep for Prep, having served as Chairman from 1990 to 2002.

The Illusory Promise of "Stakeholderism": Why Embracing Stakeholder Governance Would Fail Stakeholders

By Lucian Bebchuk, Roberto Tallarita

Stakeholderism—granting corporate leaders discretion to give weight to the interest of all stakeholders—should not be expected to deliver its purported benefits to stakeholders. Furthermore, it could well impose substantial costs on shareholders, stakeholders themselves, and society at large, and therefore should be rejected, even by those who are deeply concerned about stakeholders.

In *The Illusory Promise of Stakeholder Governance*, we critically examine "stakeholderism," the increasingly influential view that corporate leaders should give weight to the interests of non-shareholder constituencies (stakeholders).

Acceptance of stakeholderism, we demonstrate, would not benefit stakeholders as supporters of this view claim. Corporate leaders have incentives, and should therefore be expected, not to use their discretion to benefit stakeholders beyond what would serve shareholder value. Furthermore, over the past two decades, corporate leaders have in fact failed to use this kind of discretion to protect stakeholders. Our analysis concludes that acceptance of stakeholderism should not be expected to make stakeholders better off.

Embracing stakeholderism, we find, could well impose substantial costs on shareholders, stakeholders, and society at large. Stakeholderism would increase the insulation of corporate leaders from shareholders, reduce their accountability, and hurt economic performance. In addition, by raising illusory hopes that corporate leaders would on their own provide substantial protection to stakeholders, stakeholderism would impede or delay reforms that could bring meaningful protection to stakeholders. Stakeholderism would therefore be contrary to the interests of the stakeholders it purports to serve and should be opposed by those who take stakeholder interests seriously.

Some stakeholderists have already attempted to respond to our findings and conclusions. Oxford Professor Colin Mayer issued a response paper, the prominent law firm Wachtell, Lipton, Rosen & Katz published a critical memorandum, and Business Roundtable President Joshua Bolten took issue with our assessment of the Roundtable's statement on corporate purpose in a *Financial Times* interview. We plan to incorporate replies to these and other responses in our study, and we look forward to getting additional reactions from participants in the Stigler Center conference.

Stakeholderism, which provided the basis for antitakeover legislation adopted in the 1980s and 1990s by a majority of US states, has gained substantial support in recent years among academics, practitioners, business leaders, and policymakers. The long-standing debate on corporate purpose is now at a critical juncture, and the growing embrace of stakeholderism might well in the coming years have considerable influence on companies, their stakeholders, and society.

Before discussing the problems with implementing stakeholderism, it's important to distinguish between two different versions of stakeholderism and discusses their conceptual problems. According to the "enlightened shareholder value" version, corporate leaders—a term we use throughout to refer to the directors and top executives who make important corporate decisions—should take into account stakeholder interests as a means to maximize shareholder value. Such an instrumental version of stakeholderism, we show, is not conceptually different from shareholder primacy; it is merely a semantic change, and we show that there are no good reasons for adopting it.

According to the second version, by contrast, corporate leaders can and should regard stakeholder interests as ends in themselves. This view, which we call "pluralistic," posits that the welfare of each stakeholder group has independent value, and consideration for stakeholders might entail providing them with some benefits at the expense of shareholders. This version is the one that in theory—though, as we shall show, not in practice—could lead to decisions that would benefit stakeholders beyond what would be useful for shareholder value maximization.

Pluralistic stakeholderism and its implementation raise several conceptual problems and difficulties. In particular, advocates of stakeholderism have commonly avoided the difficult issue of determining which groups should be considered stakeholders, leaving this decision to the discretion of corporate leaders, and tended to overlook the ubiquity of situations that present trade-offs between the interests of some stakeholders and long-term shareholder value.

They also haven't provided a method to aggregate or balance the interests of different constituencies in the face of such trade-offs, leaving this matter, again, to the discretion of corporate leaders. Thus, the effects of pluralistic stakeholderism would critically depend on how corporate leaders choose to exercise discretion.

Before examining the effects of stakeholderism in general, it's worthwhile to consider the expected effects of the widely celebrated Business Roundtable statement. Based on a close reading of the statement and of the accompanying materials, as well as on evidence that we collected, our study shows that the statement is largely a rhetorical public-relations move rather than the harbinger of meaningful change.

In particular, we discuss

(1) the statement's ambiguity regarding the critical question of whether it advocates providing stakeholders with any benefits beyond what would be useful for shareholder value,

(2) the statement's disregard of the ubiquity of trade-offs between stakeholder and shareholder interests,

(3) the decision by many CEOs to join the statement without the approval by the board of directors that is generally obtained for major corporate decisions,

(4) the failure to reflect the commitment to stakeholders in corporate governance guidelines, and

(5) the lack of attention to legal constraints that preclude many companies from approaching stakeholder interests as an independent end.

Our analysis of each of these dimensions indicates that the Business Roundtable statement should not be expected, and was largely not intended by its signatories, to bring about major changes in the treatment of stakeholders.

Putting aside the effects of the Business Roundtable statement, we examine the potential effects of stakeholderism in general and present an economic and empirical analysis of how corporate leaders should be expected to use discretion to protect stakeholder interests. We show and empirically document that corporate leaders (both directors and CEOs) have strong incentives to enhance shareholder value but little incentive to treat stakeholder interests as an independent end.

Therefore, we argue, corporate leaders have significant incentives not to benefit stakeholders at the expense of shareholder value, and they should therefore not be expected to use the discretion awarded to them to do so.

In reaching this conclusion, we relied on the findings of a companion empirical study that we have conducted together with Kobi Kastiel, *For Whom Corporate Leaders Bargain*. The study examines whether, in fact, corporate leaders have in the past used discretion accorded to them to protect stakeholders.

During the hostile takeover era, stakeholderist arguments contributed to the adoption in many states of constituency statutes, which authorize corporate leaders to give weight to stakeholder interests when considering a sale of their company. Our empirical work analyzes in detail over 100 private equity acquisitions of companies governed by constituency statutes that corporate leaders negotiated over the past two decades.

Our empirical investigation finds that corporate leaders governed by constituency statutes used their

bargaining power to obtain gains for shareholders, as well as for executives and directors. However, corporate leaders made very little use of their power to negotiate for stakeholder protections.

Furthermore, in cases in which some protections were included, they were practically inconsequential or cosmetic. This evidence is consistent with and reinforces our conclusion that corporate leaders who have discretion to do so should not be expected to benefit stakeholders beyond what would serve shareholders.

The business corporation has proven itself to be a powerful and adaptive mechanism for producing economic growth and prosperity. As a result, some of those who wish to protect stakeholders might be attracted to stakeholderism as a way to do so by harnessing corporate power through private action and without resort to costly regulation.

However, the past success of corporations has been based on the presence of effective incentives for corporate decision makers. Therefore, with corporate leaders having incentives not to benefit stakeholders at shareholders' expense, delegating the guardianship of stakeholder interests to corporate leaders would prove futile. The promise of pluralistic stakeholderism, we conclude, is illusory.

Finally, whereas stakeholderists have advocated relying on corporate leaders to protect stakeholders without a major overhaul of existing systems of incentives, including those resulting from shareholders' exclusive voting power, we also consider the possibility of supplementing stakeholderism with reforms aimed at substantially changing the incentives of corporate leaders.

We examine changes both to executive pay arrangements and to the rules governing the election of directors. Designing reforms that would provide leaders with adequate incentives to attach independent weight to the interests of all stakeholders, we show, would be quite challenging as well as very costly.

It might be argued that stakeholderism, even if it does not provide significant benefits to stakeholders, could not hurt and might even help on the margin. As our findings show, however, accepting stakeholderism would be detrimental to shareholders, stakeholders, and society.

The acceptance of stakeholderism would insulate corporate leaders from shareholder pressures and make them less accountable. Indeed, we argue, the support of corporate leaders and their advisors for stakeholderism is motivated, at least in part, by a desire to obtain insulation from hedge fund activists and institutional investors. In other words, they seek to advance managerialism by putting it in stakeholderism clothing.

The increased insulation from shareholders, and the reduced accountability to them, would serve the private interests of corporate leaders. It would also increase managerial slack and agency costs and undermine economic performance. This would have detrimental effects for shareholders and the economy at large.

The acceptance of stakeholderism, by raising illusory hopes around the positive effects for stakeholders, would likely weaken pressures for stakeholder-oriented policy reforms and thereby impede or delay meaningful protection for stakeholders. Thus, for those interested in addressing corporate externalities and protecting corporate stakeholders, embracing stakeholderism would be counterproductive.

Lucian Bebchuk serves as the James Barr Ames Professor of Law, Economics, and Finance, and the Founding Director of the Program on Corporate Governance at Harvard Law School. Bebchuk is also a Fellow of the American Academy of Arts and Sciences, Research Associate of the National Bureau of Economic Research, Inaugural Fellow of the European Corporate Governance Network, and Director of the SSRN Corporate Governance Network. Trained in both law and economics, Professor Bebchuk holds an LL.M. and S.J.D. from Harvard Law School and an M.A. and a Ph.D. in Economics from the Harvard Economics Department. His research focuses on corporate governance, law and finance, and law and economics. Upon electing him to membership in 2000, the American Academy of Arts and Sciences cited him as "[o]ne of the nation's leading scholars of law and economics," who "has made major contribution to the study of corporate control, governance, and insolvency."

Roberto Tallarita is an Associate Director and Research Fellow of the Program on Corporate Governance. He is also an S.J.D. candidate and a Terrence M. Considine Fellow in Law and Economics at Harvard Law School.

For Whom Corporate Leaders Bargained: What the Past Can Teach Us About the Questionable Promise of Implementing Stakeholder Capitalism Today

By Lucian Bebchuk, Kobi Kastiel, Roberto Tallarita

The debate about stakeholder capitalism should seek to learn from our experience with constituency statutes, which authorized corporate leaders to take into account stakeholder interests in considering a sale of the company. We document how, over the past two decades, these statutes utterly failed to produce the hoped-for stakeholder benefits: Corporate leaders used their bargaining power to secure benefits for shareholders, executives, and directors, but made little use of it to obtain protections for stakeholders.

A critical question within the heated debate about stakeholder capitalism and stakeholderism is whether, if corporate leaders are granted discretion to give weight to the interest of non-shareholder con-

stituencies (stakeholders), they can be expected to actually do so.

In our new study *For Whom Corporate Leaders Bargain*, we put forward novel empirical evidence that can contribute to resolving this key question. We discussed these findings in the presentation of a companion study by two of us, *The Illusory Promise of Stakeholder Governance*.

Although stakeholderism has enjoyed unprecedented levels of support in recent years, in the 1980s and the 1990s many states already adopted "constituency statutes"—which are still in place today—that embrace an approach similar to that advocated by modern stakeholderists. Proposed as a remedy to eliminate or reduce the adverse effects of acquisitions on employees and other stakeholders, these statutes accord corporate leaders the power to give weight to the interests of stakeholders when considering a sale of their companies.

The current debate should be informed, we argue, by the lessons that can be learned from the results produced by this large-scale experiment in stakeholderism.

We therefore set out to investigate empirically whether constituency statutes actually delivered protections for stakeholders as was hoped for. Although constituency statutes have long been a common topic in corporate law textbooks, as well as the focus of many law review articles, thus far there has been no direct study of the terms of acquisition agreements negotiated in the shadow of such statutes. Using hand-collected data on a large sample of such agreements from the past two decades, we put forward novel empirical evidence on the subject.

We document that corporate leaders selling their companies to private equity buyers obtained substantial benefits for their shareholders as well as for themselves. By contrast, corporate leaders made little use of their power to give weight to the interests of stakeholders. Our review of the contractual terms of these deals finds very little protection provided to stakeholders from the risks posed by private equity control.

We conclude that constituency statutes have failed to deliver their promised benefits. These conclusions have implications not only for the long-standing debate on constituency statutes but also for the general debate on stakeholder capitalism. Our findings cast substantial doubt on the wisdom of relying on the discretion of corporate leaders, as stakeholderism advocates, to address concerns about the adverse effects of corporations on their stakeholders.

The debate on stakeholderism to which we seek to contribute seems to have reached a critical juncture. In this ongoing debate, stakeholderists and their opponents strongly disagree on how corporate leaders are likely to use discretion to give independent weight to stakeholder interests. We believe that, to help resolve this disagreement, it is worth examining the performance of constituency statutes in protecting stakeholders.

Our empirical analysis focuses on private equity acquisitions of public companies. Because these transactions move assets to the hands of managers with powerful incentives to maximize financial returns, such transactions often pose significant risks to stakeholders that corporate leaders who care about stakeholders may seek to address.

We analyze each of the private equity acquisitions of public companies of significant size that were in-

corporated in a state with a constituency statute during the 20-year period of 2000 through 2019. For each of these transactions, we hand-collected and analyzed detailed information about the process leading to the transaction and the full set of terms negotiated by the parties.

We find that the acquisitions were commonly the product of a long negotiation process that produced substantial benefits for both shareholders and corporate leaders. Shareholders enjoyed sizable premiums over the pre-deal stock price. In addition to the gains made on their own equity holdings, corporate leaders also frequently secured additional payments in connection with the transactions, and often obtained commitments for continued employment after the acquisition.

At the same time, however, corporate leaders made little use of their bargaining power to negotiate for any constraints on the power of the private equity buyer to make choices that would adversely impact stakeholders. Although concerns about layoffs and downsizing induced labor unions to support constituency statutes, we document that in 95 percent of cases corporate leaders did not negotiate for any restrictions to the freedom of the private equity buyers to fire employees, and that even in the handful of cases in which such restrictions were found, the deal terms denied employees any power to enforce these constraints.

Furthermore, we find that corporate leaders generally did not negotiate any constraints on buyers' post-deal choices that could pose risks to several other notable stakeholder groups—consumers, suppliers, creditors, or the environment. In a very small minority of cases, we found buyer pledges to retain the location of company headquarters or to continue some local investments or philanthropy, but our analysis of the legal terms indicates that these rare pledges were rather "soft": unlike commitments to shareholders or corporate leaders, these pledges were vague and under-specified and, importantly, denied potential beneficiaries any enforcement rights.

To be sure, many stakeholders, such as employees, customers, suppliers, and creditors, typically have contractual arrangements with the company. These contractual arrangements might provide them with some protection in the event of an acquisition even if the corporate leaders negotiating the deal with the private equity buyer do not bargain for stakeholder protections during the negotiations over the acquisition. Thus, for example, employment agreements might entitle some employees to certain benefits if they are fired, and supply agreements might entitle some suppliers to specified benefits in the event the company terminates the supply relationship.

However, the premise of constituency statutes was (as the premise of modern stakeholderism currently is) that the contractual arrangements of some stakeholders, such as employees, customers, and suppliers, do not protect them sufficiently from being adversely affected by acquisitions. Constituency statutes therefore sought to enable corporate leaders to seek stakeholder protections that could address the remaining concerns. For this reason, our analysis focuses on whether corporate leaders negotiating in the shadow of constituency statutes used their power to obtain such stakeholder protections, and it concludes that they did not.

The evidence we have put together enables reaching a clear conclusion on the performance of constituency statutes: they failed to deliver the promised and hoped-for benefits for stakeholders.

Because constituency statutes had stakeholderist justifications and goals, everyone involved in the ongoing stakeholderism debate should seek to learn from the experience with these statutes. In particular,

stakeholderists must wrestle with the failure of these statutes, identify the factors that caused this failure, and examine whether these factors would also undermine their current proposals.

As for why constituency statutes failed to deliver stakeholder protections, we extend our empirical evidence in order to evaluate possible explanations. Our analysis indicates four explanations that might be suggested for the failure of constituency statutes that are unlikely to drive our findings: uncertainty about what the statutes authorized; the shadow of the Delaware Revlon doctrine; the need to obtain shareholder approval for the acquisition; and the influence of shareholder-centric norms on corporate leaders.

Our analysis leads us to conclude that the most plausible explanation can be found in the incentives of corporate leaders. Although the interests of corporate leaders do not perfectly align with the interest of shareholders, they are substantially linked to them. Because of the pay arrangements of executives and directors, and the dynamics of the labor and control markets, corporate leaders often benefit when they enhance shareholder value.

By contrast, there is no significant link between the interests of corporate leaders selling their companies and the post-sale interests of stakeholders. In fact, to the extent that stakeholder protections would constrain the buyer and thus be costly to it, the inclusion of such protections in the deal could result in somewhat lower gains for the shareholders and/or the corporate leaders. Thus, corporate leaders had no incentives to use their bargaining power—and indeed had incentives not to use their bargaining power—for the purpose of negotiating protections for stakeholders.

The conclusions of our analysis indicate that considering the incentives of corporate leaders is crucial for assessing the promise of stakeholderism. As the supporters of constituency statutes, supporters of stakeholderism have commonly assumed that corporate leaders would substantially use discretion to protect stakeholders for this purpose. Our evidence indicates that, in the case of constituency statutes, this assumption was unwarranted. Stakeholderists, and all those concerned about stakeholders, should be wary of relying on such an assumption in assessing the promise of stakeholderism. As George Santayana warned in *The Life of Reason* a century ago, "Those who cannot remember the past are condemned to repeat it."

Lucian Bebchuk serves as the James Barr Ames Professor of Law, Economics, and Finance, and the Founding Director of the Program on Corporate Governance at Harvard Law School. Bebchuk is also a Fellow of the American Academy of Arts and Sciences, Research Associate of the National Bureau of Economic Research, Inaugural Fellow of the European Corporate Governance Network, and Director of the SSRN Corporate Governance Network. Trained in both law and economics, Professor Bebchuk holds an LL.M. and S.J.D. from Harvard Law School and an M.A. and a Ph.D. in Economics from the Harvard Economics Department. His research focuses on corporate governance, law and finance, and law and economics. Upon electing him to membership in 2000, the American Academy of Arts and Sciences cited him as "[o]ne of the nation's leading scholars of law and economics," who "has made major contribution to the study of corporate control, governance, and insolvency."

Kobi Kastiel is an Assistant Professor at Tel Aviv University, Faculty of Law. He also serves as a Senior Fellow at the Harvard Law School Program on Corporate Governance. Kastiel teaches and researches in the fields of corporate law and corporate governance, with a particular focus on public companies with controlling shareholders, and shareholder activism.

Roberto Tallarita is an Associate Director and Research Fellow of the Program on Corporate Governance. He is also an S.J.D. candidate and a Terrence M. Considine Fellow in Law and Economics at Harvard Law School.

Diversifying Corporate Boards — The Best Way Toward a Balanced Shareholder/ Stakeholder System of Corporate Governance

By John C. Coffee, Jr.

Boards can recognize that their shareholders have needs beyond financial wealth maximization. Making corporate boards representative and diverse works better than co-determination or implied fiduciary duties to everyone.

Milton Friedman never wrote more influential words than his short op-ed on the social responsibility of corporations in the *New York Times Magazine* in 1970. But what he said and how he is read by some differ significantly.

Friedman emphasized that the corporation had to play by the rules of the game. Thus, he would not allow—as some of his disciples have argued—a corporation to knowingly violate the law if it saw benefits from the crime that exceeded the maximum penalties authorized by law. What is wrong with recognizing that crime can pay? Here, the key assertion is that corporations receive limited liability from the state in return for accepting some obligations (including law compliance).

Does this mean that the state can impose duties on corporations toward stakeholders? Yes, beyond doubt, if the state acts lawfully and with requisite clarity. But beyond state-imposed duties, can a corporate board recognize duties that will restrict shareholder wealth maximization? Here, we enter a gray zone, but I would say that boards can recognize that their shareholders have needs beyond financial wealth maximization. If the board maximized profits, but polluted the earth or aggressively advanced irreparable climate change, they have not served their shareholders well. Almost certainly, even their shareholders would want such externalities curbed.

Does this mean that boards owe a fiduciary duty to stakeholders? This is a legal contradiction in terms: by definition, a fiduciary owes a duty of undivided loyalty to his beneficiaries, and one cannot owe such a duty to natural adversaries. What, then, is the answer? Some European countries believe in co-determination, under which employees and possibly other groups elect directors along with shareholders. But this has proven rigid. The better answer may be broadly representative and diverse boards that are sensitive to the corporation's impact on others and the political repercussions that will be risked.

The traditional justification for shareholder wealth maximization as the goal of corporate law is that shareholders, as the residual risk bearers, make more efficient decisions. Perhaps, but this is circular if the efficient decision is the one that maximizes shareholder wealth. Assume a case where the decision would make $1 million for shareholders, but impose costs of $100 million on laid off employees. Socially, this is a disaster, but this is a decision that a broadly representative board would not make. Making the board representative and diverse works better than co-determination or implied fiduciary duties to everyone.

John C. Coffee Jr. is the Adolf A. Berle Professor of Law and director of the Center on Corporate Governance at Columbia Law School. He is a fellow at the American Academy of Arts and Sciences and has been repeatedly listed by the National Law Journal as one of its "100 Most Influential Lawyers in America." For his work in white collar crime, Coffee was awarded the Donald Cressey Award for Lifetime Achievement by the Association of Certified Fraud Examiners in 2011. For his work in corporate governance, in 2018, Coffee received the Allen & Overy Law Prize for "The Agency Cost of Activism: Information Leakage, Thwarted Majorities, and the Public Morality," a paper exploring how the interests of activist investors can conflict with those of other shareholders.

Corporations Are Governance Mechanisms, Not Shareholder Toys

By Margaret Blair

Milton Friedman's shareholder credo is simple and catchy but has shaky foundations. Corporate directors and officers are not agents of shareholders and have no legal obligation to focus solely on enhancing share value. Business corporations are legal devices invented centuries ago by states to govern group ventures, to hold property used in the venture, and delegate decision making about the venture to boards of directors. They were intended to provide benefits to communities and customers, as well as to investors and managers.

Investors, corporate board members, and corporate managers are suddenly hearing from all sides that corporations should have a social "purpose" that addresses societal needs and takes into account the impact of their activities on communities, the environment, their workers, and the distribution of wealth and income, both within the US and globally.

According to this line of thinking, corporations should be providing solutions to the world's problems—from containing pandemics to ending racism to reversing global warming. These new expectations come after decades of shareholders and leaders of corporations being told that they should focus their attention

solely on “maximizing share value,” as instructed by University of Chicago economist Milton Friedman in 1970.

Friedman’s pronouncement about maximizing shareholder value has always had shaky foundations. But it carried the day in many policy arenas because it is simple, catchy, and has served the interests of the wealthy and powerful.

There are at least five different types of arguments made by defenders of shareholder value maximization: 1) those supposedly based on property law; 2) those based on a claim about who is bearing what risks; 3) those supposedly based on corporate law; 4) those based on the structure of incentives in corporations; and finally, 5) those based on the difficulty of holding corporate executives accountable for any goal other than maximizing share value.

Each of these arguments has gaping holes in it. Even collectively, they do not add up to a compelling case for a preference for share value maximization to the exclusion of other corporate goals.

The property law argument asserts that shareholders in corporations are the “owners” of those corporations. This is the basis of Milton Friedman’s claims about corporations. “A corporate executive is an employee of the owners of the business,” he wrote. If this were true, it might follow that corporate officers and directors are “agents” of shareholders and should do what shareholders want them to do, as hundreds of law professors and business school professors have claimed in recent decades. But the claim is false on both counts: Shareholders are not “owners” of corporations in any normal sense of that word, and directors of corporations are not the “agents” of shareholders. Although equity shares in a corporation are a species of property, like any other security issued by a corporation, the corporation itself is not a piece of property.

The corporation is a legal construct, created by an act of a state, which construes a group of individuals acting collectively as a single entity, for the purposes of holding property and entering into contracts.

The entity created by a corporate charter is legally distinct from the shareholders, the managers, the directors, and of any other participants in the activities of the corporation. It has an indefinite life (by default, though the parties who seek the charter, or the state that grants it, can impose limits), and its assets and obligations remain those of the corporation even as the individuals involved change. This has enormous advantages for the participants in any corporation because it makes it possible for the corporation to make long-term commitments to enterprises that require substantial resources that are highly specific to an enterprise (e.g., railroad tracks, or factories) over an extended period of time.

Thus, the corporation can hold property, like an individual, but the corporation is not, itself, a piece of property. Moreover, under the law, executives and officers of corporations are agents of the corporation, but are not agents of shareholders. Corporate directors are fiduciaries for the corporation, but, again, not agents of shareholders.

The risk-bearing argument starts by conceding that shareholders are not, technically, owners of corporations, but, nonetheless, they are said to be the bearers of the residual risk associated with corporate activities. Other participants, or “stakeholders,” are all supposedly compensated by complete contracts, but the shareholders are compensated by a residual contract that says they get what is left over after all the others have been compensated. Because shareholders are the residual risk bearers, the argument goes,

social value is maximized when the value of that residual claim is maximized.

This is clever, but still doesn't work as a defense of shareholder value maximization because it is not factually correct. When corporations are taken over and restructured, employees often find that the value they expected from a long-term relationship with the corporation—such as their pension plan—is destroyed. The current pandemic makes it clear that employees and communities bear substantial risks related to the performance of corporations.

The financial crisis of 2008-2009 made it clear beyond dispute that, when corporations compete by trying to maximize share value, they frequently do so by foisting risk off to governments and to society at large. Even in bankruptcy, which is the only context in which shareholders, by law, are supposed to get the residual, shareholders often participate in distributions of assets even while some creditors and claimants, such as employee pension funds and tort claimants, do not get paid in full.

The corporate law arguments are also problematic. Despite what Milton Friedman said, there is no statutory requirement anywhere, in any state, that says that corporate officers and directors must maximize share value. Corporate laws typically say something like "the board of directors of a corporation shall exercise all corporate powers." The fiduciary duties of corporate directors and officers require only that they are informed, that they exercise care in their decisions, and that they not act in their own personal interest.

There are a handful of court cases in which a simplified reading would seem to suggest that courts require shareholder value maximization. Upon closer examination, these cases involve one of two situations: either a controlling interest in the corporation is going to be sold, and existing corporate shareholders are going to be bought out, in which case courts have said directors must try to get the highest buyout price they can; or, the issue at stake is whether a controlling shareholder in a closely held corporation can use corporate assets, or cause the corporation to pursue strategies that divert value to the controlling shareholder at the expense of minority shareholders.

In those limited cases, courts have required the majority shareholders to refrain from actions that siphon value out to themselves and instead direct them to take actions that create value on a pro-rata basis for all of the shareholders, not just for the subset of shareholders that control the entity. The instructions that courts give in these cases sometimes use share value maximization language, but courts have not attempted to apply a share value maximization rule broadly across all of the decisions boards and managers make.

In recent years, some advocates of share value maximization have argued that the incentive structures in corporations will push corporate actors toward the maximization of share value. This is partly a product of several decades of business school education that has told managers they should structure compensation packages to reward corporate executives if the share price goes up. These compensation packages are choices of the existing management and boards. They could, in principle, be structured to encourage corporate officers to reduce the firm's carbon footprint, or improve their record of on-time delivery to customers, or to improve training and safety protocols for employees.

In the process of negotiating share-price based compensation packages stuffed with stock options, perverse incentives have emerged. Corporate executives often have an incentive to report bad news to the markets a few days before the issue date of new option awards so that the exercise price of the options

might be lower than it otherwise would be. It is also well known that corporate executives often accelerate the recognition of revenues, or slow the charging of costs, or delay investment expenses so that the corporation seems to meet reported net income targets. While it might seem like a good idea to incentivize corporate executives to take actions that lead to better stock price performance, actions that manipulate the short-term share price may undermine the actual long-term performance of the corporation.

Perhaps the most important argument in favor of share value maximization is that share value is a readily observed metric, while other sources of value that corporations provide to society (or costs they impose) can be extremely difficult to measure. It is also difficult to determine causal links between performance in various measurable dimensions, and the social value of the corporation. So, the argument goes, we should evaluate and incentivize corporate leaders to focus on share value because that's a metric we can measure with precision! But that's sort of like saying that we don't really know or understand all the factors that lead to good health, so let's just measure how much a person weighs and let weight serve as a proxy for the overall good health of the person. We should, instead, put our energy into finding better measures of social value, rather than finding better ways to create incentives to deliver a false or incomplete proxy for social value.

Even if social value is hard to measure, it may be possible to encourage the creation of social value if we focus on fair and efficient systems and processes for creating and distributing wealth. The Chicago School of economics has emphasized property and contract rights as essential for wealth creation, for example. But another type of institution that economists have given much less attention to are mechanisms for resolving disputes, which can facilitate cooperation and production by groups or teams.

Corporations are, by nature, group enterprises. Some of the earliest business corporations were invented as tools for the self-governance of groups of traders, or skilled workers, or other business people, who believed they could be more productive if they pooled their resources and worked together. Other early corporations were formed to hold assets necessary for the construction and maintenance of some important piece of public infrastructure, such as a canal or a bridge or a cathedral. The king, or parliament, or, in the new United States, state legislatures, would grant charters that prescribed a governance structure for these organizations, such as a board of governors or board of directors, so that disputes among the participants could mostly be settled internally and kept out of the courts. It wasn't until the mid-20th century that the law even allowed single persons, acting alone, to form business corporations (and corporations could not form other corporations).

Seen this way, corporate executives and directors should understand that a big part of their role is to keep the participants in the corporate enterprise working together in a productive way. This involves assuring adequate rewards to investors such as shareholders and creditors, but also recognizing that other participants, including employees (from key creative people to rank and file workers), suppliers, customers, and communities, also have assets at risk in the enterprise, and all need to prosper and be treated fairly over time.

The law understands this broader function of executives and directors, which helps explain why the law requires corporations to be governed by boards of directors with all corporate powers, rather than by individual founders or CEOs. That is also why the law says that the fiduciary duties of directors and officers run to the corporation, and not directly to any individuals who are involved in the corporation, including any individual shareholder.

It is complicated, uncertain, and sometimes hazardous to one's health to try to govern an institution that involves a lot of competing interests, especially one in which a number of different parties have made investments and commitments in the enterprise, and all want to be sure their interests are taken into account. This is why kings and parliaments and legislatures have tried to keep as much as possible of the decision-making about the internal operation of corporations out of the courts. It is also why the law delegates governance to boards of directors and does not designate in advance, and from outside of the enterprise, which interests should prevail in any given situation.

What does all this mean for the debate about corporate "purpose"? Corporations are legal devices, not pieces of property. Their original function was to provide for the governance of joint enterprises, developments, and projects that require the participation of a variety of different types of investors and other participants, and are expected to provide benefits for many different customers, clients, and communities. All hope to gain some advantage from interacting with the corporation. In this way, there can be no single corporate purpose. Likewise, no one metric can measure the full costs and benefits provided by the activities of the corporation. The law deals with this by delegating decision-making to boards of directors and places no obligation on them to focus only on rewarding shareholders.

Margaret Blair is an economist who focuses on corporate law and finance. She is a Professor of Law (Emerita) and the Milton R. Underwood Chair in Free Enterprise (Emerita) at Vanderbilt University. Her current research focuses on five areas: team production and the role of corporate boards of directors, the legal concept of "personhood," the historical treatment of corporations by the Supreme Court, the role of private-sector governance arrangements in contract enforcement, and the problem of excessive leverage in financial markets.

Bringing Ethics Back to Friedman's Call to Purpose for the Next 50 Years

By J.S. Nelson

Fifty years ago, Friedman compellingly presented his argument for shareholder primacy. But as currently implemented, shareholder primacy threatens the unifying purposes that drove people to form corporations to begin with. It's time for a re-examination of what binds us together to do great things.

We can bring ethics back to Professor Friedman's call to corporate purpose by returning to the more inclusive purposes that historically bound us together to form corporations. Corporations have the capacity to tap humanity's greatest potential to accomplish projects spanning, in scope and time, beyond what any individual could provide to the world. Think of the earliest forms of group associations that combined our efforts, from the Roman origin of our word for corporation, corpora (founded "around a common tie such as a common profession or trade, a common worship, or the widespread common desire to receive a decent burial"), through the intergenerational building of cathedrals erected to the glory of powers beyond ourselves.

Historically, corporations have been collaborative efforts to call people to a higher, communal purpose in their work, to take care of each other, and to accomplish what none of us could do alone. The late Cor-

nell Law professor Lynn Stout described corporations as "time machines," which allow one generation to reach beyond itself to convey benefits to the next. Corporate leaders similarly talk about a purpose larger than themselves, and the management literature is full of ways to harness the "best" from employees, asking for their personal commitments and investments in the company's mission. Corporations additionally create a "culture" around those expectations to help them become self-reinforcing in the workplace.

To what purposes will modern employees and other stakeholders—communities, governments, and those who invest in the corporation in all ways—commit themselves? When corporations ask so much of their investors writ large, corporate purpose must have both an inspirational and unifying function.

Professor Friedman's Legacy of Shareholder Primacy

In his 1970 *New York Times* essay, Milton Friedman asserted that the purpose of the corporation was to make profits. It has been understood that he meant profits primarily for shareholders, but that interpretation is less clear from his text. What he wrote was 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."

Professors Oliver Hart and Luigi Zingales have described Friedman's 1970 essay "as providing the intellectual foundation for the 'shareholder value' revolution," in the form of prioritizing profits to shareholders above other contributors to the corporation. As Zingales explains, "[s]ince the mid-1980s to the early 2000s, Friedman's position was dominant not only in academia, but also in the business world." The Chicago School provided the theoretical framework for these changes, during which economists, lawyers, and others attempted to model human behavior in terms of rational actors seeking to maximize their own utility. An argument for shareholder primacy over all other types of investors (i.e., over the corporation's other stakeholders) was that shareholders were uniquely situated to represent other stakeholders' interests and maximize them as well.

What the Data Show About the Impact of Shareholder Primacy

But these two rationales in favor of shareholder primacy are, of course, also mutually contradictory. If shareholders are rational actors, according to the Chicago School, then they are going to maximize their own utility, not that of other stakeholders. Perhaps shareholders should understand their own utility in terms of the rest of the corporation—and its other investors/stakeholders—doing well. The data show, however, that they do not.

For example, evidence compiled by Harvard's Anna Stansbury and Professor Lawrence Summers demonstrates that, since the rise of shareholder primacy, shareholders have received corporate profits at the expense of workers. In fact, since the rise of shareholder primacy, Stansbury and Summers write, the "decline in worker power is big enough to explain the entire decline in the labor share of income in the United States over the past four decades." Industries with the largest increases in corporate profitability—and payments to shareholders—were the ones with the largest decline in both worker power and workers' share of corporate profits. The authors argue that these decreases in workers' power and share of corporate profits have also driven one of the significant puzzles of the economy since the 1980s: low unemployment without inflation.

Additional descriptions map other paths of power transfer to shareholders at the expense of fellow stakeholders. An increase in monopolistic, or similar monopsonistic, concentration over the same time period has increased both shareholders' profits and corporate control over workers. The US Supreme Court's Citizens United decision, and other related cases, increased corporations', and their shareholders', political power over government policy through lifting limits on political contributions. Growing wealth inequality across society primarily benefits the top 1 percent of households who own more than half of US stocks, magnifying their power to extract profits from corporations, as well as their gains from tax policies that better insulate the transfer of that wealth.

Where Do These Results Leave Corporate Purpose?

Corporate purpose, as a motivation and unifying reason for investment from all of a corporation's stakeholders, thus suffers. As Oxford professor Colin Mayer has written, "shareholder value is an outcome, not an objective. It should not drive corporate policy but be treated as a product of it."

The traditional Chicago School's vision of human nature as always rational has been challenged by behavioral economics' rediscovery of human beings as more complicated creatures, motivated by things beyond money. Similarly, we remember again now that corporate purpose has to work for more of the corporation—and the rest of its investors/stakeholders—for them to stay a part of the corporate bargain. If a corporation is a team production, the team needs to understand why it is showing up and playing. If a corporation wants the best from its players, it needs to invest in them and inspire them to unite around its vision. Effective leaders need to explain how the corporation's victory is its players' victory, too.

Fifty years ago, Friedman compellingly presented his argument for shareholder primacy. But its manifestation over time threatens to leave behind our teams. As currently implemented, shareholder primacy threatens the unifying vision that allowed us once to build the cathedrals of their day, and to believe in such missions. We are losing our workers' engagement, and replacing it with an economy driven by fear. Tying health care coverage to employment during a pandemic further disadvantages businesses that do try to help employees, and it reveals the starkness of accumulated power differentials harming our workers. As Mr. Marc Benioff, chief executive of Salesforce, summarizes: "[L]ook where the obsession with maximizing profits for shareholders has brought us: terrible economic, racial and health inequalities; [as well as] the catastrophe of climate change."

In theory, the 2019 Business Roundtable Statement demoting shareholder primacy, and describing corporate purpose as "a fundamental commitment to all of our stakeholders," is a good start to rethink the direction in which we are headed. Recent work by Professor Lucian Bebchuk and Mr. Roberto Tallarita asks why, however, if corporations were serious about these changes, they did not bring them more often to their governing boards. Professor Tyler Wry's work further suggests that Covid-19 is testing the resolve of the companies that signed the Statement. Since the economic impacts of Covid-19 began, its signatories have paid out 20 percent more capital to shareholders than similar companies, and signatory companies have been almost 20 percent more likely to announce layoffs or worker furloughs. Given management incentive systems in place, the Statement's aspirations do not seem to be penetrating into the behavior of signatory corporations.

As another essay by Bebchuk, Tallarita, and Mr. Kobi Kastiel examining the efficacy of stakeholder constituency statutes in this *ProMarket* series concludes, there should be "substantial doubt [about]… re-

lying on the discretion of corporate leaders, as stakeholderism advocates, to address concerns about the adverse effects of corporations on their stakeholders."

A Call for Reforming Corporate Purpose and Incentives to Achieve the Most from Our Organizations

It is in moments of crisis that employees and other stakeholders will remember what corporations do. These are the moments in which having a higher, unifying purpose, and ensuring that incentives throughout the corporation are in line with that purpose, are most important. Such moments are when we decide who we want to be. Starting now, corporations could use their teams to build their own metaphorical cathedrals by acting in accordance with their ethical values. We should return to corporate purpose that inspires continued investment from all of our stakeholders, and not elevate shareholders solely above others. I acknowledge that balancing tradeoffs amongst stakeholders is hard, but that is part of why we have corporate boards. And perhaps those boards should be, as Professor John Coffee, Jr. suggests, diversified to attain these goals.

I close with Friedman's own words about businesspeople's decision-making. As he wrote: "I have been impressed time and again by the schizophrenic character of many businessmen. They are capable of being extremely far-sighted and clearheaded in matters that are internal to their businesses. They are incredibly short-sighted and muddle-headed in matters that are outside their businesses but affect the possible survival of business in general."

Friedman may have aptly identified the problem, but we have misunderstood the solution. If the goal is to ensure "the possible survival"—indeed, the flourishing—"of business in general," the solution is to encourage commitments from all those who contribute to its success. We can change our ways, and we can do something both ethically and strategically better than the past fifty years.

J.S. Nelson teaches at Villanova Law School, with an appointment (by courtesy) in Villanova's Business School, and serves as a Senior Fellow with the Zicklin Center for Business Ethics Research at Univ. of Pennsylvania's Wharton School. Her forthcoming book with the late Lynn Stout and the Oxford University Press is Business Ethics: What Everyone Needs to Know.

It Is Time to Move on From Friedman's View of the Corporation

By Stefano Zamagni

The anti-CSR position defended by Friedman would be acceptable only under conditions that have never been met by any real-world economy. Furthermore, the notion of the firm as a nexus of contracts is theoretically groundless and legally contradictory.

In his seminal book *Capitalism and Freedom* (1962), Milton Friedman considered corporate social responsibility a serious threat to the survival of the capitalist system itself. "Few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible," he wrote.

The argument was subsequently reiterated in Friedman's famous 1970 piece in the *NYT*, under the suggestive headline The Social Responsibility of Business is to Increase Its Profits. There, he wrote:

> *"The short-sightedness is also exemplified in speeches by businessmen on social responsibility ... Here, as with price and wage controls, businessmen seem to me to reveal a suicidal impulse ... 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 and fraud. Corporations do not have responsibilities. Only executives do and their responsibility as agents of their owners is to maximize returns."

The argument is seemingly persuasive, but does it stand? I limit myself to focusing on two specific points. First, the anti-CSR position defended by Friedman would be acceptable *if* all markets were *perfectly* competitive (it is not sufficient to say competitive); *if* income distribution was equitable in the minimal sense, whereby everyone is permitted to play the market game; and *if* no endogenous changes in the preferences of agents occur.

As economic textbooks inform us, under such conditions—none of which has ever been met by any real-world economy—the economy will reach a competitive equilibrium, where the notion of corporate responsibility would make no sense at all. However, in an economy of this kind, no profits are made, as Leon Walras first demonstrated back in 1874. So, in order to substantiate his thesis on logical grounds, Friedman has to assume conditions under which, if met, businesses would make no profits at all. A really disturbing paradox indeed!

The second point touches on the substance of Friedman's argument. The early 1930s witnessed a great debate over the nature and purpose of the public company—a form of enterprise born in America in the 19th century—characterized by the separation of the ownership of the company from its control. In 1932, the *Harvard Law Review* published a lively debate between Adolf Berle and Merrick Dodd, where the former strongly argued for the primacy of the shareholder, while Dodd argued against this, writing that "The corporation was coming to be seen as an economic *institution* which has a social service as well as a profit-making function" (italics added). In the end, Dodd's position prevailed, and Berle acknowledged his defeat.

Only in the early 1960s did we observe a return to Berle's position. This occurred when Friedman (and other scholars) advocated the contractarian view of the corporation, according to which the firm is a mere nexus of contracts, a view first expressed by Ronald Coase in his pioneering 1937 essay *The Nature of the Firm*.

The problem with this view of corporations is that the notion of the firm as a nexus of contracts is theoretically groundless and legally contradictory. It is a fact that the modern corporation is essentially a public entity, since it has the power to impose its rules on those who operate within it and exercises real power of influence outside of its boundaries, which means that the governance of a corporation is not something that concerns only the shareholders. Yet the contractarian view proceeds on the premise that the corporation is the product of a contract, i.e., of an agreement between private individuals.

If this were the case, it is obvious that the corporation would have a duty to meet the many contracting parties' expectations. But this is not true, since the modern corporation has become what it is in virtue of the law, which is designed to safeguard the public interest. Indeed, the privileged position enjoyed by the corporation derives from its legal personality granted by law, not the result of any contract between the parties involved. In other words, the legal personality is not acquired by contractual means, but as a result of a democratic process. Therefore, the claim that a corporation should maximize its profits for its shareholders is devoid of legal meaning.

This conclusion is reinforced by the following consideration. According to Michael Jensen's and William Meckling's well-known theory of agency, taken for granted by the contractarian view, shareholders, as the owners of the business, constitute the principal —whose aim is to make the largest profits possible— while directors and/or executives are the agents, whose objective function is to maximize their own utility.

Is it true that the corporate manager is the agent of the shareholders? Legal doctrine and jurisprudence have no doubts: no. Since the firm is a legal entity, it constitutes the principal in the agency relationship. It follows that if the manager is the agent of the firm, conceived as an independent legal entity that owns itself, they have the duty to maximize the firm's objective function, and the latter includes the interests of both the shareholders and the other stakeholders.

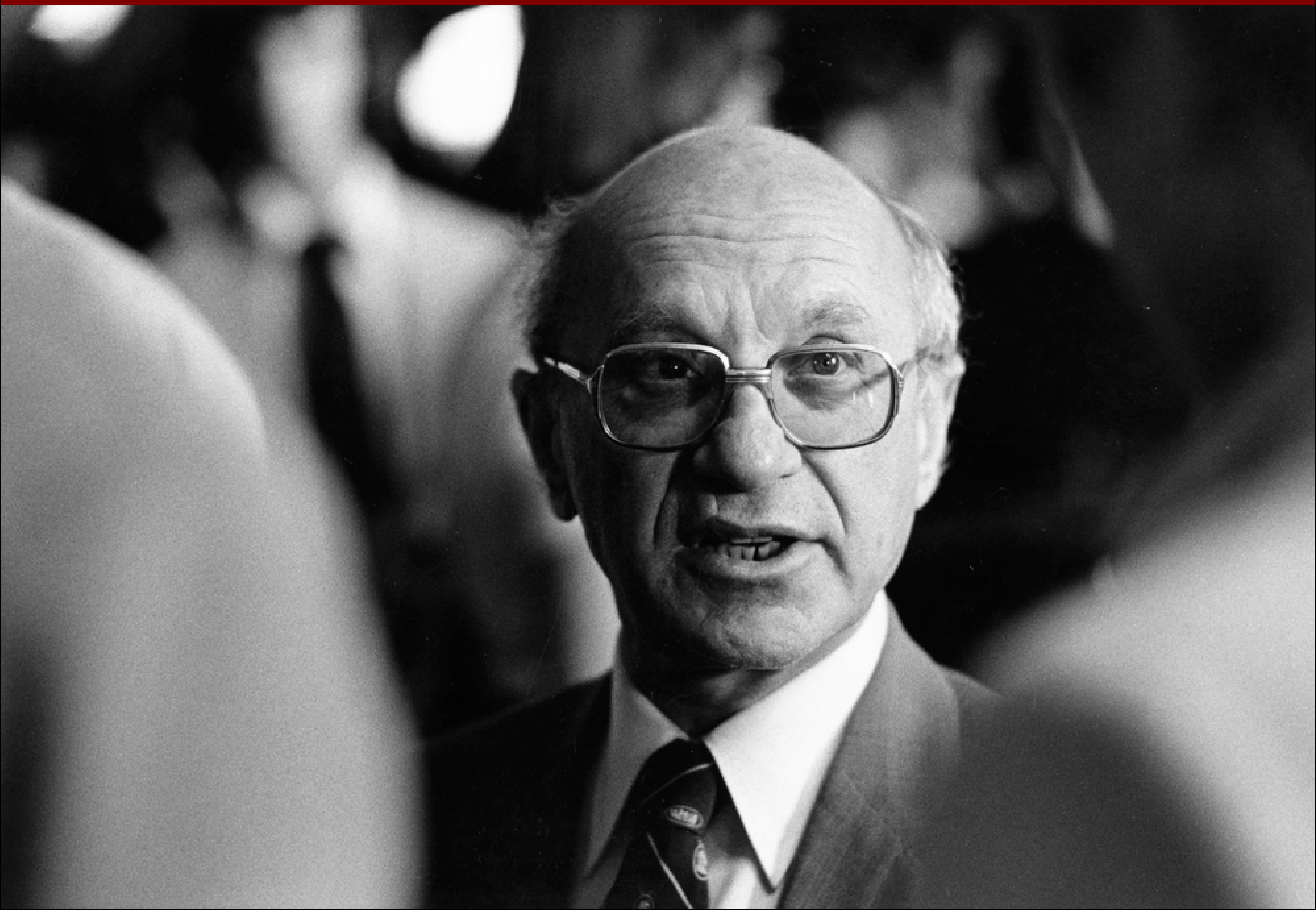
Basically, according to the contractarian view, the logical shortcomings of the corporation derive from the acceptance of an assumption that is factually false, since the firm is not owned by the shareholder: it owns itself. Shareholders own a share of the stocks of the corporation, based on a contract that they enter into with the latter that entitles them to limited rights. The corporation is controlled by the board, which is vested with all the discretionary powers necessary for such a purpose. Shareholders' power consists of removing or denouncing the directors (voice option) or selling their own shares (exit option).

The board, not the shareholders, is the principal and, according to the law, it is the duty of the board to balance the interests of the various classes of stakeholders. This is why nowhere in the world is there a law or set of rules of corporate governance imposing that the firm should maximize shareholder value.

In conclusion, it is unwisely reductionist to characterize the firm as a mere "nexus of contracts" between different parties, attributing to it only one purpose: profit maximization as the only recognized metric of business success. The firm can do much more—and better—than solely maximizing profits. The expanding movement of ideas supporting the "profit-with-purpose corporations" project, such as the Benefit and Social Purpose corporations that have been created in the US since 2010, is a clear testimony to that. Perhaps the time has come to move on from the rhetoric of "doing good by doing well" to one of "doing well by doing good."

Stefano Zamagni is a Professor of Economics at the University of Bologna. He is also an adjunct professor at Johns Hopkins SAIS Europe. He has published studies on the history of economic thought, economic epistemology, the relation between ethics and economics, the economics of cooperation and the third sector, and civil economics, a paradigm of Italian inspiration which places the common good at the center, overcoming the libertarian individualism of mainstream economics.

When Shareholders Have Other Objectives



Shareholders Don't Always Want to Maximize Shareholder Value

By Oliver Hart

Oliver Hart, winner of the 2016 Nobel Prize for economics, reflects on how the world has changed since Milton Friedman published his famous essay on the social responsibility of corporations.

Editor's Note: The following is based on a talk Oliver Hart gave during the Stigler Center's 2020 Political Economy of Finance conference.

Let me start by saying that Friedman's article obviously has had a huge impact. I think there are some things in it that stand up very well 50 years later, others a bit less so.

I agree with Friedman that most companies are set up to act on behalf of shareholders—shareholders have the votes, so I agree with him about that. I don't agree with him that it follows that companies should maximize profits or shareholder value. Why do I think that? Well, because shareholders may themselves not be interested just in the bottom line.

My view is that companies should find out what shareholders want and should pursue that goal, and that is not always value maximization. It's not even always long-run value maximization.
Let's take an example: climate change. In an ideal world, national governments would get together and

agree on a carbon tax, and most economists think that's the way to deal with climate change: you would have a worldwide carbon tax. We're very, very far away from that.

Given that there are national and international political failures, what should people do? What can they do? Well, individuals care about the environment. They don't just spend all their time trying to improve political decisions: they do things on their own. Individuals might install solar panels, or they might buy electric cars. If individuals are willing to do things on their own behalf because governments have failed to do things, then why wouldn't they want the companies they own to also do things?

Just think about reducing your carbon footprint. I've given you examples of how an individual can do that, but those examples are sort of small potatoes. It can be much more effective for companies to reduce their carbon footprint, rather than have individuals do it.

This is where I think Friedman didn't get it right, because there are some social activities in which companies have a comparative advantage relative to individuals, given that governments aren't getting things fully right.

An example I think Friedman was right about was charitable contributions. This is a famous example. I don't think companies have a comparative advantage in giving to charity. It would be much better for them to take the money they would have given to charity, hand it to shareholders, and let each shareholder decide how much to give to his or her favorite charity.

But when it comes to things like the carbon footprint, companies are actually in a much better position to help with climate change than individuals. And if you ask the individual shareholders: Would you be willing to give up some profit, some money, some long-run shareholder value, and in return, your company will become greener? Many shareholders, the very same ones who install solar panels or buy electric cars, might well say "yes." And in that case, if a majority feels that way, I think the company should do the green thing.

By the way, it's not just shareholders who may be willing to give up money for companies to do socially responsible things. It may also be consumers and workers.

Let me now turn to what mechanisms are available for influencing companies. If you accept, like me, that companies shouldn't necessarily ignore social responsibility, then how can people influence them? There are two main mechanisms: exit or voice (to use Hirschman's terminology).

What is exit? Exit refers to things like shareholders divesting from companies, or consumers boycotting their product, or workers refusing to work for "dirty" companies. Examples of voice are shareholders using their votes, or other ways, to engage with management and force company change.

In a recent paper with Eleonora Broccardo and Luigi Zingales, we compare exit and voice theoretically, and we find that voice is surprisingly good relative to exit.

Let me try to explain why: Consider a company that could spend $100 to become greener, and that would improve the environment by $120. So the value of being greener to the world is $120, and it costs the company $100 to do it. Economists would say: Well, that's a good thing for the company to do.

Now, imagine that shareholders were asked to vote on whether the company should do that. And let's suppose they're very well-diversified, so they've invested in lots of companies and each shareholder owns just a very little piece of this company. When they're considering which way to vote, they'll think to themselves: Well, if my company becomes greener, they have to pay $100, so profits will go down by $100, the share price will go down in total by $100. But as a very small shareholder, the capital loss I will experience will be extremely small. It'll be my share of that $100, and that's going to be almost nothing, a cent or something.

On the other hand, when I think about the impact of this change, if I vote for it and if it goes through, then it's going to hurt shareholders as a whole by $100, but it's going to improve the world by $120. So if I put on my social hat, that's plus $20. So what will I do if I'm socially responsible? We model this in our paper. What will the shareholder do? He or she will put 100 percent weight on their capital loss and some weight on this plus $20. Because the capital loss is negligible, since they have a negligible shareholding in the company, even though they're putting 100 percent weight on that, it's actually the other stuff that's going to dominate. The weight they put on that plus $20, even if it's a small weight, that's going to beat the one-cent capital loss that they experienced. So they're actually going to vote for installing the clean technology, for saving the environment. They're going to do the socially correct thing.

This turns out to actually be our general result for the case where everyone's very well diversified. It wouldn't be true if we had a large shareholder for whom the capital loss might loom much larger. So that's why voice actually does surprisingly well.

Now, we compare that strategy of trying to change what the company does to the indirect exit strategy. Let's stick with shareholders and consider their exit strategy, which would be to divest: if you're a shareholder who would like your company to be greener, what you do is you say, "I don't like this company, I'm going to sell my shares, I'm going to get out. That's how I'm going to show my disapproval of what they're doing right now."

That is a very indirect mechanism for achieving change, because the way it works is that you divest, and maybe some other people like you divest, and the share price goes down, and the idea would be that the company doesn't like a lower share price so it might respond. If it goes down enough, the company will say, "Oh, this isn't good." And we've heard CEOs are often paid according to share prices, so they might say, "Perhaps we should carry out this investment, become green, and that's the way to get the share price up again."

The problem with that is that even though some people might be willing to divest because they feel very strongly about it, other people who are either purely selfish or only slightly socially responsible might think, "Wow, these prices going down. This is a bargain. Now I can make money, large amounts of money, by buying these discounted shares," They'll do that and drive the price up again. So the price effect from divestment can be really quite small.

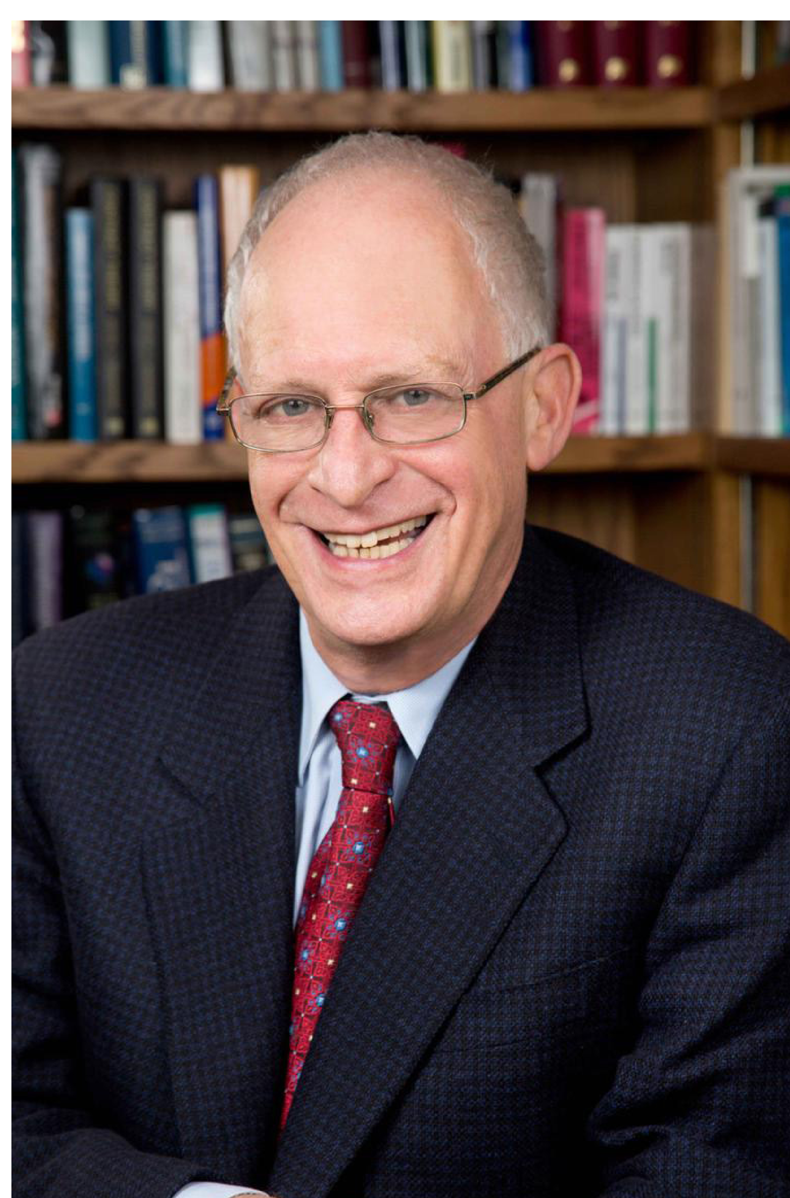
The point I would like to get across is there's a very different calculation in the vote, where you have this negligible capital loss, and you're comparing that with the social impact, and the calculation of an investor who has the opportunity to buy discounted shares and make money. That person has to be very socially responsible not to do that, whereas in the vote you only have to be slightly socially responsible to vote green.

I'd recommend reading the paper, because there's a little more to our analysis than what I'm saying, but this the broad outline.

What does one make of these results? What does one conclude? One conclusion is that a lot of government policy and regulation seems to be pushing in the wrong direction. If you look at the SEC policy over the years, it has been to make voice much more difficult. It's made it much harder for shareholders to express their views.

If you take our analysis seriously, you would say that's really the wrong way to go. You should be trying to make the expression of shareholder views easier. Just to mention a very recent example which many people will be aware of, the US Labor Department is planning to make it impossible for people running private pension funds to take ESG factors into account, regardless of what the people investing their money with them might want. The pension fund managers apparently can't even consult the investors about what they would like. Instead, according to this Labor Department proposal, they must focus 100 percent on shareholder value. That just seems to me to make no sense at all.

The world has changed in the last 50 years in many, many ways. Certainly, environmental concerns have become more serious and more salient, relative to the time when Friedman published his article. But another thing that has changed, I think, is that we've understood the limitations of some of his arguments.



Oliver Hart is currently the Lewis P. and Linda L. Geyser University Professor at Harvard University, where he has taught since 1993. He is the 2016 co-recipient of the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel, a Fellow of the Econometric Society, the American Academy of Arts and Sciences, the British Academy, and the American Finance Association, a member of the National Academy of Sciences, a Distinguished Fellow of the American Economic Association, and has several honorary degrees.

Serving Shareholders Doesn't Mean Putting Profit Above All Else

By Oliver Hart, Luigi Zingales

The time has come for companies, economists, and society to abandon the argument that the only responsibility of business is to maximize profits.

Editor's note: This article was first published on HBR.org and in ProMarket in October 2017.

Is the only responsibility of business to maximize profits, as Milton Friedman famously argued in 1970? Many scholars and business people have criticized this idea on the grounds that companies should cater to employees and the community, not just to shareholders. But the law seems to support shareholder primacy: Under Delaware law, which controls the vast majority of corporate America, directors are elected by shareholders, and, according to Leo Strine Jr., a Delaware judge, directors owe their loyalty to those who elect them.

In a recent paper we offer a different perspective, one that we believe is perfectly consistent with the fiduciary duties of corporate directors: Companies should maximize shareholder welfare, not value.

Our starting point is that shareholders care about more than just money. Many shareholders pay more for fair-trade coffee, or buy electric cars rather than cheaper gas guzzlers, because, using the current economic lingo, they are prosocial. They care, at least to some degree, about the health of society at large. Why would they not want the companies they invest in to behave similarly?

This intuition is borne out by recent shareholder behavior. Until a few years ago corporate managers heard only two complaints from institutional investors: that executive pay was excessive and that the company had an insufficient number of independent directors. Not anymore. The new mantra, especially in Europe, is ESG: Companies should care about the environmental and social impact of their investments. In fact, research has shown that the majority of shareholder proposals in the U.S. now concern ESG.

Friedman acknowledged that shareholders might have ethical concerns, but he implicitly assumed that a company's profit and social objectives are separable. This is true for the example he used in his article: corporate charity. One dollar donated by the corporation is not worth more than one dollar donated by shareholders. Why should corporate boards decide about charitable giving when they can distribute the profits to be donated as dividends and let the shareholders decide directly?

We agree with Friedman on this point. But we are interested in situations where profit and social consequences are inextricably connected. Think about the shareholders of a company such as Walmart, who are concerned about mass killings in the United States. Walmart's ability to restrict the sale of high-capacity magazines or assault rifles in its stores would be more effective than if it took the extra profits from those sales, returned them to shareholders, and let shareholders donate to gun control advocacy.

Therefore, if investors have some objectives other than money, there is no reason why a company's board should ignore them and pursue only profit maximization. The fiduciary duty a board has to a company's shareholders is to maximize their welfare, not just the value of their pocketbook. This raises an important question: How can a board do that?

Can Boards Incorporate Shareholder Welfare?

It may seem an impossible task: Should a board stop before every decision and poll its shareholders? The answer is no. In all representative democracies most decisions are delegated to representatives, who are elected on the basis of their stated preferences about important social issues. Shareholders elect directors to pursue their interests, which can include nonmonetary considerations.

Occasionally, on very important matters the citizens are polled directly, through a referendum. We propose the same for companies. On decisions with major social consequences, referenda should be used to elicit shareholders' preferences.

If shareholders care only about money, the system will produce the same result that we observe today. But if many shareholders do have social objectives, as both data and intuition suggest, the system will allow them to achieve these objectives and increase their utility.

One concern is that adding social dimensions will overwhelm investors. How many elections and referenda should an investor follow every year? Can they keep up with a company's social impact as well as its financial performance? But this problem could be solved through the formation of mutual fund companies specializing in voting on certain issues.

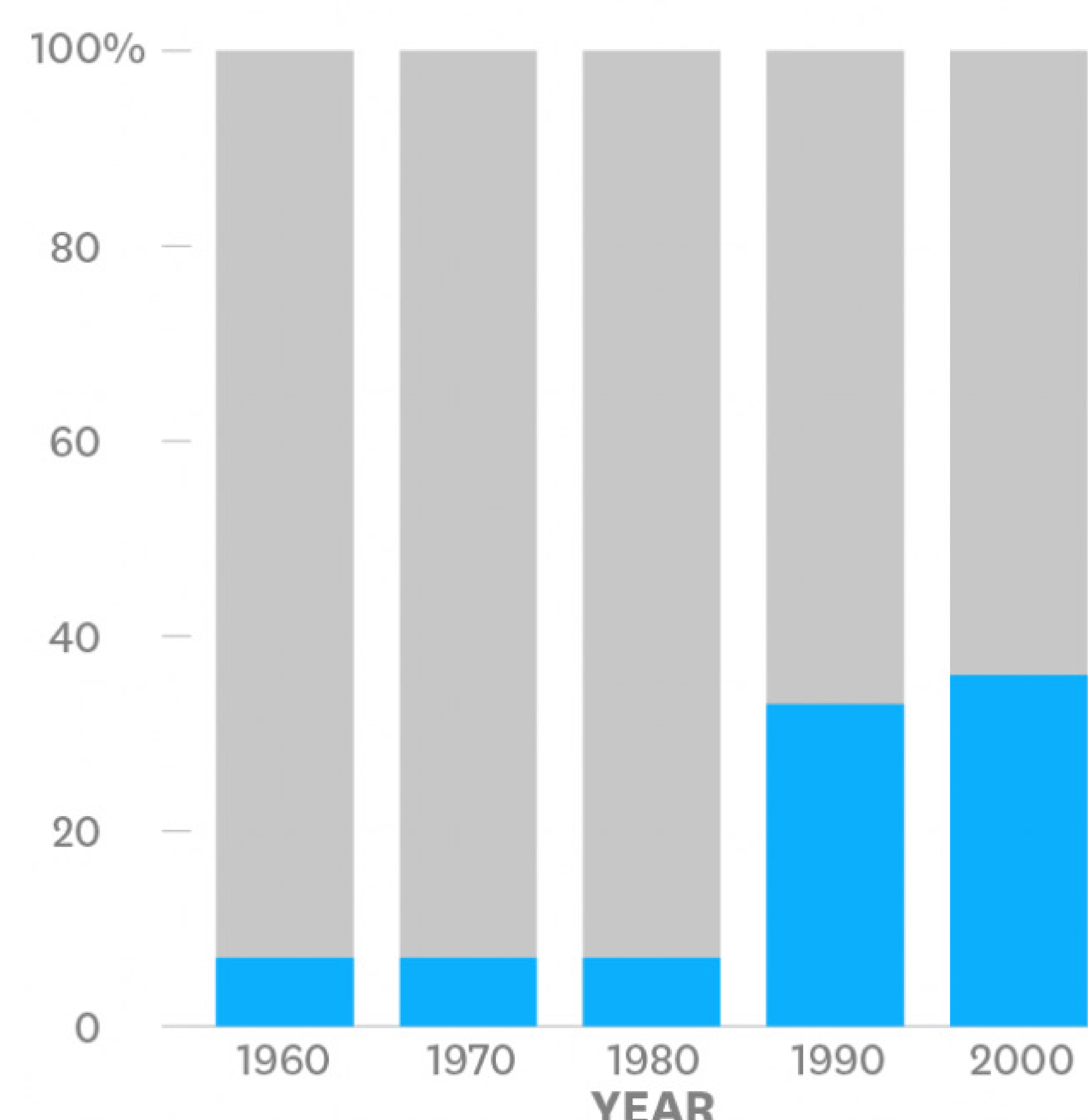
Following up on our earlier example, imagine a "curb assault weapon" index fund. It would be identical in every respect to other mutual funds, buying and selling the same basket of stocks, with the exception that it would vote against any sale of assault weapons and ammunition to ordinary citizens. (Such a fund might also stipulate that the fund would sell the stock if other shareholders voted to allow gun sales, but this is not strictly necessary for the index fund idea to put positive social pressure on companies.) Issue-oriented index funds would eliminate cognitive overload for investors and would not be more expensive than a standard index fund, which has to pay a proxy adviser to direct it in how to vote. Prosocial investors would rush to buy such a product, ensuring its success in the marketplace.

In fact, the idea is so simple that one might wonder why we do not already see such products. We think that the answer can be found in existing proxy access rules, which make it difficult for moral issues to be put up for a shareholder vote. If these rules were eased, we would expect this kind of ethical fund to arise.

Does It Matter?

To a casual observer, the difference between shareholder welfare and shareholder value might seem small. Yet it is on the basis of the shareholder value principle that corporate boards and courts of law reject the ability of shareholders to influence corporate policy on social issues that shareholders care about.

Friedman's rule has had a big impact on the way companies are managed. The figure below shows the percentage of Dow Jones Index companies that mention value maximization as an objective in different decades. It has dramatically increased in the last three decades.



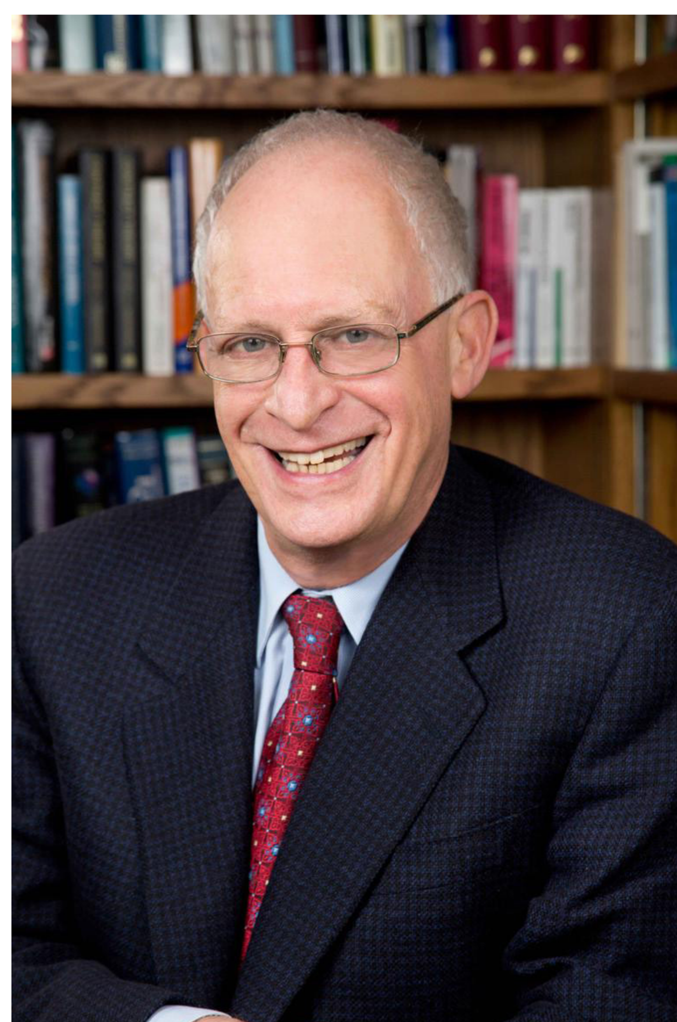
The impact extends to asset management companies. Pension funds, foundation endowments, and university endowments have been run on the basis of Friedman's separation principle: Maximize the wealth of investors, and let shareholders use the proceeds to achieve their goals. Thus it is not unusual to have peace-promoting foundations investing in arms-producing companies, environmental foundations investing in repeated polluters, or law school endowments investing in companies that regularly pay bribes. At most, there is some mild attempt to divest from these "tainted" companies, but changing their behavior has taken a back seat to financial gain.

There is no doubt that foundations and university endowments have social objectives other than maximizing return. Why should they leave those objectives out of the boardrooms? Moving from shareholder value maximization to shareholder welfare maximization may be a small step for theory, but it could trigger a leap forward in the way our corporations are run.

Some may object that our proposal is antidemocratic. Social goals, the argument goes, should be left to the political system, where every vote is treated equally. If we allow shareholders to vote on social issues involving their companies, the vote of wealthy people will count more.

We are sympathetic to this concern, but in our view it is misplaced. The same could be said of sustainable consumerism, where the purchases of richer people "count" more in dollar terms. Moreover, our proposal would make corporations more democratic, not less, by elevating the social concerns of the millions of present and future pensioners. Finally, by restricting shareholder concerns to pure profit, we're not simply leaving values to the realm of politics; in practice, we're often declining to consider those values at all.

In recent decades, companies have grown to rival governments in size: 69 of the largest 100 entities in the world by revenues are corporations. Entire industries are dominated by a handful of players, sometimes by a single one. In this world, many of the corporate choices, like the one to sell high-capacity guns, have social consequences that are not limited to economics. Yet the legitimate owners of companies are prevented from intervening to choose the social consequences they prefer. Until now these restrictions had found a justification in Friedman's argument. Our work highlights how this justification is based on an implicit assumption, but is unlikely to hold in practice. The time has come for companies, economists, and society to abandon it.



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Luigi Zingales is the Robert C. Mc Cormack Distinguished Service Professor of Entrepreneurship and Finance at the University of Chicago - Booth School of Business. He is a Research Associate of the National Bureau of Economic Research, a Research Fellow of the Center for Economic Policy Research, and a Fellow of the European Corporate Governance Institute. His research interests span from corporate governance to financial development, from political economy to the economic effects of culture. He has published extensively in the major economics and financial journals. In 2003, Zingales received the Bernacer Prize for the best European young financial economist. In 2013 he has been named founding director of the Center for Economic Analysis of the PCAOB. In 2014 he served as President of the American Finance Association. He is co-author with Raghuram G. Rajan of "Saving Capitalism from the Capitalists" (2003) and author of "A Capitalism for the People: Recapturing the Lost Genius of American Prosperity" (2012). His latest book is "Europa o no" (2014).

Market Forces Already Address ESG Issues and the Issues Raised by Stakeholder Capitalism

By Eugene F. Fama

When do market forces push firms toward stakeholder goals, rather than just shareholder goals? When do market forces push firms toward ESG goals? When are political solutions to such issues warranted? Eugene F. Fama, winner of the 2013 Nobel Prize for economics, offers thoughts and references to related work.

Stakeholders versus Shareholders

There is currently much discussion of stakeholder capitalism, the proposition that firms should be run in the interests of all their stakeholders, including workers, and various types of securityholders, and not just shareholders.

My theme[1] is that contract structures—the contracts negotiated among a firm's stakeholders—address stakeholder interests. Contract structures are an important ingredient in the survival of firms. In a com-

1 *Thanks to Oliver Hart And Luigi Zingales for helpful comments.*

petitive environment, firms have incentives to negotiate contracts that allow them to deliver the products demanded by customers at the lowest cost. This survival competition benefits consumers, and with freely negotiated contracts, it benefits stakeholders.

I focus on internal stakeholders. A firm's suppliers might be included among its stakeholders, but supplier interests are covered by suppliers. A firm's customers might be included among its stakeholders, but in a competitive environment, satisfying customers is a first-order survival consideration for firms. If the firm is a monopsonist or a monopolist, however, these conclusions might change.

Stakeholder capitalism is not a new concept. It can be viewed as an application of the Coase Theorem. In a world where contracts are costlessly written and enforced, the optimal decision rule for a firm is to maximize the combined wealth of its internal stakeholders. Contracts can then be used to split the wealth among stakeholders.

Note that I take the goal to be max wealth for internal stakeholders rather than max welfare. In my view, the divergent tastes of stakeholders for different dimensions of welfare mean that a more general max welfare rule is subject to contract costs that typically make it an inefficient decision rule. This is a central issue I will discuss in detail.

When contracts are not costlessly written and enforced, contract costs can explain how max shareholder wealth can displace max stakeholder wealth as a firm's optimal decision rule. In a competitive environment, the survival of firms requires that they cover their costs, including contract costs. If all stakeholders have rights to influence the firm's decisions, they are unlikely to agree about which decisions maximize combined wealth, and they are unlikely to agree about how combined wealth is split among stakeholders. In short, contract costs are likely to be high.

Building on Jensen and Meckling (1976) and Fama and Jensen (1983a, 1983b), Fama (1990) argues that the common solution to this contract cost problem is a contract structure in which almost all stakeholders negotiate fixed payoffs (basically, forms of debt), and shareholders bear the residual risk of net cashflows —revenues minus costs. (This is why shareholders are called residual risk bearers.) In exchange for fixed payoff contracts for other stakeholders, shareholders get most of the rights with respect to decisions that affect net cashflows. Given the contrast costs of more complicated multidimensional decision rules (like max shareholder welfare), the optimal decision rule is max shareholder wealth.

Fixed payoff contracts for other stakeholders do not mean the promised payoffs are riskless. Fixed payoffs of all types are negotiated to reflect their risks much in the way debt securities (bonds) are priced to reflect the risks of their fixed promised payoffs.

Fixed payoff contracts have details that vary from one group of stakeholders to another. To a large extent, the details center on controlling the risks of fixed payoffs, how payoff risks will be monitored, and what happens if promised payoffs are not met. Since contracts are not costlessly written and enforced, this doesn't rule out opportunistic behavior by shareholders. But the possibility of opportunist behavior is a dimension of default risk that should be reflected in the size of fixed promised payoffs. Thus, contract costs permitting, shareholders have incentives to write contracts that limit their opportunistic behavior.

Another discipline comes from contract renegotiation. Fixed payoff contracts are often subject to periodic (for example, annual) negotiation. The prospect of renegotiation limits opportunistic behavior since

it is likely to be penalized by higher fixed payoffs in future contracts. Fama (1980) calls this "ex post settling up."

The bottom line is that with freedom to contract, the contract structures we observe are bottom-up competitive solutions to the problem of maximizing stakeholder welfare in a world where contracts are not costlessly written and enforced. For most firms, the winning contract structure involves fixed promised payoffs for most stakeholders, with residual risk largely borne by shareholders, who as a result have most of the decision rights. There are, however, differences in the details for different types of organizations (discussed in Fama and Jensen 1983a, 1983b).

The competition among contract structures to deliver the products demanded by customers at the lowest cost is ongoing. My preference is to let competition produce adaptations, rather than impose top-down changes with catchy names like stakeholder capitalism that are likely rife with unintended consequences.

ESG (Environmental, Social, and Governance)

The G (governance) in ESG is easy to address. A firm's governance structure is part of its contract structure. In a competitive environment, the firm has incentives to choose a governance structure that contributes to allowing it to deliver products demanded by customers at the lowest cost. This issue is discussed in Fama and Jensen (1983a, 1983b). Constraints on governance choices (for example, laws that specify the racial or gender mix of boards of directors) are likely to introduce inefficiencies that, if forced on all producers, are in the end paid for by consumers.

E&S (environmental and social) issues are more complicated. If environmental and social goals enter consumer utility functions, they provide incentives for firms to provide products that lean toward these goals. For example, if many consumers prefer the more expensive meat of free-range chickens and cows to the meat of their caged brethren, firms will provide free-range meat without Government incentives. Consumers vote via their purchase decisions, and the economy produces the right amount of free-range meat. In this way, markets provide solutions to some E&S problems.

Asset markets can help accommodate E&S issues. Most asset pricing models assume investors are only concerned with the wealth generated by their investments. Fama and French (2007) present a model in which investors also have tastes for assets as consumption goods. The tastes might include E&S actions by the firms in which they invest. In 2007, E&S considerations, labelled socially responsible investing, started to show up in the asset management industry. There is now a wide range of E&S investment products.

On the asset pricing side, what are the costs and benefits to firms in choosing products and production techniques oriented toward E&S goals? If some investors value the E&S actions of firms, then given net cashflows, a switch from indifference to E&S virtue is rewarded via higher share prices, which imply lower expected returns and costs of capital. Lower costs of capital help firms in the competition for survival. But adopting E&S goals is also likely to raise production costs, which leans against the benefit of lower costs of capital. Note also that lower costs of capital for E&S accredited firms mean that for E&S investors, virtue is its own reward since investors get lower expected returns from the shares of virtuous firms.

Accommodating E&S issues is a step toward a more general decision rule, which is max shareholder welfare, not just max shareholder wealth. Unlike wealth, welfare has multiple dimensions, and tastes for

different dimensions are likely to vary across shareholders. Even if all a firm's investors agree that more is better than less (or vice versa) on different dimensions, they are unlikely to agree on tradeoffs.

For example, an E&S virtuous firm may commit to transfer half of annual profits that would otherwise accrue to shareholders to outside groups that fight for E&S issues. For some investors with tastes for E&S actions, 50 percent may be too much, and for others it is too little. There is also likely to be disagreement on how the 50 percent is split among different E and different S actions.

How to resolve this problem? Hart and Zingales (2017) argue that since shareholders have the decision rights, a shareholder vote is a possibility. But choosing the specifics of a question may itself be a difficult problem. Moreover, a vote implies winners and losers, and the possibility of unexpected actions that may violate the E&S tastes of some investors is likely to make investors less willing to bear the costs of E&S commitments by firms.

This discussion takes us back to the initial discussion of how contract costs affect the contract structures of firms. The conclusion there is that the costs of writing and enforcing contracts among stakeholders with divergent tastes and interests typically lead to a contract structure in which most stakeholders have fixed promised payoffs, and residual risk is largely borne by shareholders, who as a result get most decision rights. Pulling the curtains aside, the ESG movement argues that the resulting decision rule should be max shareholder welfare, not max shareholder wealth. But that puts us in the quagmire of satisfying the divergent tastes and interests of different shareholders—a multiple dimension problem that implies high contracting costs. The max shareholder wealth rule is a single dimension alternative with low contract costs relative to max shareholder welfare.

ESG and Externalities

One impetus for the ESG movement is the judgment that the actions of firms produce externalities that are ignored by the max shareholder wealth rule.

For example, suppose there are two ways to produce a product. The cheap way produces pollution that costs the firm nothing. The expensive way controls pollution but at some cost to the firm. If consumers are indifferent to pollution, dirty producers drive out clean producers (Shleifer 2004). But if some consumers value less pollution, or can be convinced by E&S arguments to value less pollution, they can vote for less by paying more for the version of the product produced cleanly at higher cost. The end result is the mix of clean and dirty products that consumers vote for with their purchases. It seems that a market solution to this ESG problem works—but not necessarily and probably only partially.

Thus, suppose all consumers care about pollution, and dirty producers offer the same products as clean producers but at lower prices. Despite their distaste for pollution, some consumers are likely to choose the products of dirty producers because they perceive that their individual choices have little effect on the amount of pollution. In other words, there is a coordination problem: everybody would pay more for the products of clean producers if they could be convinced that other consumers would not cheat.

A potential solution is to use the democratic process to control dirty production via regulation. But the Government-imposed solution is not likely to be optimal since there are surely tradeoffs of costs for benefits that change with the amount of pollution, and the tradeoffs change with the evolution of production technology. In the end, imperfect though it may be, E&S activism to shape the tastes of consumers and

investors may be a more effective route than regulation.

The coordination problem discussed above is a type of externality. In general, externalities pose problems that are not amenable to complete solutions from individual firms. For example, putting aside coordination problems (consumer cheating), suppose all consumers value and are willing to pay for less pollution, but all consumers don't buy all products. (For example, most men don't buy lipstick.) In making their pollution decisions, firms weigh benefits to them versus costs to them of producing with less pollution. But this likely means they ignore the benefits of less pollution to consumers who don't buy their products.

It is difficult to find activities free of externalities. For example, candy bars and sugared drinks are potentially toxic for consumers with a tendency towards diabetes. One might argue that personal freedom demands that such consumers eat and drink what they please since they bear the costs and benefits. But they don't bear all the costs if their health care is in part paid for by other people through higher premiums for health insurance or socialized healthcare. Smoking and hard drugs are similar examples.

When pressured, the political process might address such externalities, but the solution is likely to be clumsy. Activism that induces consumers and investors to value E&S friendly products may be a better (though imperfect) alternative. On the plus side, activism that affects the behavior of consumers and investors is a market-oriented approach that may adjust more flexibly to unpredicted negative outcomes than political solutions.

ESG activism is likely to accomplish more by working through consumer tastes than by working through investor tastes. Each consumer can react to each ESG action with respect to a specific product according to her/his tastes. But an investor is committed to the set of ESG actions of a firm during the period a security is held. Given the divergent tastes of investors, commitment to the somewhat unpredictable ESG actions of firms looks like a black box with uncertain welfare payoffs. This is likely even when investors are committed to ESG goals, but to different degrees and with different tradeoffs among the multiple dimensions of E, S, and G. The result is likely to be limited participation in ESG investment, even by investors committed to ESG action. For most investors, the single dimension max shareholder value rule is likely to be more attractive.

Conclusions

My general argument is that market forces address the issues raised by the stakeholder capitalism and ESG movements. Market solutions are not perfect, especially in the presence of externalities, but no solutions are perfect when contracts are not costlessly written and enforced.

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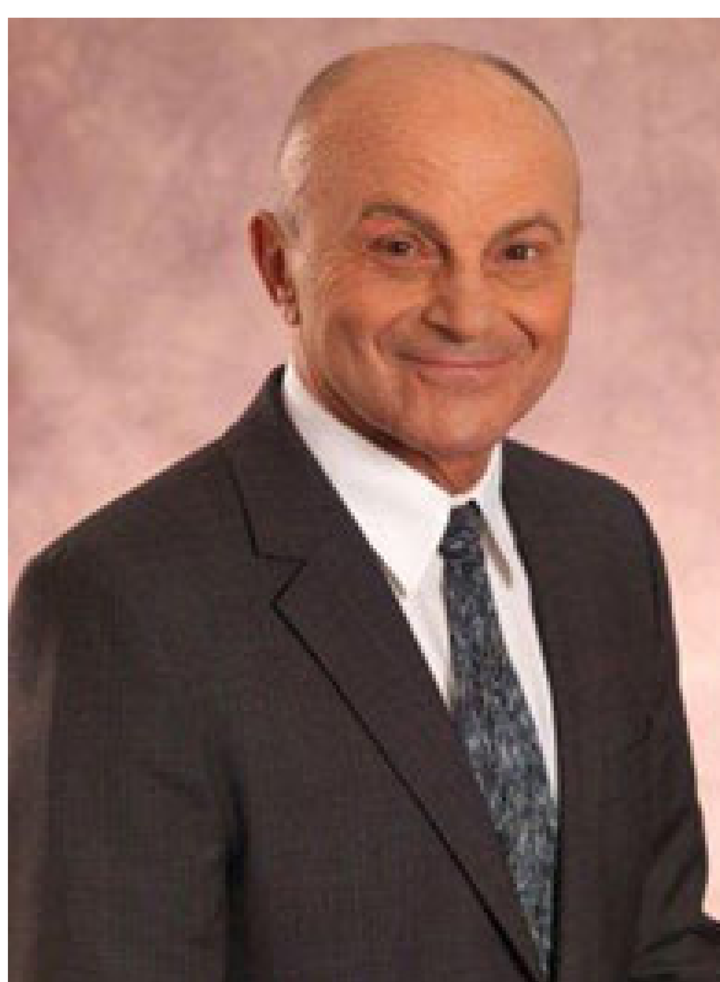

Eugene F. Fama is the Robert R. McCormick Distinguished Service Professor of Finance at the University of Chicago Booth School of Business. Fama, the 2013 Nobel laureate in economic sciences, is widely recognized as the "father of modern finance." He is strongly identified with research on markets, particularly the efficient markets hypothesis. He focuses much of his research on the relation between risk and expected return and its implications for portfolio management. His work has transformed the way finance is viewed and conducted.

The Purpose of Business is to Solve Problems of Society, Not to Cause Them

By Colin Mayer, Leo E. Strine, Jr. , Jaap Winter

Claims that a stakeholder-focused system of corporate governance cannot succeed in the US are perverse because they take as given that corporations in the US ought to operate in the antediluvian framework Friedman preferred rather than within the enlightened one associated with the New Deal and high-performing economies in Germany and Scandinavia.

Fifty years ago, Milton Friedman said that the social responsibility of business is to increase its profits.[1] He was wrong, and the consequences of the mistaken thesis have been mounting environmental and social problems around the world. Remedying this mistake requires that environmental and social policies be combined with changes to corporate law that place corporate purpose beyond profit at its heart.

According to Friedman's doctrine, directors of a company have a duty to do what is in the interests of their masters, their shareholders: to make as much profit as possible. Those who supported Friedman's stockholder focused view of the corporate world now claim that a different approach—one that embrac-

1 *Milton Friedman (1970), "A Friedman Doctrine: The Social Responsibility of Business is to Increase its Profits", New York Times, 13 September.*

es the notion that corporations that exist only by right of society have a corresponding duty to treat all their stakeholders with respect and be responsible citizens—cannot work.

This claim is perverse because it takes as given that corporations in the US ought to operate in the antediluvian framework Friedman preferred rather than within the enlightened one associated with the New Deal and that still exists in high-performing economies in Germany and Scandinavia. It fails to acknowledge businesses' own complicity in the erosion of that framework, as the very corporations that embraced their pre-reform vision of the role of businesses led the way in undermining the values of the New Deal that had previously acted to create greater economic security, equality, and fairness.

Unfortunately, some of our academic friends and colleagues are resisting a sensible rebalancing of the American corporate governance system to take into account the profound change in power dynamics that has resulted from the influence of Friedman and his anti-New Deal acolytes. That influence has markedly increased the power of the stock market and institutional investors over corporations and diminished the protections for other stakeholders.

This has left American corporate managers with far less room to balance all interests, to treat workers fairly and accord them with their prior share of productivity and profit gains. It has encouraged businesses to take shortcuts resulting in serious harm to consumers, the environment, and society generally. Not only that, it has left American corporations, even after a decade of recovery and massive tax cuts, running on fumes, with imprudent balance sheets, risky supply chains, and an inability to weather the pandemic with resilience.

In the face of this, respected thinkers like Professor Lucian Bebchuk argue that a more stakeholder-focused system of corporate governance cannot succeed in the US.[2] We respectfully disagree. For starters, Bebchuk et al. ignore the fact that the US, together with the United Kingdom, is actually an outlier among the most productive, advanced, democratic market nations in terms of its stockholder-focused corporate governance. The stakeholder-focused system he says cannot function efficiently and effectively is actually in place in Germany, Scandinavia, and throughout much of the OECD.

Professor Bebchuk is, of course, right that it is difficult for corporations in the US *now* to operate in this effective and more enlightened way.[3] But that is in large measure because for too long we have followed Friedman's lead in making public corporations playthings of the stock market, and not imposing requirements on institutional investors to represent the real interests of their human investors in sustainable growth, the fair treatment of workers, and the elimination of externalities that cost all investors in not only slower economic growth, but also higher taxes and serious harm to human health and welfare.

We note that, although the singular pursuit of shareholder value may not have become as extreme in the EU as in the US, nonetheless in many EU member states, a marked shift towards the shareholder-dominated-governance model has occurred, even in states that formally would endorse a stakeholder approach. In a recent study for the EU Commission on directors' duties and sustainable corporate governance, EY concludes that over the period 1992-2018 there was a growing trend for publicly listed companies to focus on short-term benefits of shareholders rather than on the long-term interests of companies, and that this had had a negative effect on long-term sustainable investment and company workers' pay.[4]

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2 *"The Illusory Promise of Stakeholder Governance" by Lucian Bebchuk and Roberto Tallarita, SSRN, April 2020, forthcoming Cornell Law Review, December 2020.*

3 *Lucian Bebchuk, Kobi Kastiel and Roberto Tallarita (2020), "For Whom Corporate Leaders Bargain", Working Paper, August 19.*

4 *European Commission (2020), Study on Directors' Duties and Sustainable Corporate Governance, July.*

Shareholder pay-outs have quadrupled from less than one percent of revenues in 1992 to almost four percent in 2018, with a significant number of companies paying out more than 75 percent of net profits. As an example, with its publicly proclaimed stakeholder model, the Netherlands is among the top three dividend pay-out countries in the EU. In line with this, investors rejected a proposal in the Netherlands this year to introduce an explicit duty of the board to ensure the corporation acts as a responsible corporate citizen on the presumption that investors would do the job of ensuring responsible behavior by corporations. Again, societal responsibility of corporations is acceptable only so long as it is in the interests of shareholders.

Commitments to a stakeholder approach in member states have primarily been in the form of workers' councils and systems of co-determination that were designed in the 1960s and 70s. Their ability to protect workers has not been modified, in particular, to counteract the greater pressures exerted on EU corporations by activist hedge funds and institutional investors focused on short-term profits. Furthermore, co-determination and worker consultation systems in the EU were not designed to address wider concerns about social and natural capital that have risen to the fore recently. The European Commission is currently considering what regulatory measures should be taken to promote a more sustainable corporate governance framework in Europe.

What is required is a commitment to stakeholder governance that is matched with a supporting power structure. That is what is lacking. Outside corporate law, that means restoring the spirit of the New Deal and applying it to a 21st Century world by revitalizing the right to join a union and increasing worker voice at all companies, updating minimum wage and worker safety laws, taking aggressive action to address climate change, reinvigorating antitrust enforcement and consumer protection, and requiring large corporations and institutional investors to disclose information about whether they are treating their stakeholders and society with respect.

Within corporate law itself, the time has come for change to restore needed balance and focus corporations on the socially responsible, sustainable wealth creation. Right now, corporate law leaves it up to directors and managers subject to potent stockholder power to give weight to their other stakeholders. Corporations may have a commitment to purposes beyond profit and may treat stakeholders with respect, but only if their powerful investors allow them to do so. Absent an effective mechanism for encouraging adherence to the BRT statement and the system is stacked against those who attempt to do so. When the chips are down, not many corporations turn to their purposes to support their stakeholders, because as a practical matter of power dynamics, they cannot.

That is exactly the problem—the BRT signatories could propose purposes that support their stakeholders as well as their shareholders, but they do not have to, or do so only in so far as they promote the success of the corporation for the benefit of their shareholders. In other words, the interests of stakeholders are at best derivative of those of shareholders.

What is needed is a uniform federal mandate requiring large corporations, say with revenue over $1 billion, to become PBCs under state law, such as under the leading version in Delaware, harnessing the magic of federal and state cooperation in corporate governance that has made the American markets so successful. External regulation detailing what corporations can and cannot do alone will never be able to fill the responsibility void that has been created by making corporations only responsible for financial success in the interest of their shareholders, especially when supported by incentive structures that

encourage executives to dismantle legal guardrails on corporate opportunism. Corporate law needs to ensure that corporations and boards of directors rise to the challenge of developing profitable businesses that contribute to solving society's pressing challenges.

Colin Mayer is the Peter Moores Professor of Management Studies at the Saïd Business School at the University of Oxford. He is a Fellow of the British Academy, the Centre for Economic Policy Research and the European Corporate Governance Institute, a Professorial Fellow of Wadham College, Oxford and an Honorary Fellow of Oriel College, Oxford and St Anne's College, Oxford. He was appointed Commander of the Order of the British Empire (CBE) in the 2017 New Year Honours. He leads the British Academy enquiry into "the Future of the Corporation".

Leo E. Strine, Jr., Michael L. Wachter Distinguished Fellow in Law and Policy at the University of Pennsylvania Carey Law School; Ira M. Millstein Distinguished Senior Fellow at the Ira M. Millstein Center for Global Markets and Corporate Ownership at Columbia Law School; former Chief Justice and Chancellor of Delaware; Of Counsel, Corporate Department at Wachtell, Lipton, Rosen & Katz. Mr. Strine speaks and writes frequently on corporate and public law, particularly the impact of business on society, and has been published in the Cornell Law Review, Duke Law Journal, Harvard Law Review, and Stanford Law Review, among many others.

Jaap Winter, Partner Phyleon Leadership and Governance, and Professor of Corporate Law, Governance and Behavior Vrije Universiteit Amsterdam, Former Chairman of the EU High Level Group of Company Law Experts and former partner of De Brauw Blackstone Westbroek.

Does a CEO Have a Duty to Lobby?

By Luigi Zingales

We need not only more disclosure, but also more work in alerting people in general (and students in particular) about the distortive effects of lobbying and the extent to which it takes place.

Editor's note: This article was first published in April 2016.

"To petition the Government for a redress of grievances" is a right inscribed in the First Amendment of the US Constitution. This right equally belongs to individuals, organizations, and corporations. Thus, a CEO has the right to use corporate resources to petition the government for a redress of any grievance her company might have. But does this right translate into an obligation? Does a CEO have a duty to lobby? Does this obligation follow from the shareholder value maximization principle, as Larry Fink seems to suggest in the Davos debate reported here?

If we limit ourselves to describing what businesses do (what we call positive economics), then the answer is obvious. Most CEOs lobby heavily. Not only do they do it, their main investors tell them to do so, as confirmed here by Larry Fink, CEO of Blackrock and one of the largest institutional investors in the world. They lobby not just to redress grievances, but to shape the rules of the game to their own advantage. Alphabet (Google) is not a regulated company (at least in the classical sense of the word), but it is one of the companies spending the most on lobbying. Why? Not only to defend the right to use the massive data it collects, but also to proactively shape the business environment in its favor. Whether one supports "net neutrality" or opposes it, they have to agree that net neutrality greatly favors Google, which fears being charged directly for the massive internet use it generates, while it penalizes telecom companies, which

cannot price-discriminate to recover the fixed costs of the network they build. Not surprisingly, Google lobbies very heavily in favor of net neutrality, while telecom companies lobby against it.

When economic giants fight among themselves, not only does the right to lobby fulfill a constitutional right, it is also efficient. This is what Nobel Prize winner (and late University of Chicago professor) Gary Becker thought: competition among lobbies leads to efficient outcomes[1]. Yet, for this result to be true two conditions need to be fulfilled. First, the different interests (or view points) should have equal ability to organize and finance their lobbying effort. As Mancur Olson (a Maryland economist who died too young to win the Nobel Prize) wrote, dispersed interests face a bigger hurdle in getting organized[2]. Thus, citizens interested in clean water have a harder time lobbying Congress than chemical companies who pollute it (see the DuPont case described). Second, lobbying is efficient if it is entirely dedicated to providing information to the legislator. While some lobbying certainly performs this role, not all of it does, as shown in this paper. If lobbying is (mostly?) about influencing rather than about informing, then it is a tantamount to an arms race, which leads to inefficient outcomes with too much lobbying[3].

Thus, under realistic conditions lobbying tends to be excessive from a social point of view: not only does it waste resources, but also might lead to the wrong decisions—favoring the strongest player, not necessarily the one with the most valid claim. If this is the case, then there cannot be an economic duty to lobby, at least not one based on sound economic principles, since this prescription would lead to outcomes that are inefficient.

This conclusion seems to contradict the traditional theory of the firm. If the goal of a CEO should be to maximize long-term shareholder value and lobbying does produce this outcome (see, for example, evidence that lobbying firms have higher returns), why shouldn't CEOs do so? Yet, in the famous piece where he advocates that firms should have a single-focused goal of maximizing shareholder value, Milton Friedman was very careful in stating the assumption that "the basic rules of the game" were off limits to firms. Thus, implicitly even Milton Friedman recognized that—when lobbying is present and effective—his prescription does not necessarily hold.

Then, the question is not whether firms have a duty to lobby but whether from an economic point of view the cost of putting restrictions on firms' lobbying activity (if this were constitutionally allowed) is superior to the potential benefits of these restrictions, with the understanding that–left to themselves—firms will lobby aggressively and probably lobby too much. Some people (including my colleague and friend Steve Kaplan) think that lobbying activity is a minor and inconsequential part of firms' activity. Thus, it is not worth changing our prescription for it. This belief is certainly supported by the absolute value of the amount spent in lobbying. Alphabet, a company with a $515 billion in stock market capitalization, spends only $17 million a year in lobbying. Why should this be such a big deal?

Yet, this conclusion relies heavily on a very narrow definition of lobbying. In reality, the amount of resources most firms spend in influencing public policy is much larger. It includes a big chunk of the advertising many firms do—otherwise, why would many firms with no consumer products, like ADM, engage in massive advertising? It also includes a lot of philanthropy, like many oil companies do to acquire brownie points with local communities in case of an oil spill. It includes also campaign donations and all the time and resources companies dedicate to help political candidates. During the last presidential

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1 *Becker, Gary. 1983. "A Theory of Competition Among Pressure Groups for Political Influence." Quarterly Journal of Finance 98(3): 371-400*

2 *Olson, Mancur. 1965. The Logic of Collective Action: Public Goods and the Theory of Groups. Cambridge: Harvard University Press*

3 *Tullock, Gordon. 1972. "The Purchase of Politicians." Western Economic Journal 10: 354-355.*

election, Google CEO Eric Schmidt offered technological help to the Obama campaign. Is it just a coincidence that the FTC commission appointed by his administration decided not to proceed with an antitrust case against Google, in spite of the favorable opinion of the FTC's research department?

If the definition of lobbying is broadened and the consequences are potentially so ominous, it is neither minor nor inconsequential. And if this were the case, it would be hard to argue that consumers can offset Google's lobbying. The call for papers that the Stigler Center (in conjunction with HBS) has launched tries to answer precisely these questions and to stimulate a debate on what should be done.

In the meantime, my modest proposals (which I advanced in my 2012 book A Capitalism for the People are as follows. Even if the Constitution allowed for laws to restrict corporate lobbying (and, in the United States after Citizens United, it does not), it would be a practically impossible task to achieve. Thus, one potential remedy is to introduce a progressive tax on lobbying expenditures. The proceeds of this tax could then be used to strengthen the advocacy of public interest groups, which are poorly coordinated and poorly financed, to level the playing field. This money could then be allocated to various groups using a voucher system, along the lines of Larry Lessig's proposal for campaign financing reform.

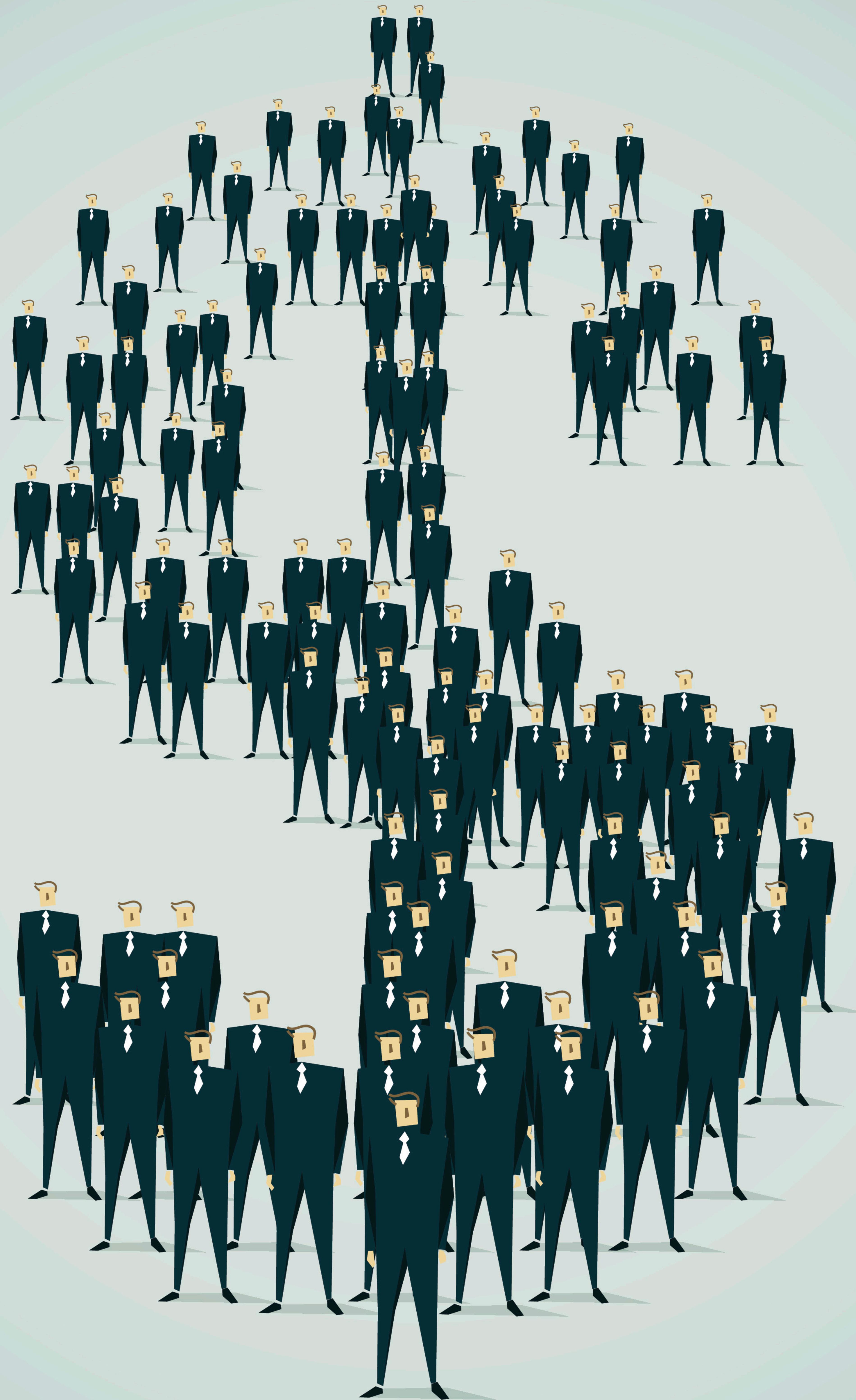
The second remedy is a combination of naming and shaming. Most people feel it is socially legitimate for a company to lobby to redress an injustice, like a higher tax rate that penalizes one company vis-à-vis the rest. At the same time, I suspect many people would feel uncomfortable with a company lobbying to protect an unjustified tax loophole that benefits it greatly (certainly I do). Thus, exposing excessive lobbying can play a role in mitigating it.

For this to take place, however, we need not only more disclosure, but also more work in alerting people in general (and students in particular) about the distortive effects of lobbying and the extent to which it takes place. Academia (and in particular business schools) should play a key role in this direction. This is one of the key missions of the Stigler Center.

With a clear social norm on what constitutes acceptable lobbying, the legal principles of corporate governance do not need to be changed. As I already discussed here, the American Law Institute's principles of corporate governance states that a CEO "may take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business" (emphasis added). Thus, there is no way a shareholder can sue a manager for breach of her fiduciary duty if the CEO does not undertake socially inefficient lobby.

Yet, who decides what is reasonable and responsible? Once again, Academia plays a big role here. Hence the importance of the conference we are organizing on this theme.

Luigi Zingales is the Robert C. Mc Cormack Distinguished Service Professor of Entrepreneurship and Finance at the University of Chicago - Booth School of Business. He is a Research Associate of the National Bureau of Economic Research, a Research Fellow of the Center for Economic Policy Research, and a Fellow of the European Corporate Governance Institute. His research interests span from corporate governance to financial development, from political economy to the economic effects of culture. He has published extensively in the major economics and financial journals. In 2003, Zingales received the Bernacer Prize for the best European young financial economist. In 2013 he has been named founding director of the Center for Economic Analysis of the PCAOB. In 2014 he served as President of the American Finance Association. He is co-author with Raghuram G. Rajan of "Saving Capitalism from the Capitalists" (2003) and author of "A Capitalism for the People: Recapturing the Lost Genius of American Prosperity" (2012). His latest book is "Europa o no" (2014).



Missing in Today's Shareholder Value Maximization Credo: The Shareholders

By Luca Enriques

Today's corporate world is very different from the one Milton Friedman wrote in. In a world where the question of whether managers should only aspire to maximize shareholder value is subject to fierce debate, the same question must be asked with regard to asset managers. The answer has some irony to it.

Fifty years after the publication of Milton Friedman's essay *The Social Responsibility of Business Is to Increase Its Profits*, the debate on whether directors and managers should only aim to maximize profits (or value) for shareholders rages on.

In a corporate world where institutional shareholders have taken center stage, this old question must similarly be asked with regard to asset managers. Where passive portfolio value maximizers dominate the scene, socially responsible corporate behavior may become more common based on premises that are, on their face, fully consistent with Friedman's framework.

Like other participants to this debate, before moving on I will summarize Friedman's *New York Times* essay.

What Friedman's Essay Says

As Alex Edmans has noted,

> *"Friedman's article is widely misquoted and misunderstood. Indeed, thousands of people may have cited it without reading past the title. They think they don't need to, because the title already makes his stance clear: companies should maximize profits by price-gouging customers, underpaying workers, and polluting the environment."*

That is not, of course, what Friedman wrote. According to Friedman:

1. Talking about the "social responsibility of business" makes no sense because the responsibility lies with people. Public corporations are legal persons and may have their responsibilities, but they act through their directors and managers. Therefore, attention must be focused on the responsibilities of such players.

2. Managers are employees of corporations, which in turn are owned by their shareholders. Therefore, managers must act in accordance with the wishes of the shareholders. Unless the shareholders themselves explicitly determine an altruistic purpose, this means "conduct[ing] the business in accordance with [shareholders'] desires, which generally will be to make as much money as possible while conforming to their basic rules of the society, both those embodied in law and those embodied in ethical custom."

3. If managers also had a social responsibility, they would find themselves in the position of having to act against the interests of shareholders, for example by hiring the "hardcore" unemployed to combat poverty instead of hiring the most capable workers. By doing so, they would spend shareholders' money to pursue a general interest. In other words, they would impose a tax on shareholders and also decide how to use its proceeds. Yet, it is countered, if there are serious and urgent economic and environmental problems, then it is necessary that managers face them without waiting for politicians' action, which is always late and imperfect. According to Friedman, it is undemocratic for private individuals using other people's money (and, importantly, exploiting the monopolistic rents of the large corporations they lead) to impose on the community their political preferences on how to solve urgent economic and environmental problems, which should instead be addressed through the democratic process.

4. The market is based on the unanimity rule; in "an ideal free market," there is no exchange without the consent of those who participate in it. Politics, on the other hand, operates according to the conformity principle, whereby a majority binds the dissenting minority. The intervention of politics is necessary because the market is imperfect. But the social responsibility doctrine would extend the

mechanisms of politics to the market sphere, since a private subject (enjoying some monopoly power) would impose its political will on others.

5. Often, the idea of corporate social responsibility (CSR) is just a public relations exercise to justify managerial choices already consistent with the interests of shareholders. Looking after the well-being of employees, devoting resources to the firm's local communities, and so on may well be (and, as a rule, will be) in the long-term interest of corporations. Indeed, cloaking these actions under the label of CSR, as it was fashionable to do in 1970 (and is again today), can in itself contribute to increasing profits.

Missing from Friedman's Picture: The Shareholders

Friedman's essay assigned a totally passive role to what he calls the corporation's "owners" or "the employers"—that is, the shareholders. They are merely the beneficiaries of directors' duty to increase profits, but they have no role to play in pursuing that very goal other than (as he notes in passing) when they elect the board.

That's understandable. When Friedman wrote his piece, the shareholders of US companies were mostly individuals and rarely voted at annual meetings other than to rubber-stamp managers' proposals. Today, a large majority of listed firms' shares are held by institutional investors—that is, managers of other people's funds. Institutions have become key players at US (as well as non-US) listed corporations (e.g., this OECD study with data from across the world), because they regularly vote portfolio shares at shareholder meetings. And their pro-management vote is nowadays anything but certain.

This creates one additional layer of employee/employer relationships, to use Friedman's terminology (today, we would say principal/agent relationships): the one between the institutions holding shares or (as Friedman saw it) their own managers, and the individuals (usually workers and pensioners) whose funds the managers invest. (To be sure, it is often more complicated than that because some institutions, such as pension funds, often delegate their assets management to other institutions; but this is not relevant for the purposes of my analysis).

Friedman's essay raises the question: is there any room for asset managers to assume social responsibility duties in deciding how to invest and how to vote? In Friedman's logic, the answer should be "no," and it's easy to imagine that he would chastise those fund managers who portray themselves (not always veritably) as socially responsible investors. Like corporate managers, fund managers manage other people's money and should not grant themselves the license to make political choices, which will inevitably please some of their beneficiaries and not others. Their only goal should be giving their clients the highest returns on the funds invested.

Of course, much like a corporation can be set up with an altruistic (or mixed) purpose, so can asset management products expressly be marketed as socially responsible or ethically-investing. Intuitively, investors in such funds expect them to invest and vote in accordance with the socially responsible commitments undertaken. But absent a CSR connotation—namely, if the mutual fund has been marketed as a tool for generating financial returns—fund managers have to assume that the fund's investors have a financial objective in mind and do not expect their own political preferences to be promoted by their fund manager, especially if that comes to the detriment of their return. Whether implicitly or explicitly, that's the bargain with each of the fund shares buyers.

However, things are not always so straightforward. Passive institutional investors replicating indexes and, therefore, holding the entire market rather than picking stocks now hold more than 40 percent of the US stock market. As Madison Condon and Jack Coffee have noticed—here and here, respectively—for investors of that kind, portfolio value maximization may well mean pushing for ESG (Environment, Social and Governance) policies at the individual company level that, while not necessarily profitable for that company, will increase portfolio returns by making other companies more profitable. Think, for instance, of systemically important financial institutions adopting more conservative risk management policies that significantly reduce the chances of a potentially devastating financial crisis.

Hence, the overlap between socially responsible and profit-maximizing behavior, which Friedman himself acknowledged to be present at the individual company level and criticized only as being politically dangerous, is now even more pervasive at the institutional shareholder level.

In theory, all portfolio value maximizers' decisions on ESG matters should be based on an assessment of the effects that the adoption of a given policy by an individual portfolio company would have, both on its value and on the value of the totality of other portfolio companies. Because ESG policies require widespread adoption to be effective, different scenarios will have to be elaborated and factored in to estimate those effects. Multiple other variables will have to be considered and a number of questionable assumptions made.

Passive investors, like any organization, are unlikely to have the human and financial resources to fully engage with this kind of assessment, let alone reach solid conclusions. And it would be naïve to assume that political preferences do not affect the simplified analysis they inevitably resort to in determining their ESG preferences.

Owing to shareholder pressure and/or managers' desire to retain their jobs, the ESG preferences of portfolio value-maximizing institutions may well trickle down to the individual portfolio company level. Under what conditions that is the case will depend on a number of factors, including whether the company is protected from competition, undiversified shareholders' stakes in the company, how politically divisive the socially responsible action is, and so on. Yet in some cases, and in respect of some of the socially and politically sensitive issues, managers will yield to those preferences. Given Friedman's premise that "increasing profits" must be the only corporate goal because the shareholders are the owners/employers, there is some irony to that.

Irony aside, today's corporate world is very different from the one Milton Friedman wrote in. Yet, his essay still provides a useful framework for understanding the implications of managing companies for one purpose or another. And perhaps also for answering the reframed question of whether corporate managers should cater to the preferences of their portfolio-value-maximizing indexing investors when making decisions on behalf of their corporations.

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Luca Enriques is a Professor of Corporate Law at the University of Oxford Faculty of Law. He is a European Corporate Governance Institute (ECGI) Research Fellow, a member of ECGI's board, a Fellow Academic Member of the European Banking Institute, and one of the founding academic editors of the Oxford Business Law Blog.

Pursuing Stakeholder Capitalism Is an Impossible Task When Stakeholders Have Different Beliefs

By Marc Painter

Can companies really attempt to benefit all stakeholders, when stakeholders rarely agree on the best course of action? A new study examines Walmart's 2019 decision to enact some gun control measures in its stores and finds that the customer response to Walmart's statement differed sharply along partisan lines.

The job description of a CEO was turned on its head last year when the Business Roundtable promised "to lead their companies for the benefit of all stakeholders—customers, employees, suppliers, communities and shareholders."

The new view complicates the CEO's already difficult job– to maximize profits for shareholders. Though endorsed by some (including Joe Biden), others have commented that the statement is "at best misleading marketing, at worst a dangerous power grab."

If we take the Business Roundtable at their word, will they even be able to achieve their new purpose? My research shows that the goal of "stakeholder capitalism" is an impossible task when stakeholders hold

different values.

I focus on the customer response to Walmart's decision on September 3, 2019 to discontinue sales of certain gun ammunition, ban open carry in stores, and encourage congress to enact stronger gun control policies. These decisions were made directly after a mass shooting that killed 23 people occurred at a Walmart in El Paso, Texas. Walmart's statement also follows a long history of public scrutiny over the firm's policies toward guns.

Gun control is one of the most divisive social issues in America today. Survey evidence from Pew Research Center shows that Republicans are nearly four times as likely—relative to Democrats—to believe that protecting gun rights is more important than gun control. Walmart's customers are ideologically diverse, making it difficult to follow the Business Roundtable's goal of delivering value to all stakeholders when wading into a topic as polarizing as gun control.

To study how customers respond to Walmart's stance on guns, I use smartphone geolocation data from SafeGraph, which allows me to compare how foot traffic to Walmart varies relative to competitors around the release of the retail juggernaut's statement on guns. The granular nature of the data allows me to see customer reactions that would be undetectable in aggregate sales data. I join the geolocation data with county vote records in the 2016 presidential election to see whether the customer response is different in Democratic versus Republican areas.

I find that store visits to Walmart decreased by 3.3 percent relative to competitors after Walmart's gun control statement, suggesting that customers overall were not thrilled about the store's new policy. I also find that the customer response to Walmart's statement differed sharply along partisan lines. Walmart stores located in highly Democratic counties saw an increase in foot traffic of 3 percent, while those in highly Republican counties had a decline of over 8 percent.

I find mixed evidence regarding whether the change in consumer behavior is temporary or permanent. Figure 1 shows the aggregate response to Walmart's statement over time by comparing the change in foot traffic at Walmart to the foot traffic at their local competitors' stores. Customers overall had a sharp negative reaction to the gun control statement, but aggregate foot traffic was back to normal after three months.

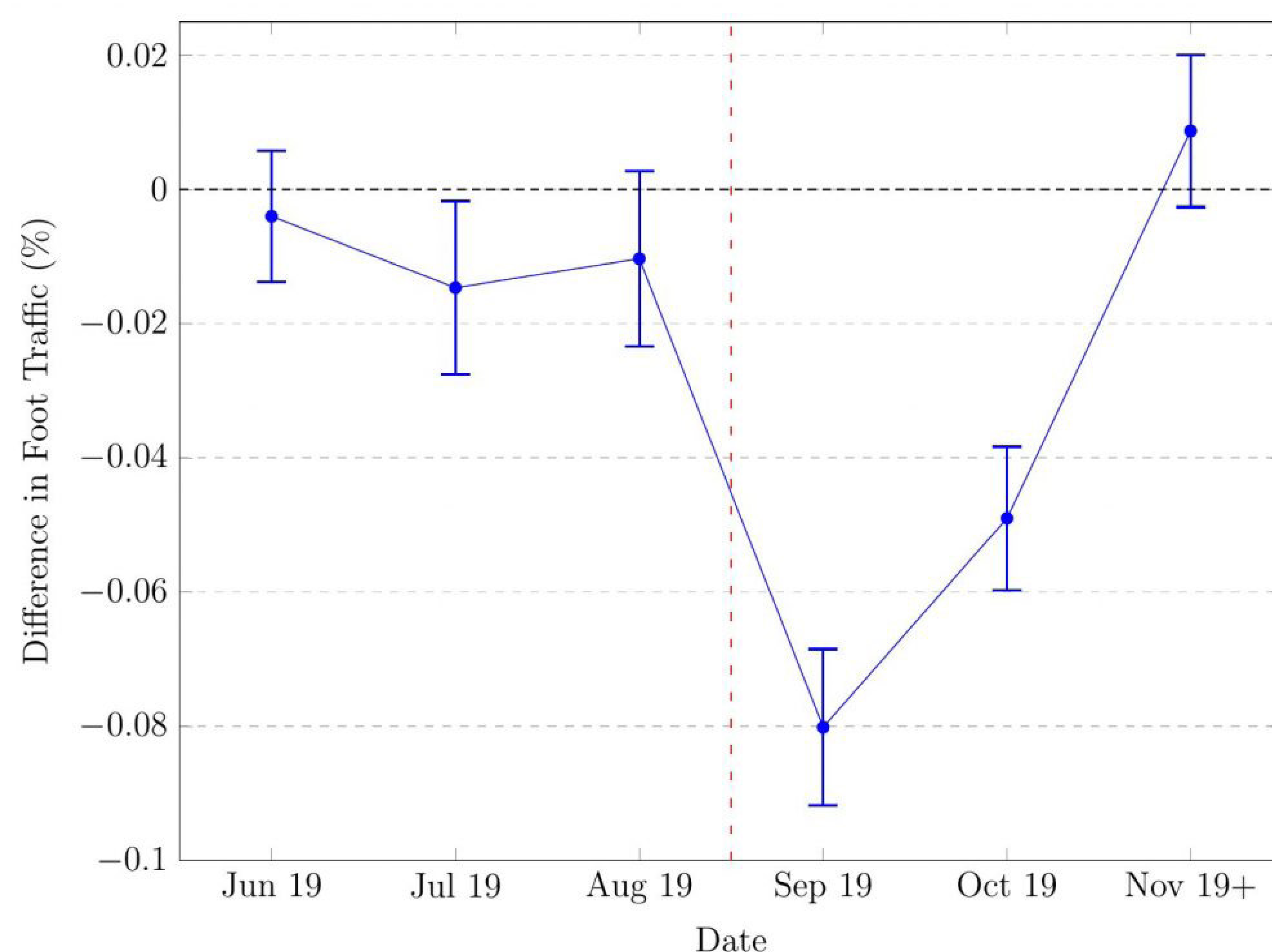

Figure 1: Aggregate Customer Response to Walmart's Gun Control Stance

However, stores in highly Republican counties saw a persistent decline in foot traffic, as shown in Figure 2. The month after Walmart's statement, the change in foot traffic to Walmart stores in highly Republican areas was 18 percent lower relative to competitors. Foot traffic stayed lower as far as five months later, when foot traffic was 8 percent lower. These results suggest that political statements made by firms can permanently alter the shopping habits of consumers with strongly opposed views.

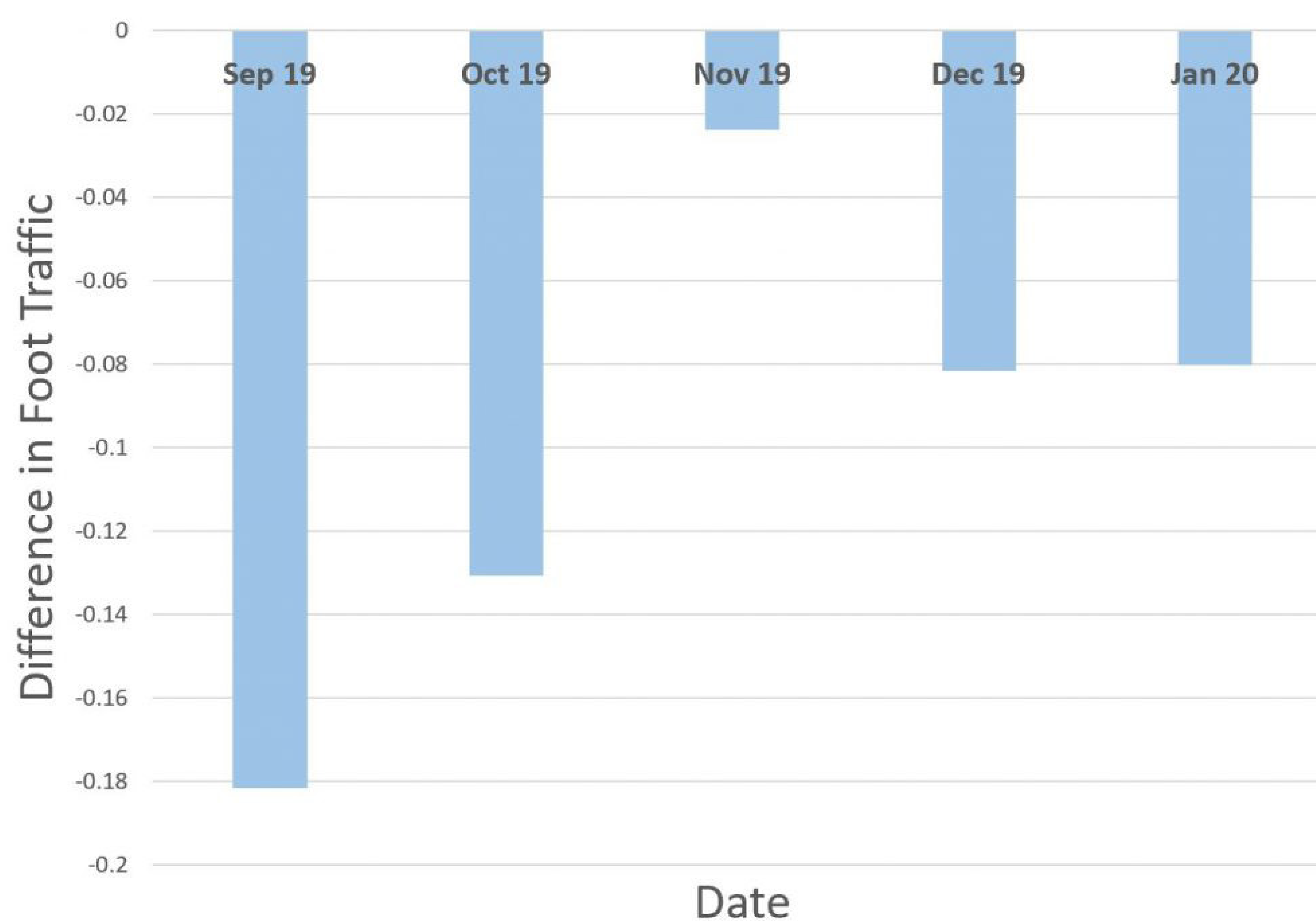

Figure 2: Change in Foot Traffic to Walmart in Highly Republican Counties

What can we learn from Walmart's attempt at stakeholder capitalism? If Walmart CEO (and Chairman of the Business Roundtable) Doug McMillon's goal was to take a stance on gun control while maintaining the same level of foot-traffic to stores, it appears this goal was eventually achieved, as most customers reverted to the normal shopping habits a few months after the statement. However, if McMillon's goal was to benefit all stakeholders—the stated purpose of the Business Roundtable—it is difficult to see the new policy as a success as the gun statement caused a significant portion of customers to permanently reduce their shopping at Walmart.

My results highlight how a corporate stance on social issues can decrease the value of a firm to some stakeholders while increasing value for others. Though gun control is a particularly divisive topic, it will be rare to find a social issue where all stakeholders agree. Consequently, businesses attempting to pursue stakeholder capitalism will struggle to deliver equal value when stakeholders have different beliefs.

Marc Painter is an Assistant Professor of Finance at the Richard A. Chaifetz School of Business, Saint Louis University.

Which Problems Should Companies Try to Solve?

By Sanjai Bhagat, R. Glenn Hubbard

It is true that capitalism needs to be inclusive in its benefits, but 50 years on, Friedman's shareholder primacy remains the right place to start.

Editor's note: The following article has originally appeared in the AEIdeas blog.

In the midst of economic calamity and the pandemic, capitalism is under fire. Present important debates over inequality of opportunity and outcomes, reinvigorating communities, and addressing challenges from globalization to technological change to climate change to broader social justice come together in

questions for our economic system: What should businesses and their leaders be doing? For whom is the corporation run? For whom should it be?

Emotions are running high on these questions. One recent salvo came from the CEO-led Business Roundtable (BRT) in 2019. After acknowledging "Americans deserve an economy that allows each person to succeed through hard work and creativity…" and the "vital" role businesses play, the CEOs committed their firms' allegiance to *stakeholders*. Those stakeholders are customers, employees, suppliers, communities, and shareholders. Seemingly different from the organization's 1997 affirmation of shareholder primacy, the new statement elicited praise and howls when it emerged. The current environment of social and political discord only highlights the pressure on companies.

To some, the BRT's restatement struck a chord. Intones Darren Walker, the influential president of the Ford Foundation: "It will require that corporations operate, in the words of the BRT, 'for the benefit of all stakeholders…" Politicians from Senator Elizabeth Warren to Senator Marco Rubio have joined the stakeholder chorus. By contrast, writing with former Secretary of State George Shultz, Stanford economists Michael Boskin, John Cogan, and John Taylor recently wrote: "The [BRT] statement lends credence to an incorrect view of the way American business operates in today's economy… and it fails to consider the practical, real-world, adverse consequences of demoting shareholders' interests…"

And now for something different: "… 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…" Front and center in this fight for the future of the capitalist corporation—or, at a minimum, the elephant in the room—is the late Nobel laureate in economics Milton Friedman, who famously uttered these words against earlier stakeholder views 50 years ago this year. *Shareholders* rule.

But, while these issues are important, Friedman's argument still has stood the test of time well —with a few twists—50 years on.

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Busy buzzing about what firms should do was present in Friedman's day, too, and motivated him to weigh in. What is the 'purpose' of the corporation? Whose interests are corporate leaders—managements and boards—supposed to advance and maximize? How do corporate leaders trade-off interests of stakeholders in making business decisions? Is the corporation the right vehicle for addressing social concerns?

There's a back story here: Departing from the owner-managed enterprises of earlier times, capitalism in the twentieth century featured managers as leaders of large corporations with many diverse shareholders. Managers run the corporation on behalf of shareholders represented by a board of directors. Without proper monitoring and rules of the road, managers may pursue other objectives than the long-term value of the enterprise for its owners —shareholders. Such concerns rose to prominence among both economists and business leaders in the 1960s and 1970s.

It was against this backdrop that, seeking to re-center the debate over the corporation's objectives, Milton Friedman fired a broadside not from an esoteric academic outlet but from the Sunday Magazine of *The New York Times*. Essentially, the business of the corporation is maximizing its value for shareholders. Managers and boards owe a duty to shareholders, full stop, to maximize their value in the firm. Of course, shareholders could use the profits of the corporation for social purposes if they wished, less wastefully than if management pursued such activities with, perhaps, more self-interest on its part. (For example,

Bill Gates, having founded a very successful company, Microsoft, now uses his share of the profits from this company to engage in significant philanthropic activities across the globe.) And, other stakeholders—workers, customers, suppliers, and the broader society—must be treated equitably to ensure their willingness to engage with the firm—and government policy still constrains the corporation's use of assets and business practices.

Friedman insisted that the corporation should focus on doing just one thing. The economist in us sees a more nuanced picture with trade-offs. What if a corporation has one goal, but that goal is multi-faceted? What if shareholders want the corporation to maximize profit, but they also care about corporate social responsibility? For example, what about corporate sponsorship of non-profit and charitable activities in neighborhoods populated by the company's employees? The corporation should embrace that corporate social responsibility if by doing so it can trade-off profits and social good better than individual shareholders can. That becomes a way to unlock hidden value for shareholders. A fair point, but a minor change to Friedman's basic one.

Less fairly, Friedman's shareholder focus has been taken to mean a focus on 'short-term' value alone. One can imagine actions Acme Co. may take to bolster its short-term value at the expense of the long-term value or viability of the enterprise. But that wasn't Friedman's intent. Interpreting Friedman as emphasizing the maximization of the long-term value of Acme Co. for its shareholders gives the board of directors the leeway to evaluate management on its stewardship and growth of the firm's value over time. While excessive managerial "short-termism" in corporations is the subject of disagreement, nothing in Friedman's dictum precludes a focus on the long term for shareholder value maximization.

Also unfair is the idea that a focus on long-term shareholder value maximization means poorly treating other stakeholders or, worse, taking away value rightfully theirs. Friedman acknowledged these points explicitly: "… it may well be in the long-run interest of a corporation that is a major employer in a small community to devote reso urces to providing amenities to that community…" He goes on to explain that resulting social goodwill is "… a by-product of expenditures that are entirely justified in [the business'] own self-interest."

There are, to be sure, legal or regulatory constraints on what corporations' leaders and boards of directors can do. But going further, managers and directors acting in shareholders' interest will want to preserve valuable relationships with employees, customers, communities, and the public. They will do so when the firm and shareholders can capture the value of those relationships. So today's critics overstate the tension—we can square the circle of Friedman's advice and calls for stakeholder capitalism.

Yes, but: What if the value of these relationships *can't* be fully captured by the firm investing in them? For example, what if an employer makes major investments in training its employees only to see them leave to accept a job at a competing firm? What if a corporation's investments in its community are met by free-riding by other firms? OK, but we can fix these twists by subsidizing training in the tax code, just as we do for R&D, which also generates spillovers. And corporations can band together in communities, working with, say, a local community college on training. These are not problems completely solvable by an individual corporation on its own.

Even when the corporation can't capture value in all trade-offs among stakeholders, it's not usually in shareholders' interest. Friedman realized that the very existence of the modern corporation and its freedom to engage in commerce are in social constructs. Caring about broader social concerns is not just an

exercise in 'corporate social responsibility,' as meritorious as that activity may be, but a realization that a lack of such concerns can weaken *social* support for corporations' economic foundation. Today's anti-capitalism protests highlight that idea for corporate leaders.

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So how do Friedman's arguments look 50 years on? Answering calls for stakeholder corporate governance, Friedman today might pause with an 'Ahem.' The first rejoinder is practical. It is difficult to maximize more than a single objective. Consider the stakeholder perspective of "delivering value to our customers." A company like Apple can improve value to current customers by selling its high-quality products at a fraction of current prices, to higher market share and happier customers. In the long run, if Apple continues to maintain or increase the quality of its products, it may face financial difficulty. In other words, focusing on just the short-run value to customers is not a long-term sustainable practice.

The second goes to the core of governance. Who monitors the stakeholder monitor? It is *this* concern that animated Friedman's 1970 contribution: "The whole justification for permitting the corporate executive to be selected by the stockholders is that the executive is the agent [employee] serving the interest of his [or her] principal [the shareholders]. This justification disappears when the corporate executive imposes taxes and spends the proceeds for 'social purposes'... If they are to impose taxes and make expenditures to foster 'social' objectives, then political machinery must be set up to guide the assessment of taxes and to determine through a political process the objectives to be served." Friedman, and later Shultz and colleagues, invoked the 's' word — socialism — in response to this stakeholder challenge.

Is it really so simple? Well, yes and no (We are economists, after all!). Yes, Friedman anticipated these arguments; his idea of shareholder value maximization generally works just fine despite them. But no, today's complex markets and rules require more qualifications. Differences arise mainly from a lack of competitive product or labor markets or from different time horizons among stakeholders.

Friedman had competitive labor and product markets in mind when recommending shareholder value maximization. When labor markets are competitive, companies must compensate their employees fairly at market levels and treat them well, else the employee will go elsewhere. Companies with a reputation for recruiting and treating their employees well (poorly) will find it easier (more difficult) to attract and retain higher caliber employees. Similarly, in competitive markets for the firm's products or services, companies will lose customers to competition (and, ultimately go out of business), if they are not able to provide those customers with attractive products or services.

What if shareholders or managers place greater emphasis on short-term corporate performance? Stakeholders, especially those concerned about the environment, may be more focused on the long-term impact of a company's actions. Even here, the remedy does not have to wander far from shareholder value maximization if we add a wrinkle: The long-term negative impact on the environment could lead to a negative impact on the company's long-term share price via costs of litigation and adverse effects on its reputation. If managers' and directors' incentive pay is appropriately focused on the long-term share price, then managers and directors will be discouraged from engaging in actions that impair long-term shareholder value.

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These thoughts take us to perhaps the biggest question in today's debates: *Which* problems should companies try to solve? We've seen that many stakeholder interests, including shareholder interests, can be

accomplished by a board of directors engaged in maximizing long-term shareholder value. Directors may use their business judgment to allocate value to non-shareholder stakeholders if directors believe that so doing will enhance *long-term* corporate business success, value, and reputation. As an example, openness to all talent and concern for communities almost certainly serves shareholder interests as well as social justice.

Martin Lipton, a founding partner of corporate law giant Wachtell, Lipton, Rosen & Katz, and colleagues push back that the shareholder-value maximization model of corporate governance is politically and commercially unsustainable in view of the acute challenges confronting this generation. Yet Lipton's own corporate "new paradigm" would allow corporate boards the wide latitude to advance the long-term interests of the firm we described above.

There is a rub, and Friedman anticipated it: While long-term shareholder value maximization can balance trade-offs among other corporate stakeholders, it can't address *all* problems faced by the firm. Some social problems are even more complex than Friedman imagined. Climate change, for example, poses significant challenges for societies and businesses to reduce carbon in the atmosphere and greenhouse gas emissions, as well as to adapt to evolving changes in surface temperatures. Investors could and should press corporations to disclose more information about the exposure of their long-term value to climate change, and corporations may act to reduce emissions and increase their adaptability in service of a focus on long-term value maximization. That step is an extension of a market process and response. But that step alone will not resolve climate change. Significant changes to combat climate change require *public policy* changes in the United States and abroad— a carbon tax or alternative-energy technology subsidies, for example. Turning more to corporations alone simply because the political process seems broken and makes little progress won't do.

Friedman recognized this very point, referring to "problems … too urgent to wait on the slow course of political processes, that the exercise of social responsibility by business[people] is a quicker and surer way to solve pressing problems." In his view, such an appeal is undemocratic. Of course, this deference to democratic politics does not mean that corporations and their leaders shouldn't focus on their firms' sustainability as BlackRock's Laurence Fink and Bank of America CEO Brian Moynihan have recently and persuasively observed in the context of climate change.

There are other instances when public policy is required to alter what's in the interest of shareholders. Examples include laws to limit abuse of market power; rules to enhance firms' competition for employees and eliminate discrimination; and tax policy to affect corporate profitability, location decisions, wages, or incentives to invest. These policies address social objectives that would not, in some cases, be pursued by individual firms. But even in such cases, public policy interventions complement, not substitute for, long-term shareholder value maximization.

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The modern corporation has been an enormously productive societal and organizational invention. Milton Friedman credited that success with the corporate objective of maximizing the company's shareholder value, while conforming to applicable laws and regulations. That capitalism needs to be inclusive in its benefits is also true, and invites a public policy agenda for opportunity—one in which business leaders' voices should be present. But 50 years on, Friedman's shareholder primacy— long-run shareholder value maximization—remains the right place to start, even if it is not the end.

Sanjai Bhagat is a professor of finance at the University of Colorado.

R. Glenn Hubbard is a visiting scholar at the American Enterprise Institute and dean emeritus and the Russell L. Carson Professor of Economics and Finance at Columbia Business School.

A Challenge for Stakeholder Capitalism: Solving the Paradoxes of Voting

By John G. Matsusaka

If corporations are to maximize shareholder welfare, managers need to discover what shareholders value; political theory shows how difficult this can be.

One of the virtues of wealth maximization is its simplicity. Managers do not need to know anything about the preferences of investors when making decisions, they simply adopt all projects with a positive net present value.

In contrast, maximizing shareholder welfare would require managers to know the preferences of shareholders. For example, are they willing to give up 10 percent of profit in order to reduce greenhouse gas emissions? And it would require a way to adjudicate differences of opinion. What does Walmart do if some shareholders want to stop selling guns while others want to continue gun sales?

The comments in this series often mention the complexity of decision-making if managers were charged to maximize shareholder welfare (or stakeholder welfare), but the problem is even more complex than sometimes is recognized. Here, I would like to flag some challenges that have been identified by political

economy research and offer thoughts on how they might be addressed.

Challenges

To maximize shareholder welfare, managers somehow would have to aggregate the preferences of individual shareholders into a "social welfare function" that can be maximized. One aggregation procedure, for example, would be to determine preferences by voting, allowing each share one vote, and let the majority rule.

1. The first challenge is Arrow's Impossibility Theorem, proved by Nobel economist Kenneth Arrow in 1951, which shows that it is impossible to aggregate preferences in a way that does not violate at least one of a small number of basic decision principles. These principles include: one person's preferences do not always determine the outcome (non-dictatorship), if every person prefers option A to option B then option A is selected, and preferences over irrelevant alternatives do not affect the outcomes.

The theorem is difficult to explain in plain English but is recognized by theorists as the starting point for analysis of collective decisions. Its scope is far-reaching. It is not that we haven't yet figured out a coherent way to aggregate preferences; it is that a coherent solution does not exist: every collective decision process must violate at least one of the basic principles. Charging managers to maximize shareholder welfare would ask them to solve a problem that has no solution.

2. A second important insight pertains to voting, which likely would be part of any process of maximizing shareholder wealth. The Gibbard-Satterthwaite Theorem, proven in the 1970s by a philosopher and an economist, shows that almost all voting systems are subject to strategic voting. That is voting in which people do not select their top choice. A simple example, familiar to most readers, is a three-candidate race in which only two candidates are viable. A voter who prefers the third candidate might not vote for that candidate but rather strategically choose one of the top two. The importance of the theorem is that companies cannot rely on voting to accurately reveal preferences.

3. Another concern is the power of agenda control in determining the outcome of elections. The person who decides what is to be voted on, and in what order, has tremendous power to influence the outcome. One of the key theorems in this regard is that if the issues are two-dimensional or more and voters disagree over the options, by arranging the order in which options are decided (taking a vote on A vs. B, followed by the winner vs. C), the person with agenda control can induce any possible outcome. To prevent this sort of manipulation, legislatures impose extensive procedural constraints on their decision processes. It would be necessary to restrict managers' control of the voting agenda as well.

4. Finally, there is "capture theory," the problem of interest groups' influence, which can be traced to an article by Nobel economist George Stigler in 1971 that emphasized the vulnerability of democratic systems to influence by wealthy and/or organized groups. In the public sector, capture occurs when elected officials and their appointees are susceptible to lobbying, revolving doors, and campaign contributions. In a corporate environment where directors and managers were charged to make political tradeoffs, similar channels of influence could well emerge. This problem is mitigated if voters are fully informed, but many investors are now passive owners, with little incentive to collect information, and few are confident that proxy advisors can cover for the information deficit. We already have some evidence that organized groups such as unions and public pensions are able to use shareholder proposals to advance narrow objectives.

Paths Forward

Despite these theoretical challenges, countries are able to function more-or-less effectively with democratic systems (although, many would say they skew toward "less" these days). Political theory points to some possible paths around these challenges.

Even though theory suggests that voting outcomes are unreliable indicators of voter preferences, there is one special exception. May's Theorem, proved by mathematician Kenneth May, shows that voting accurately represents preferences and avoids the Arrow problem when there are only two choices and the winner is decided by majority rule. One path out, then, may be voting on issues for which there are only two essential options, usually called "referendums" in the political context. The obvious limitation is that many issues are not binary in nature—one can imagine a host of climate abatement strategies or an election with more than two candidates—and forcing them into a binary choice would allow the agenda controller to induce an outcome. Nevertheless, there may be some issues that naturally resolve themselves into two broad options.

To solve the challenge of manipulation by agenda control, the agenda can be constrained in advance. Perhaps the simplest way would be to require a specific action in the corporate charter, such as Patagonia's commitment to contributing one percent on net revenue to organizations promoting environmental conservation and sustainability. A more flexible approach would be to require yes-or-no shareholder votes on certain issues. States and cities require voters to approve actions such as issuance of debt, authorization of a casino, and school district budgets. One could imagine a progressive company's charter requiring a shareholder vote before investing in a country listed as a human rights violator by international organizations, or to get shareholder approval before testing products on animals.

What does this mean for the bottom line: is shareholder or stakeholder capitalism feasible or not? Steve Kaplan's argument in this series is compelling: the current system of shareholder value maximization has served us well, and should not be replaced without a strong sense that there is a superior alternative. At the same time, Hart and Zingales are right that there ought to be space for investors to create and operate companies that pursue social goals if that is what they prefer. The lesson I would take away is that it may be possible to implement stakeholder capitalism, but we would need to know in more detail how the collective decisions would be made, and how the known challenges to collective welfare maximization would be addressed.

John G. Matsusaka is the Charles F. Sexton Chair in American Enterprise at the University of Southern California (Marshall School of Business, Gould School of Law, and Department of Political Science), and author of Let the People Rule: How Direct Democracy Can Meet the Populist Challenge (2020).

The Real Effects of Environmental Activist Investing

By S. Lakshmi Naaraayanan, Kunal Sachdeva, Varun Sharma

A new study examines the efficacy of climate-focused investor engagements initiated by the New York City Pension System. Its findings support the view that long-term shareholders—through environmental activist campaigns—improve firms' environmental impact and indicates that such campaigns could be an effective tool for shareholders to address climate change risks.

Scientists warn us that climate change is the greatest challenge facing humanity in the foreseeable future. Mounting evidence suggests that climate change poses a significant risk for firm profits, capital markets, and households. Given this, investors are increasingly concerned about the long-term viability of their investments. In responding to such concerns, large institutional investors, including pension funds, have resorted to putting pressure on companies to consider and address climate change risks adequately.

Against this backdrop, understanding the willingness and ability of long-term investors to influence a corporations' environmental impact is important. It informs policymakers who are increasingly trying to understand the impact of funds pursuing a non-financial objective. For example, the Department of Labor recently proposed new rules that restrict retirement accounts' such that it would be, "…unlawful to sacrifice returns, or accept additional risk, through investments intended to promote a social or polit-

ical end."

Ultimately, research on the efficacy of climate-focused engagements brings us one step closer to understanding the costs and benefits associated with corporations having a social purpose.

In our paper *The Real Effects of Environmental Activist Investing*, we study one such climate-focused engagement initiated by a large pension fund system. We ask whether these campaigns can affect the environmental impact of firms. If so, what are these effects, who benefits, and what are the costs of such engagements to firms? To answer these questions, we focus on the Boardroom Accountability Project (BAP), an initiative of the New York City Pension System (NYCPS) aimed at addressing climate change risks through engagements.

The BAP is a socially motivated activist campaign initiated by the NYCPS and focused on improving portfolio companies' sustainability characteristics. The campaign brought together two other influential investors: the California Public Employees' Retirement System (CalPERS) and the California Teachers' Retirement System (CalSTRS). While the BAP targeted firms for distinct mandates, we focus on firms targeted for failing to adequately address climate change concerns, which was one of their most significant mandates.

Our results support the view that long-term shareholders, through environmental activist campaigns, improve targeted firms' environmental impact. Using plant-level data, we find that plants of targeted firms reduce their toxic chemical releases, that are harmful and cancer-causing. Moreover, following the targeting campaign by the BAP, we see a significant reduction in emissions of lethal greenhouse gases that contribute to global warming. These improvements benefit the surrounding areas of the targeted firms, with air quality improving within a one-mile radius of targeted plants. These improvements suggest potential important externalities to local economies, perhaps due to these investors engaging in environmental activism.

Evaluating the measures undertaken to achieve these improvements, we find that firms incur costs along two dimensions: They adopt operation-related initiatives and invest in abatement technologies. This increase in expenditures is not perfectly offset by financial benefits, at least in the short run. It is possible that these benefits, such as customer acquisition and retention, or a lower cost of capital, may take time to materialize and offset the costly investments in abatement technologies. These results shed light on the fundamental cost-benefit tradeoff that firms face when incorporating stakeholders in their decision-making.

At its core, our research brings nuance to the basic tenet of the economic theory that a firm should maximize shareholder value. It shows that shareholder engagements can benefit the firm, its stakeholders, and society.

Relatedly, our findings have implications for current debates on stakeholder welfare, which questions the recent shift towards "Stakeholderism." Moreover, our study suggests that shareholders can impose their pro-social preferences on firms and provides investors and asset managers a useful framework for engaging in responsible investment. Further, our results provide direct evidence that institutional investors' engagements provide a countervailing force to parts of the market that are difficult to monitor and regulate.

To elaborate on our paper, we use the BAP as a setting to understand whether long-term shareholders can affect their targeted firms' environmental impact. Our study compares plants of targeted firms to the plants of similar firms. We ensure that the comparison firms are in the same industry and have similar financial characteristics and sustainability performance. These comparisons of similar firms rule out factors such as industry-wide shocks as explanations for the changes in environmental performance that we capture. This allows us to attribute the changes to environmental activism.

To accurately measure and identify the effects of climate-focused engagements, we rely on administrative data from the Environmental Protection Agency (EPA, the Energy Information Administration (EIA), and commercial datasets. This helps provide a complete picture of the changes in corporate environmental behaviors of firms.

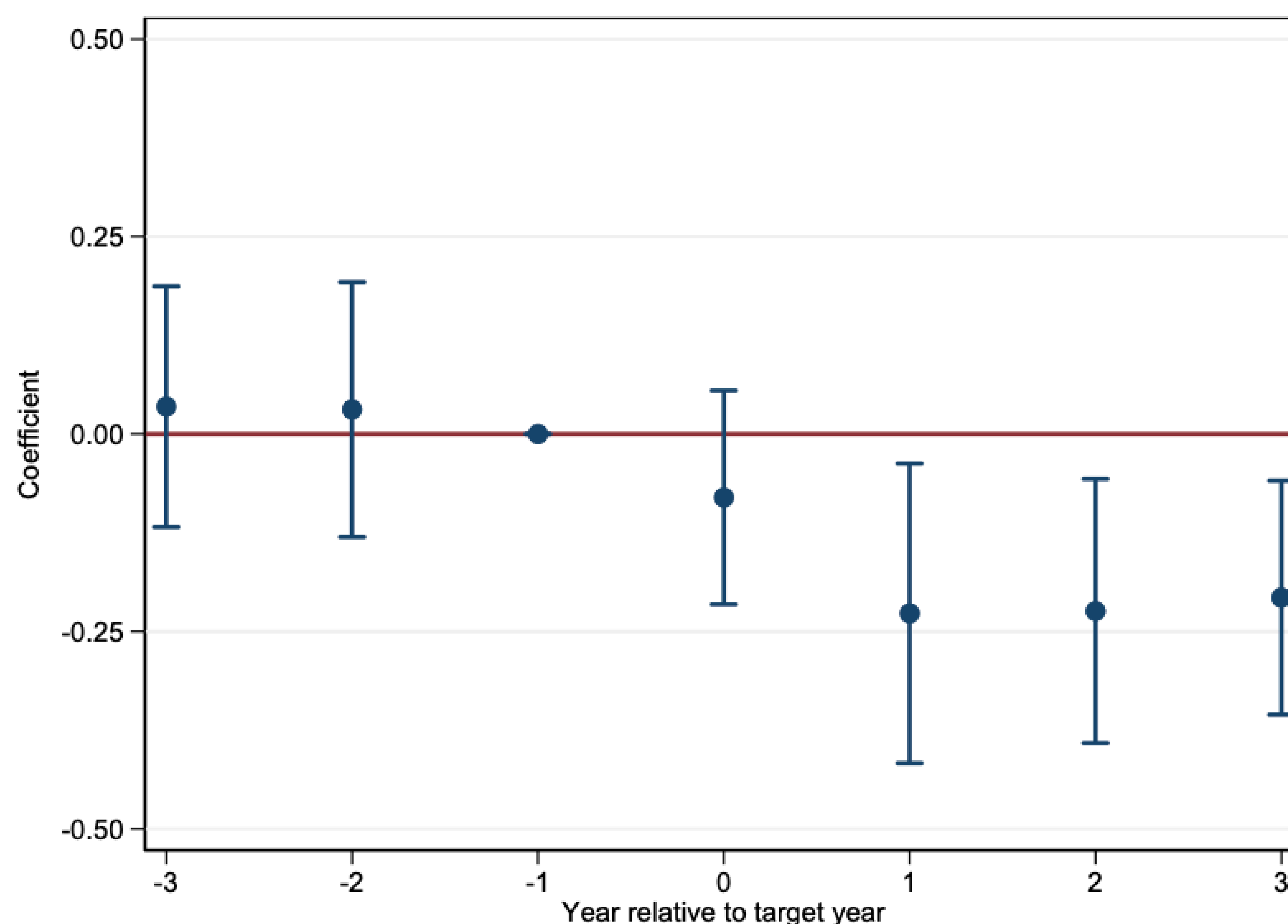


Figure 1: Changes in plant-level toxic chemical releases around environmental activism campaign

Our analysis of the impact of the environmental activist campaigns finds that plants of targeted firms, relative to plants of similar firms, reduce their total toxic chemical releases (see Figure 1). This improvement is not preceded by a decline in toxic releases before the campaign, suggesting that the BAP did not target firms that were already improving their environmental performance. Furthermore, these improvements are persistent. The empirical estimates imply that plants of targeted firms, when compared to plants of another similar firm, reduce their toxic chemical releases, on average, by 13 percent.

Breaking down these results, we find that active on-site reductions in releases drive overall improvements. Thus, firms are less likely to move their pollution off-site for release or disposal.

Studying the medium of releases, we find that the improvements primarily arise from reductions in stack-air emissions. Stack emissions relate to gases and solids that come out of the smoke-stack after the incineration process. When we focus on the type of air emissions, our estimates suggest that plants of targeted firms reduce their greenhouse gas emissions. They reduce releases of some of the most lethal greenhouse gases like methane, carbon dioxide, and nitrous oxide, contributing to global warming.

These improvements beg the question of whether their benefits extend to stakeholders beyond the firm.

Our results suggest that climate-focused engagements have several positive effects on stakeholders.

First, we find that targeted firms effectively reduce their release of cancer-causing chemicals, benefiting public health. Second, we find that the improvements in pollutive activities benefit the surrounding areas of the targeted firms. Specifically, using air quality monitor data and focusing on a one-mile radius around targeted plants, we find a significant drop in key emissions. The targeted firms choose to decrease their pollution intensity distant to New York City, the location of the lead activist investor (see Figure 2). Lastly, we also find that targeted firms' plants reduce the intensity and toxicity of their pollutive activities around environmental activism campaigns. Overall, our results suggest that targeting seems to positively impact stakeholders close to plants of targeted firms.

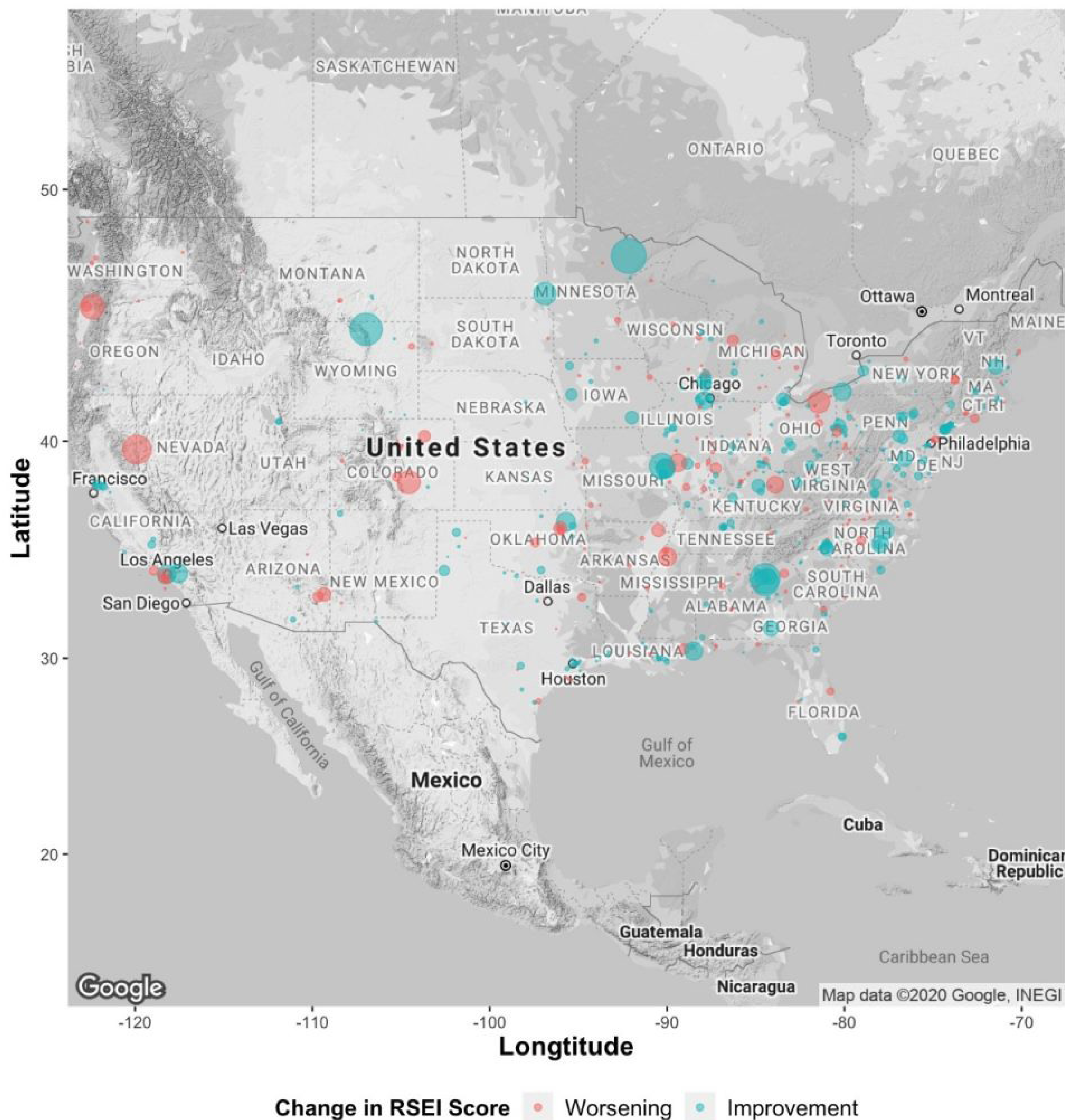


Figure 2: Positive impact of environmental activist campaigns on the local economy

Furthermore, we ask how the firms are achieving these improvements and what the associated costs are. We consider measures that firms undertake to reduce chemical releases and emissions. We find that firms adopt costly operational practices that reduce, eliminate, or prevent pollution while also increasing abatement expenditures focusing on emission control. Disclosures in the sustainability reports of targeted firms corroborate that firms are making these investments.

As the firms increase their abatement investments significantly, these costs are not perfectly offset by fi-

nancial benefits in the short run. When we focus on the changes in targeted firms' financial performance, we see a commensurate decline in the return on assets. Nonetheless, long-term benefits such as new customers or a lower cost of capital may take time to materialize and offset the costly investments in abatement technologies.

One alternative interpretation for the observed decline in emissions is that firms are now producing less, which mechanically leads to lower emissions. To put it differently, if firms make less, it is apparent that they also emit less. We do not find that this is the case. We examine and see no changes in both the level and growth in production. Further, we conduct a set of robustness tests to mitigate concerns related to reporting biases, offshoring, plant closures, and indirect governance effects, among others.

Finally, we consider the broader implications of our study for other environmental campaigns. To this end, we conduct external validity tests using other climate-focused campaigns initiated by other shareholders and find that our results extend outside of the BAP. Targeted firms respond only in cases where the activist investor has a firm-specific environmental mandate. These results, coupled with our baseline estimates, establish that shareholders can impose their pro-social preferences on firms to improve corporate environmental impact.

Recent research points to investors' strong preference for sustainability, resulting in investors moving away from low sustainability investments. At the same time, this preference for sustainability may come at the cost of lower future expected returns. Our results provide a counterpoint, suggesting that investors may maximize their total value through monitoring and engagement to affect change. These findings also indicate that focused engagements could be an effective tool for shareholders to address climate change risks.

In conclusion, our study takes an essential step towards understanding the costs and benefits associated with engagements driven by investors who want corporations to have a social purpose.

S. Lakshmi Naaraayanan is an Assistant Professor of Finance with the London Business School. His research interests lie in the fields of corporate governance, entrepreneurship, financial intermediation, and political economy. His research has won several awards and has been featuring in numerous media outlets such as the Financial Express, Forbes, Oxford Business and Law, and the World Bank.

Kunal Sachdeva is an Assistant Professor of Finance with the Jesse H. Jones Graduate School of Business at Rice University. His research focuses on financial intermediation between institutional investors and households. Prof. Sachdeva holds a Ph.D. in Finance from Columbia University.

Varun Sharma is a finance Ph.D. candidate at London Business School. His research interests lie in the field of climate finance, financial intermediation, and political economy. Before joining the Ph.D. program, Varun worked as an Associate Director with PwC risk advisory practice in London. Varun holds a Master in Finance degree from London Business School. He is also a CFA charter holder.

Can Institutional Investors Solve Societal Issues When Governments Fail to Do So?

By Eyub Yegen

A new study looks into the social costs associated with private prisons to show that privatization may come with social trade-offs when governments fail to write complete contracts. However, the study finds that social trade-offs are partially mitigated by the monitoring role of institutional investors, highlighting the importance of institutional investors in corporate social responsibility outcomes.

Privatization has been a popular policy tool among legislators around the globe. Starting in the 1980s, with the Reagan administration's motto "don't just stand there, undo something," the United States government has been heavily relying on outsourcing government services to private enterprises, especially in sectors like the prison industry.

With the expansion of the War on Drugs under Reagan, the US observed nearly a 50 percent increase in incarceration rates between 1980 and 1985. This sudden spike in incarceration rates gave further incentive to the US government to outsource prison services to the private sector. Although privatization of prison services has been a popular policy tool in the 1980s and 1990s, there has still been an increasing reliance on private prisons. For instance, although the total number of prisoners rose by only 10 percent between 2000 and 2016, the number of inmates in private prisons increased by 47 percent, whereas the number of inmates in private immigration detention centers rose by 442 percent.

Was the decision of the government to rely so heavily on the private sector to incarcerate and rehabilitate criminals been a good choice, from a social welfare perspective? Alternatively, did privatization come

with a cost to society, given that private prison management companies may have an incentive to only care about profits?

Privatization advocates argue that private enterprises may provide services in a more efficient way than the government does. Yet previous academic studies, such as a seminal 1997 Quarterly Journal of Economics paper by Oliver Hart, Andrei Shleifer, and Robert Vishny, raise a serious theoretical concern that privatization may come with trade-offs that society has to pay for.

In particular, when the government fails to specify what needs to be done in every possible incident in the contract it signs with a private enterprise (i.e., the contract is "incomplete"), owners of the private company have the residual right to make decisions on the non-contracted dimensions that may be optimal from a profit maximization point of view, but may be socially suboptimal.

In other words, when the government leaves gaps in the contract with the private company that manages prisons, the ultimate decision goes to the owners of the prison management company who need to decide on whether to solely maximize profits or to consider social consequences of not providing adequate rehabilitation services in prisons. Considering the fact that there has been a nearly 60 percent increase of institutional ownership in public companies that manage prisons between 2000 to 2016, one may wonder whether institutional investors internalize the social consequences of prison privatization.

Institutional investors around the globe have been vocal in calling out CEOs of portfolio firms to take societal concerns into account when making managerial decisions. For instance, in his past three annual letters to CEOs, Larry Fink of BlackRock, the largest asset management company in the world, has sent a strong message that companies need to have a positive contribution to society, or else they will lose the support of BlackRock. Do such efforts by institutional investors, however, translate into improvements that ultimately benefit society?

To tackle the question on whether institutional investors may offset the social costs that arise as a result of outsourcing government services to private enterprises, I have compiled a novel dataset on almost 1,500 state prisons after filing 51 state-specific (including Washington, DC) Freedom of Information Act (FOIA) requests and hand-collected data from thousands of government documents.

Consistent with theoretical predictions of prior studies, I find statistically significant evidence that prison privatization is associated with an increase of inmate suicides by up to 40 percent. These results are robust to controlling for 27 time-varying prison-level factors that may impact the ex-ante likelihood of committing suicide or unobserved changes that take place at the state, year, or prison levels.

To examine why there is a high number of suicides, unexpected deaths, and total deaths in private prisons compared to public prisons, I also examined whether there were fewer resources provided in private prisons. I do find strong statistical evidence that the high association between privatization and mortality rates is possibly due to the fact that there are fewer educational, social, and overall rehabilitation programs offered in private prisons. However, these results do not examine whether different investor types may matter when examining the social costs that arise as a result of privatization.

As theory predicts, when government contracts are incomplete (i.e., not everything is written in the contracts), residual decision rights may play an important role in examining the social costs that arise as a result of prison privatization. In particular, what is the role of institutional investors when the government

does not write a complete contract and public companies that manage private prisons sacrifice quality to be more profitable? As Oliver Hart and Luigi Zingales predict in their 2017 paper, shareholders may "take social factors into account and internalize externalities," which may include social costs.

Institutional investors have the ability to use their voice when such social costs arise and may offset such negative social externalities. I find consistent evidence that for a 1 percent increase of total institutional ownership in public companies that manage private prisons, there is a reduction of 1.2 percent in prisoner suicides. These magnitudes are economically significant considering the fact that there was an increase of over 30 percent in institutional ownership levels since 2013.

However, given that institutional investors have different preferences, I further examine whether investors with different investment strategies and holding horizons have a different impact on prison conditions. Prior studies, such as a 2001 study by Brian Bushee provide empirical evidence that ownership by institutional investors with a passive investment strategy and a long-term holding horizon is positively correlated with long-term firm value, whereas ownership by investors with an active investment strategy and a short-term holding horizon is positively associated with short-term firm value.

These results are primarily driven by the fact that investors with a passive investment strategy have a long-term investment horizon, and therefore these investors are more attentive to long-term outcomes. Similarly, in his most recent letter to CEOs, Fink argues that "these [short-term profit maximizing] actions that damage society will catch up with a company and destroy [long-term] shareholder value." Therefore, institutional investors with a long-term investment horizon may have an incentive to internalize social costs.

Consistent with these arguments, I find that the negative association between ownership and mortality rates is primarily driven by long-term investors, given that neglecting to incorporate social externalities has long-term consequences both from a reputational and valuation point of view.

To establish a causal relationship between social outcomes in prisons and ownership by long-term investors with a passive investment strategy, I use a novel identification strategy that exogenously changed the ETF ownership levels in public companies that manage prisons. In particular, at the end of 2012, the Internal Revenue Service reclassified public companies that manage prisons as Real Estate Investment Trusts (REITs).

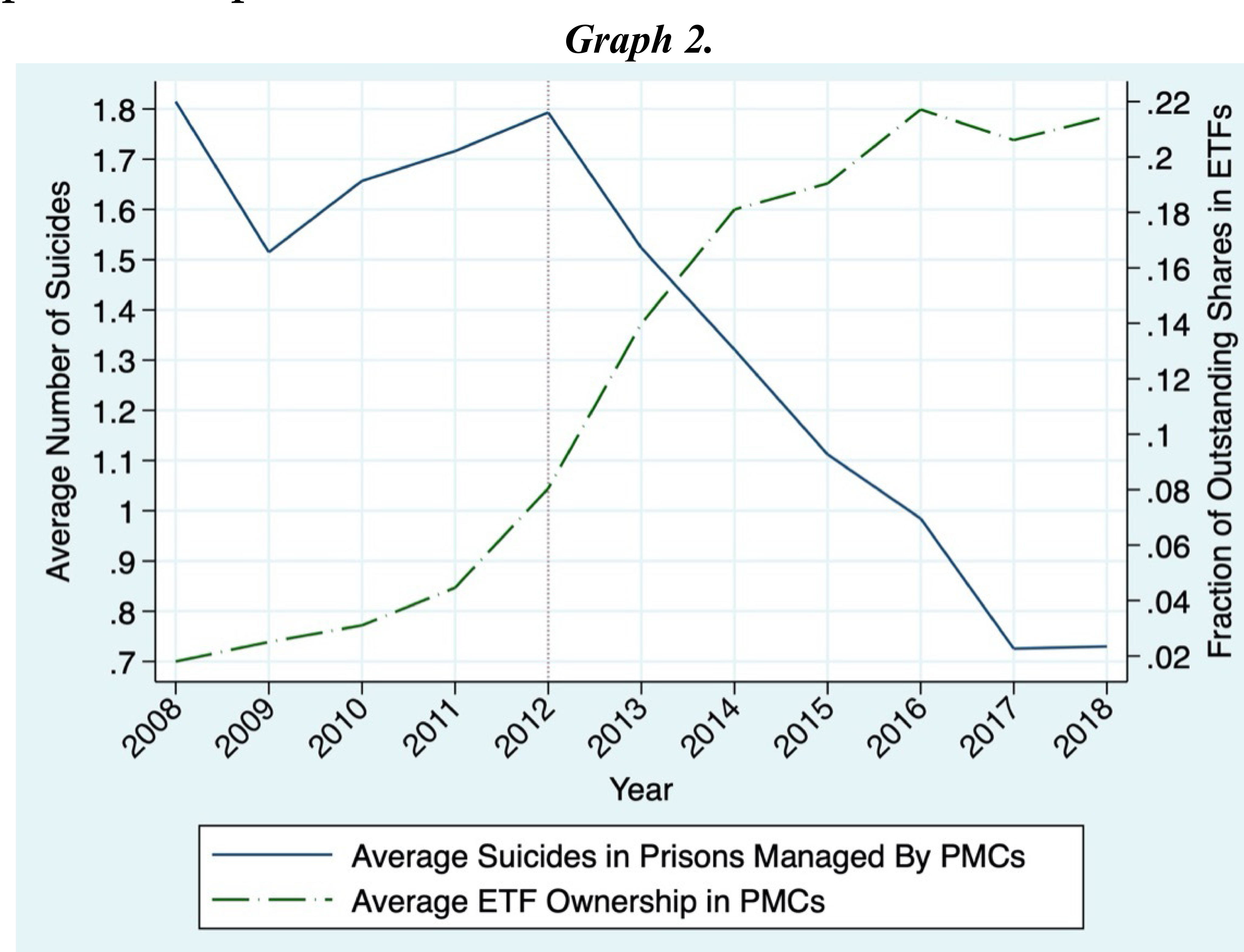
Graph 1.

As shown in Graph 1, this tax reclassification of public companies that manage prisons led to a doubling in ETF ownership levels since these public companies entered into ETFs that track the real estate sector, whereas such patterns were not seen in other stocks.

In particular, using an instrumental variable approach where I rely on the exogenous change in ETF ownership in prison management companies due to the REIT reclassification, I document a causal effect of ownership by institutional investors with a passive investment strategy on social outcomes.

These positive effects of institutional investors with a passive investment strategy on social outcomes may also be depicted in Graph 2, which shows the relationship between ETF ownership in public companies that manage private prisons and suicide rates. I document that these improvements in prisons are likely to be driven by more educational, social, and general rehabilitation programs being offered in private prisons managed by public companies.

Graph 2.



These results so far highlight the fact that privatization may come with a cost to society, but these social costs are partially mitigated by the monitoring role of institutional investors. To further examine why institutional investors may have an incentive to internalize the social costs of privatization, I examine whether litigation and reputation risks may play a role. In particular, using a proxy for litigation risk that measures whether the given state in which a prison is located is more friendly to plaintiffs, I find that the institutional ownership effects are stronger in prisons that are more likely to be successfully sued for negligence.

In other words, the positive effects of institutional ownership on social outcomes are more pronounced in prisons that are more likely to cause reputational or litigation damage to shareholders and the firm, given that the litigation environment is riskier.

Overall, my paper shows that privatization may come with a social trade-off when governments fail to write complete contracts. However, such social trade-offs are offset by the monitoring role of institutional investors. This is especially true for investors with a long-term investment horizon, given that these types of investors pay attention to long-term firm value and have an incentive to internalize social externalities that may harm the long-term success of the portfolio firm. My paper highlights the importance

of shareholders in eliminating the tendency of firms to focus on short-term profits that may come with a cost to society.

Eyub Yegen is a Ph.D. Candidate and Instructor of Finance at the University of Toronto, Rotman School of Management. His research focus is on the role of institutional investors in society. Specifically, his research is at the intersection between institutional ownership and corporate social responsibility, political economy, and product market competition.

Strength in Numbers: Using Data to Track Diversity and Inclusion

By Marianne Bertrand, Caroline Grossman, Mekala Krishnan

Recent protests against racism and police brutality, along with the #MeToo movement, have increased pressure on businesses to measure and improve their recruitment and promotion of women and people from underrepresented racial groups. Chicago Booth's Marianne Bertrand, the Chris P. Dialynas Distinguished Service Professor of Economics and Willard Graham Faculty Scholar, and Mekala Krishnan, a senior fellow at the McKinsey Global Institute, discuss with Caroline Grossman, executive director of the Rustandy Center for Social Sector Innovation, how businesses use data to track diversity and inclusion.

Editor's note: The following is an edited and condensed transcript of a panel discussion held during the Corporate Social Responsibility Revisited conference hosted by Chicago Booth.

Caroline Grossman: Research and data must play a role when it comes to implementing Diversity and Inclusion (D&I) strategy that actually moves the needle on equity. If you don't collect data, it's hard to diagnose how your company is performing. If you don't track data, you won't know how you're improving.

A necessary complement to putting a diversity and inclusion plan in place is using research and data to ensure change is actually happening. Our two panelists today offer that complementarity a two-way lens: Chicago Booth Professor Marianne Bertrand and Mekala Krishnan, Senior Fellow at McKinsey Global Institute.

Much of Marianne Bertrand's research on this topic uses data to quantify the effects of racial and gender bias and to understand which mechanisms work better than others. Because many firms are in early stages with these topics and may not have great data, it's also useful to have Mekala's voice on what this looks like in practice today.

One possible lever to pull that may make sense for some industries more than others is the question of quotas. On the topic of hiring, quotas have been adopted in a few countries, especially here, for those of us who are in Europe as they're tuning in, and recently in the US in the State of California. Proponents see quotas as mechanisms to increase gender and racial diversity, but they can also lead to concerns like tokenism. Research, including some by you, Marianne, suggests that quotas aren't a panacea. Based on the data you've seen, what's your take?

Marianne Bertrand: We studied, a few years back, the first gender quota policy that was adopted in Europe, and that was in Norway back at the beginning of the millennium. I think the main way to summarize what we saw in the data is that quotas didn't really do anything bad, but they are not the kind of transformative tool that I think companies may be looking for if they're really trying to improve diversity.

Just so everybody's on the same page, Norway—very similar to a lot of other European countries after it—passed a law that forced publicly traded corporations to have 40 percent of women on their board. There was a lot of pushback by corporations that were basically saying, "We're never going to be able to find women with the kind of talent that is required to be on those corporate boards."

What we found was that corporations were clearly wrong when making that statement. We were able to document the qualifications of the women that were appointed to the board once the companies were forced to find 40 percent of women on the board. These women were, if anything, more qualified than the very few women that were on the board prior to the quotas being put in place.

So those companies managed to find highly qualified women to serve on these boards, which means that once you force the companies to look beyond the standard network that they have, let's call it the old boys' network, there are a lot of qualified women to fill in those positions. So that's really, I think, the good news about what we found in the context of this quota reform.

What is, I think, the less optimistic message is that if you believe that this is a policy that is really going to make a difference, that's going to be transformational for women's opportunities inside of corporation, you really have to hope that there will be spillovers of these quotas beyond the corporate boards. Corporate boards are very, very few individuals. So the idea theoretically is by appointing movement to the boards, you may have more women joining the C-suites, more women rising in the operational ranks of the organization. And then what we do is basically check the data to see whether that was happening. And there was really no sign of that.

So the bottom line is: by forcing companies to look for women, they're going to be able to find highly qualified women to serve on the board. But you should not expect that this kind of policy will be trans-

formational in terms of bringing more talented women at the top of organizations. So the main takeaway for me is that there was a sense in a lot of European countries that, "Okay, we have these quotas in place. That's it. Our job is done, and we've achieved gender diversity in the corporate sector." And that would be a really, really big mistake.

I think gender is quite different for me than racial minorities and their representation. When it comes to gender and the representation of women in the corporate sector or in the higher-paying jobs, in many ways I think that the key difficulties are not so much biases but really have to do with the structure of work, really have to do with what just happened today. Kids are walking around the home and the other responsibilities that women may have that make it very difficult for them to succeed at balancing the work and the family responsibilities.

Mekala Krishnan: Just to add a couple of thoughts, Marianne, because I completely agree with what you just said. I feel like with quotas, people arrived at quotas as a panacea, as the silver bullet. And it's great that it has led to increase representation on boards, but that's really not had the kind of spillover effects that people had hoped. And in fact, our research would suggest two things that I think are of interest to this conversation. The first is there is a lot of work out there including boards that correlates representation in leadership positions with corporate outcomes. And of course, it's correlation, not causation. But interestingly, that correlation is not as strong compared with women in top management positions when you look at women in boards. If you think about appointing women in boards as a corporate performance driver, it may be less helpful than having women in top management positions.

I think the second is when you look at the corporate pipeline, it's really interesting to see that as quotas have been implemented, you see this funnel go down way from entry level to C-suites and then a jump up at the end for boards as we've put quotas in place. But really, that funnel, if you look at the data carefully from our survey of North American companies, where you see the funnel drop off is really that first promotion. So from the entry level to that first manager role is where you see most women fall off. And of course, for some companies, it might be the end of the funnel. But on average, if you're focusing your efforts at the end of the funnel, you're not really solving the issue, which is enabling women to make that first promotion.

I think the second thing that was really interesting with that data is that that first promotion, people came to us to say, "Okay, the reason that women are dropping off at that first promotion point is that that's the age where they want to leave the workforce to have children, and so it's women leaving companies." But actually, when we looked at the data, attrition rates for women and attrition rates for men were essentially the same. It was the promotion rates that were quite different. So what's happening is that women are getting stuck at that first entry level. They aren't progressing through the funnel, whereas the common zeitgeist is that women want to leave the workforce to have kids. But we aren't really seeing that, at least when we look at data in North America and Europe. It may be different than other countries, but in those two regions, we aren't really seeing that in the data. And this, again, emphasizes why data is so important.

Marianne Bertrand: So that's super interesting, and this is about data to study diversity and inclusion. This is the call out for more corporations to make the study of the funnel and how it evolves available because absent the ability to look inside of corporations and see the funnel that you're able to see by your consulting work, it's really hard for us researchers to bring additional insights. One more thing I will say is that what you described is somewhat different from what I've seen in other data set. So there's a lot of

really, really good research that documents that it's not so much women want to leave the workforce to have children, but really documents the dramatic effect that having children, the birth of a first child has on the career opportunities of women. So it is not being done, unfortunately, focusing solely on the kind of woman that would have the potential to lead corporations. It's done on a much broader side of the populations, but the data is remarkably striking You see the career of men and women evolving really in parallel with one another up to the point of the birth of a first child. And this is really the point where women start experiencing very rapid losses and really never fully recover.

Mekala Krishnan: I completely agree with that, actually. We've done some work— again, simple correlation analysis—but it correlates the time that women versus men spend on unpaid care work, what we call unpaid care work, things like childcare and household work, and correlate that with labor force participation rates, correlate that with relative rates in leadership positions. And there's very, very strong relationships between the two. One of the things that our surveys of employees have also found is the number one challenge that women cite is what they call the double burden syndrome or the fact that they're working both in the workplace as well as in the home. So I think it is significantly impacting women's experience in the workplace. I think it's just that the idea that women prominently drop out is not true it's that they are struggling to manage both work in the workplace, work in the home. It may be limiting how many hours that women work. It may be limiting the types of opportunities they reach out for. It may be impacting their own aspirations for their career.

Marianne Bertrand: And the point that you just made about this double burden and not being able to work as long hours I think also ties back to another fact that is in the data, which is that in the corporate sector there is massive reward, financial reward, for the ability to work very, very long hours. So that's really the massive difficulty that women face is that in order to succeed, you have to work these long hours.

Caroline Grossman: I actually want to go back to something you said on quotas Mekala, you said that data doesn't indicate that having more women on boards actually has an effect on corporate performance. What is the time horizon on that? We know performance is measured on a quarterly basis, but when would you expect to see the impact of diversity on boards on corporate performance? I know this is an issue we talked about a lot relative to the environment, that if a company makes decisions around sustainability, will you see it on a quarterly basis? Maybe not. Well, is it an important long-term strategy? I think certainly. So how do you see this play out?

Mekala Krishnan: A corollary to that question is also, if companies are putting in certain D&I practices, when do you actually expect to see those practices pay off in representation data? So maybe with something like hiring, you expect to see it relatively near term. But on inclusion practices, for example, promotion practices, maybe it takes time for things to actually peter through the dataset. We haven't really looked at timeline analysis of this kind just because these data sets are all relatively new. What I will say is that when we work with corporations—not so much on this topic—on broader organizational transformations, so culture shifts that kind of work in companies, what we find is that for change to really start to peter through the organization can take anywhere from five to seven years.

So really, true culture shifts, mindset shifts, norm shifts, practice shifts happening in a way that the entire psyche of a company changes can take time. And so I agree that maybe this is, again, a plea for more research and data as these data sets become available, that the ability to do more analysis that is over time and allows us to do timeline analysis is super important.

So as we think about data, there's almost two flavors of data that we need more of. The first is data on actual outcomes, gender-disaggregated data on outcomes both in labor markets more broadly but also within corporations. And then data on what works. How do you actually drive change?

Marianne Bertrand: When I think about the relationship between the diversity inclusion agenda and corporate performance, I think there's really two ways I think about it. And that also ties back to Friedman, which is what this event is all about. There may be really value having more diversity in management for corporate outcomes. So there's just more ideas, different ideas. People are going to talk about different things, and that's valuable. It is just remarkable to me that that's an argument we hear very often, that diversity per se is going to help corporate outcomes. This is an area where there's essentially no research that I can think about. There's really not a good piece of research that can point out that convincingly shows that diversity is valuable for corporate outcomes.

But there's another angle to it, which is that if you are focusing all of your recruitment on one half of the population because you're only looking at men, there's absolutely no way that you're on the frontier in terms of the talents that you bring within your organization. And that in itself I think doesn't even need to be demonstrated in data. That seems pretty sensible that by limiting your search to half of the labor market you cannot be at the frontier. So I just want to make this point because they're really the two ways I think about the relationship between diversity and inclusion and corporate performance and why there would be a positive relationship. The second one is pretty straightforward to me. The first one is one that we hear a lot of corporations talking about, that diversity is good for corporate outcomes, that we really don't have the kind of research I would like to be able to point at to say, "Yes, here's the proof of that."

Mekala Krishnan: Yeah. And I think the other argument you were making, Marianne, it's especially true in a world where in many developed countries now women are graduating from college at exactly the same rates, maybe higher rates, than men. So it's not on just innate talent. It's also learned skills that women are actually possessing at maybe higher rates than men. So it's just such an economically inefficient argument to not be tapping into that talent pool. So fully agreed.

Caroline Grossman: One place I think there is some data is on parental leave policies and the effect that those have. Marianne, could you speak to that?

Marianne Bertrand: There's lots of discussion about the value of giving women longer maternity leave to be able to have children but remain in the workforce. The research there, I think, says pretty clearly that longer maternity leaves are not going to be beneficial to women, especially the more educated women.

What you find in the data, which is typically put all of UCD together, study economic outcomes for women, and look at the correlation with these economic outcomes and the lengths of maternity policies that these countries have in place, you will find that among the more educated women, longer maternity leave policies associate with a bigger gender wage gap, so lower wages for these educated women compared to men.

I think what is behind this result is really that as you make this maternity leave longer, women become kind of separated from the labor market for longer, and there's a price for that. Companies like to keep their employees. They want to have them kind of continuously, and the longer you let the mothers out of the labor force, the more difficult it is for women to reenter these corporations on the same track as the

one they were in before.

That's, I think, one of the explanations. The other one is really just strategically, corporations may not want to put women, single women, in important positions knowing that these women will leave the company for an extended period of time when they become mothers.

That is, I think, kind of a really important finding which sometimes people find counterintuitive, but longer maternity leave policies are not a silver bullet to help women in labor force, especially the more educated women.

Now, what is, I think, much more promising to the extent that children will keep on appearing is policies that try to change the norm, moving away from maternity leave policies to parental leave policies and paternity leave policies.

In this regard, the Scandinavian countries, I think, have been the most frontier in terms of trying to put in place policies and incentivize fathers to stay at home and share the burden with mothers when kids are born. It's still to be determined whether these policies will make a difference, but in many ways, I see them as really the directions we need to go into, because those policies are about trying to change the norms, trying to change the norms that say that the mother is going to have a disproportionate share of the burden when it comes to child rearing.

Mekala Krishnan: You know, I think that your last point about changing the norms, I actually think these policies are important for such vital reasons. The first is the fact that they change norms about who actually bears this "burden". It actually signals that this is not just the woman's burden.

I think the second thing it does in terms of changing norms is in the company, now, you have both men and women taking leave. It's not just the women taking leave, so just from the equality that it creates in terms of career progression, in terms of norms related to performance reviews in terms of some of the mindsets that you talked about, about how companies perceive single women, it changes those norms, and I think that's also incredibly important.

Then, I think the third thing it does is for women, themselves. In one of the surveys we did about two, three years ago, surveyed employees about if an employer has maternity leave practices, they have flexible leave practices, a whole set of policies, what's the adoption rates? They were abysmal, like 10 percent.

I think the third thing it does, it actually makes it okay to adopt some of these policies, because people don't feel like their careers are threatened. I think it's important on multiple fronts to think about these not as women policies but as people policies and make them ones that everyone in the organization feels comfortable adopting.

Marianne Bertrand: I just cannot reinforce that last point you made enough. In many ways, when I think about good policies in that environment, they are not women's policies. They are human policies. The more we take gender out of these policies, the more we make them policies for all employees, the better it will be.

Caroline Grossman: Marianne, earlier in the conversation you said women are one side of it, but this is different when we talk about issue of race, and I want to come back to that question. I first want to ask,

as you think about diversity and inclusion, and you think both about the questions of gender and race, what are some of the common themes you look at across, and where do you see them diverging?

Marianne Bertrand: When I think about issues of race or ethnicity, thinking about Europe and European audience that we have here where they may not just be issues we have with African Americans in the US and compare that to women, in my mind, where I am right now based on my research and the research that I've read is that I think that bias and discrimination is a much more important force when it comes to thinking about the under-representation of racial minorities in corporations than it is with respect to gender.

I am not saying that there's no gender discrimination going on, but I do believe the force that we just talked about are much more important than just discrimination per se to explain why women are under-represented. I think when it comes to racial minorities, bias, whether it is implicit or explicit, is a much more important force.

I think the other big difference when I think about women versus racial minorities is that there's a lot that comes with being a racial minority in America or in Europe that is not associated with just being a woman. When you think about racial minorities in the US that goes hand in hand with economic disadvantage. That goes hand in hand with access to lower-quality schools, lower-quality public services, and lower quality amenities because of residential segregation.

Obviously, that's not for gender. Boys and girls are born in equally rich families. They are very different conversations in my mind at least when I think about what we do in terms of improving women's representation compared to when it comes to improving racial minorities' representation.

Caroline Grossman: One complement to this conversation is the question of individual responsibility and action and Booth Professor Jane Risen teaches a course on this topic, and she weaves in research from behavioral economist Dolly Chugh from Harvard by really digging into the book, The Person You Mean to Be, How Good People Fight Bias. Chugh encourages us to acknowledge unconscious bias, take a stand, get involved, and be a builder.

What are things that each of us can do, and this is a question for Marianne, Mekala, the things that each of us can do in our day-to-day work, particularly in a virtual world where we're feeling more disconnected, to check our unconscious bias, be advocates and allies, and drive forward meaningful change?

Mekala Krishnan: I think the main unconscious bias lever that we see companies implementing, and then I think employees and individuals can complement that, there's a variety of trainings that companies do related to unconscious bias. It's to create awareness of unconscious bias.

I think the corollary here is step one—actually recognizing that you have unconscious biases—but I don't think it's necessary that every unconscious bias you have is a negative thing. The reason we have these biases is this is how it's helpful to process the world in some ways, but recognizing where they exist and where they are really biases, so I think step one starts with that.

Just recognizing that you have your own world view and there may be others that are experiencing real challenges that you may not be seeing or be aware of, so that's kind of step one.

I think step two is having the conversation. As we've been surveying employers and employees, it's really stark to me how much sometimes employers put in place policies and practices that employees don't really care about or want. One of the funny examples is we've done a survey now of Covid practices, and one of the things that so many companies have put in place is practices around open forums with senior leadership to create encouragement and lift morale, but when we surveyed employees, they don't see it as a high priority.

I'm using that as a silly example, but the idea is I think we often make assumptions about what people want and what people need and what is helpful, which may completely be a flawed assumption. I think really asking the question and having an authentic conversation coming from a place of curiosity and spirit of learning I think is really important.

Then, I think there are a bunch of things that you could do structurally even as an individual. If you're a manager ensuring that a performance review has an unconscious bias check. If you think about all the activities you engage in on a day-to-day level, finding ways to embed that check on your biases through those day-to-day activities I think is important, too.

Marianne Bertrand: Yeah, I agree with kind of all that Mekala said. To go back to your original question, Caroline, I'm inspired by the work of psychologists that have studied particularly implicit bias and kind of tell us about the particular situations under which it is more likely to creep in and drive our decisions. We know the implicit bias is more likely to drive our decisions when we are rushed, when we are stressed, when we are angry, even when we are happy. So, when we are more emotional, we have more implicit bias.

Just that suggests that, and taking it back to the corporations, taking it back to the HR process, the more we can move away from HR decisions being made under those kind of, say, time pressures, the better probably it will be in terms of having HR managers really taking the time to review applications or be thinking about promotion decisions.

There's also lots of work, again in psychology, that tells us that we can train ourselves to be less biased. Same way that we have this increased association between seeing a black face and feeling frightened, we can teach ourselves to engage in contrary to stereotypical thinking.

There's good evidence from the lab, fairly short-term, that by forcing yourself to associate positive thoughts with a black face rather than the negative thought you would have, you can make a difference. You can make people kind of less biased. We don't know how long this lasts, but this matters.

Another thing that I think comes strongly from the debiasing literature in psychology is to really move away from thinking in categories. That goes back to the point we were making, Mekala. It's not about men and women. It's about people.

One of the kind of methods that psychologists would use to debias people is to get them to think about the person, individuating. Thinking about not this black guy, but think about him: What's his life like? What does he do? Thinking beyond the category and trying to imagine the person, putting yourself in the shoes of the person.

There are lots of tools that have been shown, again, in lab experiments, to help in reducing bias. I'm go-

ing to make the same call as the one I made before. As Mekala said, I'm sure there's lots of corporations that are using those kind of training to try to improve bias inside the corporation. It would be fantastic to allow researchers to take a look at whether or not this makes a difference.

Besides the work in the lab, we really don't have the kind of data to assess whether those kind of training programs matter.

The other thing that I would stress, and I think Mekala also mentioned that, is that if you don't believe that those kind of training are really going to make a long-term difference, I think the other important step is really to have formal processes in place.

When I think about my own organization and how we do recruiting, I feel like over the two decades I've been doing it, we are moving slowly towards having more and more structure. As much as we dislike structure, because it feels like it's bureaucratic and academia shouldn't be bureaucratic, structures really help.

The most common examples that I always come back to is just rejecting someone for a promotion or for a job because he or she's not a good fit. That is just not the world that we should still be in. We should have explicit criteria ahead of time when we decide what are the kind of skills that we're looking for in a person and not deviate from those, because we don't like the person that emerges after we've gone through these criteria. So I think formalizing a lot of the HR structure, even though it means more bureaucracy, is also, I think, another way to reduce the extent to which we have biases creeping in.

Mekala Krishnan: Yeah. Just on the company training on unconscious bias, I mean, what we're seeing, similar to the quota crutch, this is becoming the crutch where a company does an unconscious bias training with their employees once a year. And then they think they're done and people are all set for the year. When really, I mean, it's such a process. So you need to think about continuous nudges. You need to think about structural change, but it's what I worry about is that this is now kind of the buzzword that everybody's using and it's going to be the quotas of 2020 is going to be unconscious bias training.

Marianne Bertrand is the Chris P. Dialynas Distinguished Service Professor of Economics at the University of Chicago Booth School of Business. She is a Research Fellow at the National Bureau of Economic Research, the Center for Economic Policy Research, and the Institute for the Study of Labor. Professor Bertrand is Faculty Director of Chicago Booth's Rustandy Center for Social Sector Innovation and the Faculty Director of the Poverty Lab at the University of Chicago Urban Labs. Professor Bertrand also serves as co-editor of the American Economic Review.

Caroline Grossman is the executive director of the Rustandy Center for Social Sector Innovation. As an adjunct assistant professor of strategy, Grossman has designed and taught two Booth courses, including the Corporate Social Responsibility (CSR) Social Impact Practicum, which allows students to delve deeply into a project to consider the role of the firm in society. Beyond Booth, Grossman has extensive experience as an educator and business leader, teaching at the Chinese University of Hong Kong and DePaul University, and in brand management at Kraft Foods Inc.

Dr. Mekala Krishnan is senior fellow at the McKinsey Global Institute (MGI), McKinsey's business and economics research arm, based in Boston. Krishnan's research has focused on various topics related to inclusive growth and economic development. Krishnan is a frequent speaker on these topics as well as on broader global trends, and helps advise decision makers, multilaterals, private sector companies, and non-profits on these issues. She co-leads MGI's research on global gender equality. She has provided research support to the UN's High Level Panel on Women's Economic Empowerment. Krishnan serves on an advisory board for the Sibley School of Mechanical Engineering at Cornell University, and serves on the board of the Global Fund for Women.

Friedman Meets Stigler

There Is a Direct Line from Friedman to Donald Trump's Assault on Democracy

By Martin Wolf

Milton Friedman believed that corporations have a social responsibility to play within the rules of the game. But corporations aren't just players of the game, they are the ones setting the rules—bad ones.

I used to think Milton Friedman was right. But I have changed my mind. I also increasingly realize that I have changed my mind because I no longer believe in the contractarian view of the firm: that it is merely an aggregate of voluntary contracts which reflect the freedom of individuals to choose.

In reality, corporations are powerful entities able to exercise immense influence within society. Since corporations have been told that their only responsibility is to make profits and this has been internalized within their operations, the result is that society, including in particular its notionally democratic

politics, is dominated by feral institutions. This is an important reason why the US has ended up with a president who is now running against democracy itself.

The central point I would make comes from Friedman's view that corporations have a social responsibility to play within the rules of the game, "which is to say, engage in open and free competition without deception or fraud". But this is vastly too narrow a perspective on the "rules of the game".

The rules of the game have to include everything a society does to ensure that the activities of corporations, individually and collectively, are consistent with its core objectives: promoting competition and innovation, protecting public health, protecting the environment, protecting employees from abuse, raising the tax revenue needed to meet democratically-agreed objectives, and so on and so forth. The rules of the game are, in sum, everything a society does to organize itself through politics and law.

So, who makes these "rules of the game"? Well, we know quite well that a dominant influence is the power of money. In particular, the activities of companies, as lobbyists, funders of research and donors, play a decisive role in *creating* the rules of the political game. As Mancur Olson told us, concentrated interests, with large resources, win. There are no interests more concentrated and with more resources than corporations, individually or in associations. Corporations are not players of the game, playing according to rules set by others. They play the game according to rules they largely set themselves.

In sum, Friedman's view is *faux naif*. Of course, companies should play within the rules of the game. But let us agree first on the game we are talking about. If, as I am arguing, the game is fundamentally political, then the social obligation is to use their power to create a good game, rather than a bad one.

What is a good game? Well, here are some things it most definitely is not.

It is one in which companies would not promote junk science on climate and the environment; it is one in which companies would not kill hundreds of thousands of people, by promoting addiction to opiates; it is one in which companies would not lobby for tax systems that let them park vast proportions of their profits in tax havens; it is one in which the financial sector would not lobby for the inadequate capitalization that causes huge crises; it is one in which copyright would not be extended and extended and extended; it is one in which companies would not seek to neuter an effective competition policy; it is one in which companies would not lobby hard against efforts to limit the adverse social consequences of precarious work; and so on and so forth.

This, then, is a political problem of the first order. As I have suggested above, such failures, and many more, have so weakened the democratic system that we risk ending up in dictatorships. There is a direct line from Milton Friedman to Donald Trump.

Why is this? Consider how one goes about persuading people to accept Milton Friedman's libertarian economic ideas when, in practice, they shift economic rents upwards and desperation downwards. In a universal-suffrage democracy, it is impossible. Such libertarians are a minority. To win, they have to embrace ancillary causes such as culture wars, racism, misogyny, nativism, xenophobia, and that good old standby: nationalism. Much of this has of course been sotto voce and so plausibly deniable: "No, we are not in favor of discrimination, but your precious freedom does indeed include the right to discriminate."

The financial crisis and bailout of those whose behavior caused it made selling the deregulated free-mar-

ket even harder, as Mitt Romney's 2012 failure showed. Afterwards, it became politically necessary for libertarians embedded within the Republican Party to double down on those ancillary causes. Trump was simply the political entrepreneur best suited to do this. A natural demagogue, he was perfectly comfortable saying out loud what his predecessors had said quietly or let others say for them. This is why his supporters claim that "he says it like it is". Those desperately-needed voters loved him for it, because he respects their rage. Of course, his nativism, nationalism, protectionism, demagoguery, lying and now open assault on the notion of a fair election are a bit uncomfortable for corporate elites. But, if he gives them lower taxes and sweeping de-regulation, how many really care? If the result is to poison democratic politics forever, again, who cares?

So, to return to my main point: one cannot get away with stating that corporations should play by the rules, when they create the rules they play by. The system for creating the rules of the game is corrupt.

So, what should be done?

The starting point for that is to recognize that corporations are not persons, cannot be citizens and, qua corporations, have no political rights whatsoever. Corporate personality is a fiction created solely for economic reasons. Individuals associated with corporations (including shareholders) do have political rights, provided they are citizens of the country in question. But that is an entirely different matter. The question of the use of their private money in politics is also a different one.

Corporations, qua corporations, should not be permitted to make political contributions, fund political campaigns or engage in any other political activities. They may lobby on behalf of their commercial interests. But they must be forced to be completely transparent about what they are doing. Drawing these lines is, of course, difficult. But it is essential, if democracy is to survive.

Corporations must indeed play by the rules of the game. But they must be prevented by all means necessary from writing them. I do not expect them to do the right thing in the public square. But I would really like to stop them doing the wrong thing.

Doing the right thing is the job of citizens.

Martin Wolf is Associate Editor and Chief Economics Commentator at the Financial Times, London. He was awarded the CBE (Commander of the British Empire) in 2000 for services to financial journalism. Mr. Wolf won the Overseas Press Club of America's prize for "best commentary on international news in any medium" for 2013 and the 2019 Lifetime Achievement Award at the Gerald Loeb Awards. He was a member of the UK's Independent Commission on Banking in 2010-11. His most recent publication is The Shifts and The Shocks: What we've learned – and have still to learn – from the financial crisis (London and New York: Allen Lane, 2014).

Milton Friedman and the Need for Justice

By Anat Admati

Milton Friedman predicated his shareholder value maximization credo on the strong implicit and explicit assumptions that the rules of society protect stakeholders other than shareholders, and that businesses operate in an environment of "open and free competition without deception and fraud." These assumptions are far from true in the real world, where laws and even basic notions of justice are routinely perverted in the corporate context.

Milton Friedman's claim that business managers would fulfill their social responsibility by making "as much money as possible while conforming to the basic rules of society" is highly problemat-

ic. It is based on false assumptions. The widespread acceptance of his dictum, and implicitly of his false assumptions, have caused substantial and preventable harm.

First, in banking and more generally (as Oliver Hart and Luigi Zingales discuss), "making as much money as possible" in the name of creating "shareholder value" may not produce the outcomes many shareholders, not to mention society at large, prefer most.

Second, Friedman's argument relies on an implicit assumption that the basic rules of society protect all stakeholders other than shareholders. He also assumes that businesses operate in an environment of "open and free competition without deception and fraud." These strong assumptions are far removed from reality. In the real world, governments often fail to design the best rules in society's interest. Moreover, managers do not take the rules of society as given and often use corporate resources (i.e., shareholders' money) to try to skew the rules. Thus, even if managers operate technically within the law, excessive market power and reckless conduct that distort markets and harm society can persist.[1]

Third, and worse yet, basic law enforcement and the principle of equal justice under the law also fail routinely in the corporate context. Rules become meaningless without effective enforcement, with the ultimate outcomes reflecting little if any "social responsibility."

Corporations are abstract legal entities. Early corporations were monopolies chartered by government. In *The Anarchy*, William Dalrymple describes in fascinating detail how the East India Company, created in the early 17th century and for much of its existence answerable only to its distant shareholders, routinely used violence to gain its ends in India.

In the US, corporations have won many legal rights over the years, including civil and constitutional rights originally intended for citizens. (On the history of the "corporate civil rights movement," see Adam Winkler's eye-opening book *We the Corporations*.) While they have amassed significant rights, compelling corporations to obey the laws and fulfill the legal *responsibilities* that ordinarily accompany those rights has been more difficult.

Forming a corporation for any purportedly legal purpose is very easy today. With minimal disclosures, and sometimes with anonymous beneficial owners, corporations with no productive economic activity can hide ill-gotten assets and evade laws. Governments, in turn, fail to enforce laws consistently or effectively, particularly in the context of white-collar crime. (For more on this, see Jennifer Taub's recent book *Big Dirty Money*.) Corporations in fact can "shop" legal jurisdictions to minimize taxes and regulations. An opaque system of offshore finance, termed "*Moneyland*" by journalist Oliver Bullough, converts illegally-obtained funds to legitimate currency, often through the corporate form and aided by mainstream financial institutions.

Criminal justice for large corporations—those Brandon Garrett refers to as *Too Big to Jail*—generally consists of settlements obtained out of the courts in a non-transparent process. In such settlements shareholders, often the beneficiaries of the corporate wrongdoings that harm other stakeholders but sometimes the victims, pay fines, corporations promise to comply better, and little else happens. Most corporate wrongdoings, including wage theft, consumer or investor fraud, and unsafe products or work conditions,

1 *See, for example, Lee Drutman's The Business of America Is Lobbying, how flawed claims maintain a dangerous financial system and too-big-to-fail institutions, and the evidence on corporate political and market power in Matt Stoller's Goliath, David Dayen's Monopolized, or Thomas Philippon's The Great Reversal.*

result in civil penalties even when they involve criminal violations. Whether this system creates proper accountability or deterrence, whether fines and penalties are appropriate, and when and whether justice is actually served, is hard to tell and often doubtful.

Data that would enable us to understand the issues and address the failings of the justice system in the corporate context are remarkably scarce. Among the important questions we cannot answer because we lack information are: Do current laws impose sufficient accountability for those with power, in corporations and in governments? Are current laws able to prevent law evasion by corporations but fail to do so due to ineffective enforcement (due to, for example, insufficient resources or the incentives of the attorneys involved), or do we need to write expanded "responsible officer" statutes? Are the resources devoted to detecting and investigating corporate misconduct enough to maintain trust in the system and in the institutions that control our economy and our lives?

In ongoing research with my colleague Greg Buchak, we are assembling data that we hope will help us study the workings of the justice system in the corporate context in a more systematic way. Among other things, we will explore whether and how the outcomes of corporate wrongdoing in the justice system may depend on the type of law, offender, victim, harm, jurisdiction, or other factors. We need better understanding of the situation so as to find ways to address any failings of the system.

This research is important in the context of Milton Friedman's once-celebrated *NYT* piece, because Friedman effectively presumes that law enforcement works properly. Proper enforcement should be blind to the identity of the victim or perpetrator. If enforcement outcomes depend on such factors as the identity of the perpetrator or the victim, then the administration of justice is perverted and the rules do not achieve their intended goal.

Some examples will illustrate why there are legitimate reasons to be concerned about the justice system in the corporate context. In June 2020, PG&E, a California utility, pleaded guilty to 84 manslaughter charges stemming from a massive 2018 fire that destroyed a town and led to dozens of deaths and much suffering and losses. The company paid $4 million in penalties, which is the maximum under California law, and will have to report to a monitor appointed by a federal judge overseeing its criminal probation for previous safety violations related to a 2010 fatal gas-line explosion that killed eight and injured dozens.

In approving the current settlement, the judge noted that PG&E's sentence did not fit the enormity of its crime. One headline about the story declared that PG&E dodged 90 years in jail by being a corporation and not a natural person. No individual within PG&E was charged with any crime.

Other examples come from the many corporations that enabled and benefitted from the opioids crisis that killed hundreds of thousands of Americans in the last two decades. Purdue Pharma, whose conduct since the late 1990s is described in Berry Meier's book *Pain Killer: An Empire of Deceit and the Origin of America's Opioids Epidemic*, is now in bankruptcy and trying to settle hundreds of lawsuits from state and cities, as well as fraud charges from the federal government. No individual within Purdue went to jail for perpetrating this massive crisis.

Purdue was not alone in breaking the law and profiting from the opioids epidemic, even as many have died and suffered and the cost on society had been enormous. Possessing and selling highly addictive drugs violates the US Controlled Substance Act, which for individuals carries substantial, sometimes-mandatory

prison terms. Drug distributor McKesson Corporation repeatedly turned a blind eye and failed to report hundreds of thousands of suspicious opioids orders, including enough to provide an excessive number of pills to every person of some small communities. Yet, according to a scathing report by *60 Minutes* and the *Washington Post*, despite its extensive and repeated violations, McKesson paid $150 million in a civil settlement in 2017 for years of misconduct that followed a prior 2008 settlement. This fine was equivalent to about a week and a half of the company's profits. Individuals pushing drugs in such quantities on the streets would, of course, spend many years in jail.

Another highly disturbing report by *ProPublica* describes how Walmart Pharmacy violated the same drug distribution laws on a large scale for years. According to the report, Walmart pharmacists were pressured by bosses to fill prescriptions from pill-mill doctors that pharmacists knew, and as their professional and ethical code suggested, should have been refused and reported in detail as inappropriate. "Driving sales" was more important than obeying the law, even as pharmacists were put in tough situations and as the devastating consequences of the opioids crisis were becoming evident. In late 2018, top Department of Justice officials instructed prosecutors in Texas, who had built what they believed was a strong criminal case against Walmart and sought to proceed to indictment, to drop the case. A civil suit remains unsettled.

Other examples abound. Institutions such as HSBC, Danske Bank, and many others have engaged in money laundering for years, generating large profits. The first chapter of David Enrich's book *Dark Towers* about Deutsche Bank is entitled "a criminal enterprise." The details in the Theranos case in the US or Wirecard in Germany are shocking. These cases, as well as DuPont's contamination of drinking water and cover-up, Wells Fargo Bank's account-opening scandal, and the reckless actions of Boeing and its regulator, the Federal Aviation Administration that caused two plane crashes killing hundreds, are the tip of the iceberg.

Corporate misconduct often persists for long periods, as was the case in most of the examples above. In a dissent over a 2015 decision to renew Deutsche Bank's special issuer privileges despite manipulating Libor, Kara Stein, then-Commissioner of the Securities and Exchange Commission, stated that the bank's "illegal conduct involved nearly a decade of lying, cheating and stealing". Whistleblowers, investors, or investigative reporters who try to expose some of the most egregious cases suffer harassment or worse.

After the financial crisis of 2007-2009, many asked why no high-level executives went to jail. Much of the buildup of risk that led to the crisis did not break the letter of the law. Although the rules in place before the crisis were poorly designed and inadequate, post-crisis reforms continue to tolerate and even encourage recklessness. Fraud and deception, however, were also a problem in the run-up to the crisis and remain pervasive in the financial sector and beyond, yet it is exceedingly rare for any executive to face criminal charges or go to jail.

In his 2018 book *The Chickenshit Club*, Jesse Eisinger argues that prosecutors in the US Department of Justice have found it increasingly difficult, costly, and personally unattractive to investigate and try to prosecute executives when corporations commit crimes. Judge Jed Rakoff, whose experiences include years in both prosecution and defense of corporations and executives, advances a similar hypothesis.

Legal systems outside the US face related challenges, as seen in the recent failure of UK authorities to hold Barclays and four of its executives criminally liable for fraud. German law still provides virtually no tools to deal with crimes by corporations.

Returning to the US Constitution, Founding Father James Madison stated in Federalist 51 (1778), "If Men were angels, no government would be necessary." Madison continued to recognize that "The great difficulty lies in this: you must first enable the government to control the governed; and the next place, oblige it to control itself." As Daron Acemoglu and James Robinson show in their latest book, legal systems matter greatly to economic outcomes and corrupt and incompetent governments and badly designed and enforced laws can undermine markets and take down nations.

In her 2019 book *The Code of Capital*, Katharina Pistor argues that the legal code, and the lawyers who shape it, play key roles in creating wealth inequality. The devil is often in the details, and lawyers know how to work them to advantage those who can pay the most. Pistor ends with an ominous warning that if trends such as attacks on independent judiciaries and free press even in countries with long traditions of democracy and the rule of law continue, "naked power will once more gain sway over legal ordering… and we will all be worse off for it".

None of these issues about the challenge of writing the rules of society and compelling corporations to comply with the rules as embodied in the law are discussed by Milton Friedman. Even as Friedman takes for granted that, somehow, lawful conduct by corporations, as well as the idealized conditions of "free competition without deception and fraud" come about, he displays disdain and derision towards the very governments that are often essential for making his assumptions hold.

In direct contrast with the market system he extolls, Friedman presents the caricature of a "centrally controlled" system in which governments determine prices and wage, and he laments that executives who speak of corporate social responsibility will bring back "the iron fist of government bureaucrats". These narratives, and the stark choices we are often presented within the political discourse—between "free market capitalism" and "big government socialism"—are simplistic and misleading. The key issue is not the size of government but rather the competence, incentives, and integrity of those who act on its behalf.

Uncorrupted governments, capable of providing essential services effectively, creating and enforcing proper rules and administering justice for all, are essential for prosperity.

Yet, hostility towards governments, and actions by corporate managers and others that deprive governments of resources, expertise, and incentives to act in the public interest, can cause government failure to become self-fulfilling. In *The Fifth Risk*, Michael Lewis warns of the dangers we face when people with significant power over the government are ignorant as well as short-sighted and greedy. In a recent interview, Lewis expressed hope that the pandemic would help people "figure out just how critical government is".

Neither corporate managers nor government leaders are likely to act in society's interests unless stakeholders express their wishes and take action to hold power to account. In her recent book *Superman's Not Coming*, consumer rights advocate and environmental activist Erin Brockovich shows that many in the US cannot even count on having unpolluted water without fighting for it; as Katherine Eban suggests in *Bottle of Lies*, generic drugs may also be unsafe; and in the US, information about unsafe products is not shared effectively. We must exert whatever influence we can have as shareholders, consumers, employees, academics, and citizens to impact the actions of those with power over our lives.

I hope those who continue to celebrate Friedman's value maximization credo recognize that the assump-

tions Friedman makes about the environment in which businesses operate and the rules of the game by which they play don't actually hold in reality. I also hope that they become forceful advocates for changes that would bring the world closer to the conditions needed for Friedman's arguments to hold. Being blind to how far we are from such a world is among the reasons both capitalism and democracy appear to experience an existential crisis today.

The author thanks Greg Buchak, Paul Pfleiderer, and Graham Steele for helpful comments and discussions.

Anat R. Admati is the George G.C. Parker Professor of Finance and Economics at Stanford University Graduate School of Business (GSB), a Director of the GSB Corporations and Society Initiative, and a senior fellow at Stanford Institute for Economic Policy Research. She is an economist with broad cross-disciplinary interests in the interactions between business, law and policy, and an advocate for better governance and accountability in the private sector and in government. She is also the author of The Bankers' New Clothes: What's Wrong with Banking and What to Do About It (Princeton University Press, 2013).

Corporations Are Already Plenty Powerful. Stakeholder Capitalism Could Make Them More So

By Karthik Ramanna

Encouraging corporations to further step into the role of governments and civil society groups by becoming more "socially focused" risks greater depreciation of our public institutions. What we need instead is a moratorium on corporations setting the rules of the game.

Editor's note: This article is an excerpt of a longer piece by the author recently published in the California Management Review.

It is somewhat fashionable these days for CEOs to speak about "stakeholders." Last year, the Business Roundtable, arguably the most powerful agglomeration of big business in America, abandoned its longstanding shareholders-first policy, ostensibly in favor of a less-rapacious approach towards the environment and labor.

On the surface, this shift looks like good news, and, as with Blackrock CEO Larry Fink's now-famous

2018 memorandum calling on corporations to have "a sense of purpose," the Business Roundtable statement received some cheerful coverage in the press.

Yet conspicuously absent from these platitudes about sustainability, ethics, and fairness is any commitment to changing the way companies lobby to set the "rules of the game." One of the main reasons why so many big US companies today are feeling the heat to be seen as "socially responsible" is that they have spent the last forty years manipulating public policy to serve their interests, to the point where the country's ability to govern is now so withered that capitalism itself is teetering. In this moment of populist reckoning, let us then not allow half-measures to fool us.

Just as significantly, let us beware of a cure worse than the disease. It is tempting, seeing liberal democracy at its nadir, to heed an attempt at rescue from big business. Perhaps, in recommitting themselves to all their stakeholders, we might hope that the Business Roundtable will save America from angry, underpaid crowds. But nowadays, ever more so, corporations are designed to turn a profit, and in an increasingly cutthroat globalized economy—facing competition from China, India, and elsewhere—this is a good and useful thing for American businesses and, under the right circumstances, for American society.

The idea that corporations have responsibilities to citizens, customers, and employees is eminently sensible—but those responsibilities are usually met if corporations focus on creating long-term value for shareholders.

Conflicts sometimes arise when managers are incentivized to generate short-term returns, either to satisfy transient investors looking for a quick buck or to boost their own bonuses before cashing out. Addressing this mismatch in horizons has been the dominant focus of corporate-governance experts for many decades now. This work should obviously continue.

But the real challenge with corporate social responsibility, or CSR, is posed when purported corporate responsibilities to citizens, customers, and employees are at odds with responsibilities toward shareholders, even over the long-run. For instance, what should happen when it is in the best interest of shareholders to shut down a cash-bleeding factory that is a major local employer?

Corporations in so-called stakeholder economies—Germany and Japan, for example—are generally expected to address this question in favor of their broader social responsibilities. And indeed, even after decades of economic stagnation, many Japanese corporations continue to consider it their duty to protect the implicit covenant of lifetime employment.

Not so in corporate America, and not particularly since the 1980s. Why?

In 1970, Milton Friedman wrote in the *New York Times Magazine* that "the social responsibility of business is to increase its profits." The article struck a nerve, and it had a titanic impact, largely because it was timely. Friedman was responding to what he saw as a deteriorating competitive environment in the US, where major corporations were becoming, so to speak, fat and happy.

Friedman worried that this situation made American business vulnerable to international competition (Japan, at the time, was resurgent). He warned that a business strategy that picks and chooses across competing social responsibilities is wasteful of investors' capital and opens the door to managerial profligacy and corporate mediocrity. In the long run, no one in the country benefits.

In just over a decade, the Reagan revolution had taken hold in America, and Friedman's postulate had become policy.

Critics of the American embrace of shareholder primacy often point out that CSR is not incompatible with the US remaining competitive. Witness corporate Germany, they argue. But as tempting as the German model may appear to outsiders, it hasn't really spared that country from populist disenchantment with its own economy today.

Crucially, America ignored an important caveat in Friedman's own dictum—that corporations' social responsibility to increase profits was subject to externally imposed rules of the game. In order to work in society's benefit, profit-seeking companies require strong non-market institutions to safeguard the conditions for competition, since corporations have little interest in doing so. After all, monopolists earn greater profits than firms in competitive markets.

A recent study of market concentration by economists Jan De Loecker and Jan Eeckhout shows that since 1980, corporate markups over marginal costs—a measure of a firm's ability to command a price premium in the absence of substitute products—have increased substantially to about 67 percent in 2014. For reference, such markups averaged 18 percent in 1980 and about 20 percent in the period from 1950 to 1980.

If corporations can shape the rules of markets to undermine competition, then such markets will have no legitimate basis in a liberal democracy. This is the world in which we now live, having been delivered here in part by the lobbying of some member-companies of the Business Roundtable.

As such, encouraging such corporations to further step into the role of governments and civil society groups by becoming more "socially focused" risks greater depreciation of our public institutions. Evidence from decades past suggests big business will simply use any expanded social role to extract more profit. What we need instead is a moratorium on corporations setting the rules of the game.

If that sounds Sisyphean, scarier still is the proposition that business leaders like Jamie Dimon—who leads both the Business Roundtable and JPMorgan Chase, one of the most-fined companies in history—are serious about being socially responsible. If corporate titans are not constrained by the principle that their actions should be value-accretive to shareholders, expect more rapid erosion of liberal democracy, as they use their political power to subject us to their own idiosyncrasies on what is socially desirable.

Karthik Ramanna is a professor of business and public policy at Oxford university's Blavatnik School of Government. Ramanna joined Oxford in 2016, after nearly a decade on the faculty of Harvard Business School. At Harvard, he also held the Henry B. Arthur Fellowship in ethics, the Marvin Bower Fellowship recognizing innovative faculty research, and a visiting fellowship at the Kennedy School of Government. Additionally, he is a faculty associate of the Weatherhead Center for International Affairs. He received his Ph.D. in management from the Massachusetts Institute of Technology. Ramanna's scholarship explores the role of business leadership in shaping the basic rules that govern capital-market societies. His book Political Standards (University of Chicago Press) studies the political and economic forces that have shaped corporate financial reporting standards over the last 30 years. He argues that accounting rulemaking is an allegory for the "thin political markets" where businesses shape – and sometimes subvert – the essential technical edifices of our economy. Ramanna has authored over two-dozen HBS case materials and over a dozen original research articles in leading professional outlets such as the Accounting Review, the California Management Review, and the Harvard Business Review. His scholarship has won awards from numerous bodies such as the American Accounting Association. He serves on the editorial boards of several scientific journals, including as co-editor of the interdisciplinary journal Accounting, Economics & Law and as associate editor of the Journal of Accounting & Economics, the most-cited outlet in that field.

Friedman's Legacy: From Doctrine to Theorem

By Luigi Zingales

Friedman was more right than his detractors claim and more wrong than his supporters would like us to believe. However, after 50 years of lax enforcement and a digital revolution that increased network externalities and created digital monopolies, we cannot continue to assume we live in a society where there are no monopolies and where corporations do not have much influence on legislation, as Friedman did.

Love it or hate it, the piece that Milton Friedman wrote in the *New York Times* 50 years ago should be considered one of the most influential op-eds of the 20th century. The fact that 50 years later the best minds in economics and the law have been willing to debate its consequences on *ProMarket* is a testimony to the enduring legacy of Friedman's contribution.

In the popular press, Friedman's principle is treated as a matter of religion; while in the more formal academic publications, it is ignored (after all, it was not written as a formal theorem). As a result, even half a century later, it is difficult for an educated reader to grasp what Friedman's enduring lesson is. The 27 articles *ProMarket* published provide an excellent overview of the diversity of opinions still existing on this topic. In my concluding piece, it is impossible to do justice to this variety. I will try my best to weave them together in a common thread, highlighting where Friedman was right, where he was wrong, and where the matter has not been settled yet.

First of all, there are two ways to read Friedman's contribution. Is Friedman writing about what is optimal for shareholders or what is optimal for society? The title seems to suggest the second interpretation, but in the text, Friedman focuses mostly on the first. The first dimension, emphasized by Steven Kaplan and Lucian Bebchuk and Roberto Tallarita, is less controversial. While Friedman gets the law wrong (corporate managers are not "employees of the owners of the business," but of the corporations), he gets the substance right. If shareholders desire "to make as much money as possible," corporate managers, who have a fiduciary responsibility towards shareholders, need to focus on maximizing profits.

The second dimension—i.e., whether it is socially desirable that firms maximize profits—is much more controversial. In his piece, Alex Edmans correctly compares Friedman's idea to the celebrated Modigliani and Miller Theorem, a benchmark that every finance student confronts. The Modigliani and Miller theorem is not an article of faith; very few people believe that in practice the cost of capital is totally unaffected by the financing mix, but it is an extremely useful instrument to understand why financing matters. The problem was that in the *New York Times* piece, Friedman's idea was not stated as theorem, but literally as a "doctrine," triggering a religious reaction, rather than a more balanced academic response.

Five decades later, it is important to fix this mistake and restate Friedman as a theorem. Under what conditions is it socially efficient for managers to focus only on maximizing shareholder value? First, companies should operate in a competitive environment, which I will define as firms being both price *and* rules takers. Second, there should not be externalities (or the government should be able to address perfectly these externalities through regulation and taxation). Third, contracts are complete, in the sense that we can specify in a contract all relevant contingencies at no cost.

If these conditions are satisfied, Friedman's result, which I will label the Friedman Separation Theorem, holds. In the 1930s, Irving Fisher established that a firm can determine how much to invest solely on the basis of the market interest rate, regardless of the temporal preferences of its shareholders. This result is known in the literature as the Fisher Separation Theorem. Friedman significantly extends Fisher's results establishing when corporate managers can ignore not just the temporal preferences of their sharehold-

ers, but all of their preferences and the preferences of their workers, suppliers, etc. Friedman Separation Theorem makes the life of a corporate manager much, much simpler—this is one of its many attractions.

Any well-trained economist will recognize that my formulation of the Friedman Separation Theorem is nothing more than a restatement of the celebrated First Welfare Theorem, establishing the social optimality of competitive equilibria. Proven in its generality by Arrow and Debreu in 1951, this idea was initially relegated to the abstractions of mathematical economics. Friedman has the merit to see the tremendous practical implications of this theorem and to push it into the real world.

Addressing a general audience, Friedman also understands that the mathematical subtleties of the Arrow and Debreu proofs will not cut it. Instead, he chooses to present an argument that appeals directly to the core American values of freedom and independence. In a free economy, Friedman notices, stakeholders voluntarily get together. By and large, they choose to provide everybody a fixed-payoff contract, except the shareholders. As a result, shareholders absorb all the risk and reap all the rewards of the company's performance. In this context, maximizing profits (i.e., the residual after all the fixed contracts are paid) is tantamount to maximizing the size of the entire pie.

Furthermore, under those assumptions, any additional social responsibility imposed on a company is a cost born by shareholders (and only shareholders). Thus, imposing this responsibility against their consent is tantamount to taxation without representation. Thus, Friedman unleashes the shareholder revolution appealing directly to the American Revolution.

Given these assumptions, the Friedman Separation Theorem holds. But do these assumptions hold, at least approximately, in the real world? If they do not, should the Friedman Separation Theorem be thrown away altogether? Let me analyze the assumptions in reverse order.

Are contracts complete? The answer is a resounding "no." When contracts are incomplete, all the stakeholders (not just the shareholders) are affected by corporate decisions. When a company fails, the suppliers lose their credit, the workers experience a drop in wages, and entire communities are devastated. In a world of complete contracts, shareholders could have provided full insurance against this risk. In a world of incomplete contracts, they cannot. Anticipating these partial expropriations, workers, suppliers, and customers will be reluctant to make a firm-specific investment, reducing the value of the firm. In other terms, when contracts are incomplete, maximizing the firm's value and maximizing shareholder value are not one and the same, and Raghuram Rajan is right: managers should maximize the firm's value. If that is the objective, why should we leave this decision solely to shareholders?

This is where Friedman's "proof" of the theorem becomes handy. Let's look at what people choose voluntarily. If we rule out externalities (e.g., tort claimants) and we focus on contractual stakeholders (suppliers, customers, employees, and financiers), we should ask ourselves why the for-profit corporate form, where shareholders are given the exclusive rights to appoint directors, is so widespread. It is possible for businesses to organize as cooperative, as non-profit, and in recent years even as benefit corporations, where managers are required by law to consider all stakeholders in their decisions. Why do businesses keep choosing the traditional corporate form in overwhelming numbers? When Leo Strine was still a Delaware Justice, he stated that power is purpose. If companies keep giving shareholders (and shareholders only) the power to elect corporate directors, this implies that they want those directors to do what shareholders want: to maximize the value of their claims.

I am old enough to know that the evolutionary argument in economics is often abused. Even in the biological world, evolution leads to the survival of the most prolific, not necessarily of the fittest organism. Why should it be different in the economic world? It is easy to concoct examples where inefficient organizational forms prevail because of wealth constraints (especially of workers) or bounded rationality. Yet, the burden of proof is on the stakeholders' advocates. Even in the most progressive Silicon Valley start-ups, workers receive stock options, but not voting rights. Companies only offer voting rights to workers where they are required to by law, as in Germany. They do not do so voluntarily. If it is so efficient to allocate votes to workers, why don't they do it voluntarily?

The empirical implausibility of assumption three does not, in my view, undermine the practical implications of the Friedman Separation Theorem, but it should temper its most cynical interpretations. Companies should maximize shareholders value, but not in an opportunistic way, or at the expense of other stakeholders. As Friedman himself recognizes, corporations should "make as much money as possible *while conforming to their basic rules of the society, both those embodied in law and those embodied in ethical custom*." It is not Friedman's fault, but society's fault (and the fault of us teachers of business executives) if the ethical customs of business have deteriorated so much that they do not impose any limitation to opportunistic behavior other than those imposed by reputation.

When it comes to the second assumption, nobody in their right mind will defend the idea that we live in a world without externalities. Thus, to believe that assumption two holds (at least approximately) we need to believe that the government is relatively good at addressing these externalities via taxation or regulation (including the creation of "rights to pollute").

Before we address the plausibility of this assumption, we need to confront the fact that corporations are born with an original sin: the ability to externalize some of their costs. While limited liability vis-à-vis contractual claimants can be achieved via ordinary market contracting, limited liability vis-à-vis tort claimants is a privilege granted by the State. Historically, as Stefano Zamagni reminds us, this privilege was granted only when a social purpose (like building a road or a bridge) was involved. Over time, the explicit social purpose was dropped, because the economic growth triggered by freedom of incorporation was considered a sufficient social benefit.

Yet, it is important to remember that corporations are not just purely contractual entities; they are granted by the State an extraordinary privilege and, thus, the State itself can demand something in exchange for this privilege. The British Academy goes too far in this direction, asking to reintroduce an explicit mandatory social purpose for corporations. This is a very dangerous position because it delegates to the state the right to decide not only what is good and what is bad, but also which business can be pursued and which one cannot, undermining the freedom of enterprise. But some milder mandates (more on this later) could be justified.

Having understood that when it comes to corporations the production of externalities is a feature, not a bug, we are left assessing how good the government is at addressing these externalities. As economists, our preferred way to deal with externalities is taxation (referred to as Pigouvian taxes). As I explain in my book, *A Capitalism for the People,* political economy considerations make the approval of Pigouvian taxes very difficult. Just look at the carbon tax, overwhelmingly supported by economists, but rejected even in the most liberal states of the union. Thus, claiming that Pigouvian taxes will address all the externalities is untenable.

When it comes to regulation, the argument is more subtle. There is certainly a lot of regulation aimed at addressing the externalities produced by corporations. For relatively small companies, it is debatable whether this regulation is enough. But when we look at very large corporations, the ones Anat Admati defines as too big to jail, regulation becomes ineffective. Roy Shapira and I have studied how, in 1984, DuPont decided to dump lethal toxic waste in the Ohio River and how it got away with it for more than thirty years. Not only was DuPont able to capture the regulators with a smart combination of revolving doors and aggressive lobbying, but it was able to hide the very dangers of the substance it was producing and freely disposing of in the environment. When discovered, DuPont was able to draft the regulation to its own needs to avoid liability and was successful in doing so while its CEO was celebrated as an environmental leader.

It was only a combination of a clever lawyer and many strokes of luck that eventually led to a conviction of DuPont more than thirty years later. All the corporate scandals listed by Admati suggest that DuPont is not the exception, but the rule: large companies are subject to regulation only de jure, not de facto.

If the government is unable to fully address the externalities, should managers maximize profits? From a societal point of view, the answer is clearly "no." But the answer is "no" even from a shareholder point of view if shareholders have some social objectives. Friedman recognizes this possibility by saying that the desire of investors "*generally* will be to make as much money as possible." Yet, he is quick to suggest that even when this is not the case (as when shareholders are interested in charity), it is better for companies to maximize profits, distribute them, and let shareholders donate those profits to their favorite charities.

This result had enormous consequences for the asset management industry. If the Friedman Separation Theorem holds, asset managers do not have to care about the social preferences of investors, they just have to maximize financial returns. For example, one of the goals of the Bill & Melinda Gates Foundation is to reduce inequities in health by developing new tools and strategies to reduce the burden of infectious disease and the leading causes of child mortality in developing countries. However, their asset managers do not have to decide whether the firms they invest in are pursuing or undermining the goals of the foundation. Managers can invest purely based on financial considerations, to maximize the money the Gates Foundation has to pursue its goals. Is this the best way for the foundation to reach its objectives? No.

Oliver Hart and I show that Friedman's result only holds in the knife-edge case when a company does not have any comparative advantage vis-à-vis shareholders in pursuing a social objective. This is certainly the case for corporate charity. One dollar donated by Microsoft is equally as effective as a dollar donated by me. Yet, it is not the case for most other social objectives. It is cheaper not to pollute than to pollute and clean up. It is cheaper not to sell guns to the Saudi than to do so and then help the Yemen refugees, and so on and so forth. Why should companies pursue the maximization of monetary returns at the expense of the social goals of their investors? If I am a 100 percent owner of a company, I will be running it to maximize my utility, not my wealth. Why should it be different when many of us own it? The modified Friedman principle should be that managers should maximize shareholders' *welfare,* not value.

As Eugene F. Fama and John G. Matsusaka correctly point out, the difference between a firm owned by an individual and one owned by a multitude of individuals is the difficulty in reconciling different opinions. When there are multiple owners, they will disagree on what social objectives to pursue. Some very conservative investors would want a pharmaceutical company not to pursue an abortion pill even when such a pursuit is profitable, while some very liberal investors would like to sell such a pill below cost to

help poor pregnant women. How to reconcile these preferences? We know from Arrow's impossibility theorem that no voting system can convert the preferences of individuals into a community-wide ranking, while also satisfying a set of desirable properties. Yet, Arrow's impossibility theorem has not led us to give up political democracy, so why should we give up shareholder democracy?

The difference between maximizing shareholder welfare rather than value might appear to be mere semantics, but it is big. It really destroys the separation result that made Friedman's theorem so appealing to the asset management industry. Taken seriously the Hart and Zingales result will make corporate democracy necessary, revolutionizing the way companies are run. This democracy, as all democracies, will impose information costs. In spite of these costs, shareholder pressure seems able to reduce toxic chemical releases and inmate suicides in private prisons. Whether the costs are worth the benefits is still open for debate.

Information costs aside, can these externalities be resolved by the private sector? In a recent paper with Eleonora Broccardo and Oliver Hart, we show that if the (wealth weighted) majority of investors are even slightly altruistic and if they are well diversified, then they will vote as a benevolent planner would, so they will lead companies to internalize externalities. Thus, there is hope that shareholder democracy could fix even this problem, but only if we let democracy work. Unfortunately, the Department of Labor is currently trying to prevent asset managers from considering any factor other than financial returns in casting their corporate ballots. It is ironic that alleged libertarians resort to the coercive power of the state to prevent shareholders from expressing their opinions about the companies they own. If we eliminate these restrictions, however, the modified Friedman principle (i.e., maximization of shareholder welfare) leads to desirable social outcomes.

The really problematic assumption is assumption number one. Friedman himself recognizes that a monopolist maximizing shareholder value is not good for society. Yet, writing in 1970, at the peak of the US antitrust enforcement, Friedman was not overly concerned about monopolies. After 50 years of lax enforcement and a digital revolution that increased network externalities and created many digital monopolies, we cannot be so cavalier. Consider Google's choice of how to rank news about political candidates. Experimental evidence shows that searches leading to a higher ranking of bad news about a political candidate result in fewer votes for that candidate. A board that maximizes profits would tweak the search results to disadvantage those candidates who want to tax Google or to break it up. In a competitive market, reputation prevents these abuses, but Google is a de facto monopolist. It will take a lot of abuses for a customer to switch to Bing. Do we want Google to manipulate elections?

While Friedman was well aware that the "price taker" assumption could be violated, he was not equally aware of the "rule taker" assumption. In his essay, he states that corporations should "make as much money as possible while conforming to their basic rules of the society" as if these rules were exogenously given. Only six months after Friedman wrote his *NYT* piece, George Stigler published his regulatory capture piece in an academic journal, explaining how regulated companies distort regulation in their favor against the public interest.

Stigler and Friedman were not only colleagues at the University of Chicago, but also close friends, who had lunch together almost every day. It is hard to imagine that Friedman had not been exposed to Stigler's idea even before he wrote his *NYT* piece. Certainly, he was exposed to it afterward. Yet, there is no record (at least none that I am aware of) of any attempt to integrate the two points of view.

If lifting environmental regulation has the effect of killing thousands of people, but increases the profits of chemical companies, should a CEO pursue this objective through any legal means at her disposal? I refuse to think that Milton Friedman would have endorsed this idea. After all, in his 1970 piece, he wrote that maximization of profits should be pursued "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." Thus, the only society in which Friedman's principle applies is a society where there are no monopolies and where corporations do not have much influence on legislation. This might have been the world Friedman lived in then, it is certainly not the world we live in today, as Martin Wolf clearly describes.

Thus, in 2020, how should we interpret the practical implications of Friedman's idea? If you are a small to medium-sized company, let's say Chuck E. Cheese, a company with no market power and no real power to influence regulation or elections, maximizing shareholder welfare is the right goal to follow. Especially if this goal is pursued with attention not only to legal rules but also ethical customs, like Friedman advocated, but most companies ignored.

When it comes to super corporations, corporations that have market power, like Google and Facebook, or political power, like BlackRock or JP Morgan, or regulatory power, like DuPont or Monsanto, a single-minded pursuit of shareholder value maximization can be extremely bad for society. This is the reason why Oliver Hart and I have advocated requiring boards of monopolies, like Google, or of firms too big to regulate, like Blackrock, to maximize social welfare, the utility of society as a whole, not shareholder welfare.

How do we convince a board elected by the shareholders to maximize social welfare? The simple answer is that we impose an additional fiduciary duty toward society, in addition to the existing one toward shareholders. This fiduciary duty would make directors personally liable (for a multiple of the director's fee they receive), if the company inefficiently pollutes, influences legislation, or abuses its monopoly power.

The proposal advanced in this debate by Colin Mayer, Leo Strine, and Jaap Winter goes in a similar direction. They require companies with sales above $1bn to adopt the Delaware public benefit corporation statute. This statute requires directors to "balance the pecuniary interests of the stockholders, the best interests of those materially affected by the corporation's conduct, and the specific public benefit or public benefits identified in its certificate of incorporation." This is tantamount to a license for directors to do whatever they want. It is difficult to imagine that directors, elected by shareholders, will change their behavior based on this prescription. By contrast, the fiduciary duty comes with an already existing enforcement mechanism.

The Mayer et al. mandate is triggered by a fixed level of sales ($1bn). We can quibble where it is too low (even Chuck E. Cheese might trigger it). We think that a flexible criterion, which looks at the effective political and regulatory power of the super corporations, might be more effective. This criterion would be similar to the Systemically Important Financial Institution (SIFI) label imposed by Dodd-Frank. In this way, the mandate will have an effect of discouraging opportunistic behavior even by firms below the threshold, which fear to fall under the mandate.

In sum, Friedman was more right than his detractors claim and more wrong than his supporters would like us to believe. His "theorem" has greatly contributed to determining when maximizing shareholder value is good for society and when it is not. The discipline imposed by Friedman's theorem also forces greater accountability on managers. In the world of 2020, the biggest shareholder in most corporations

is all of us, who have their pension money invested in stocks. We are the real silent majority. Corporate managers finance political candidates, lobby for self-serving legislation, and capture regulation. They have the power to use our money to fight against our own interest. While Friedman did not anticipate these degenerations, he warned us against the risk of unaccountable managers. This warning will remain his most enduring contribution.

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