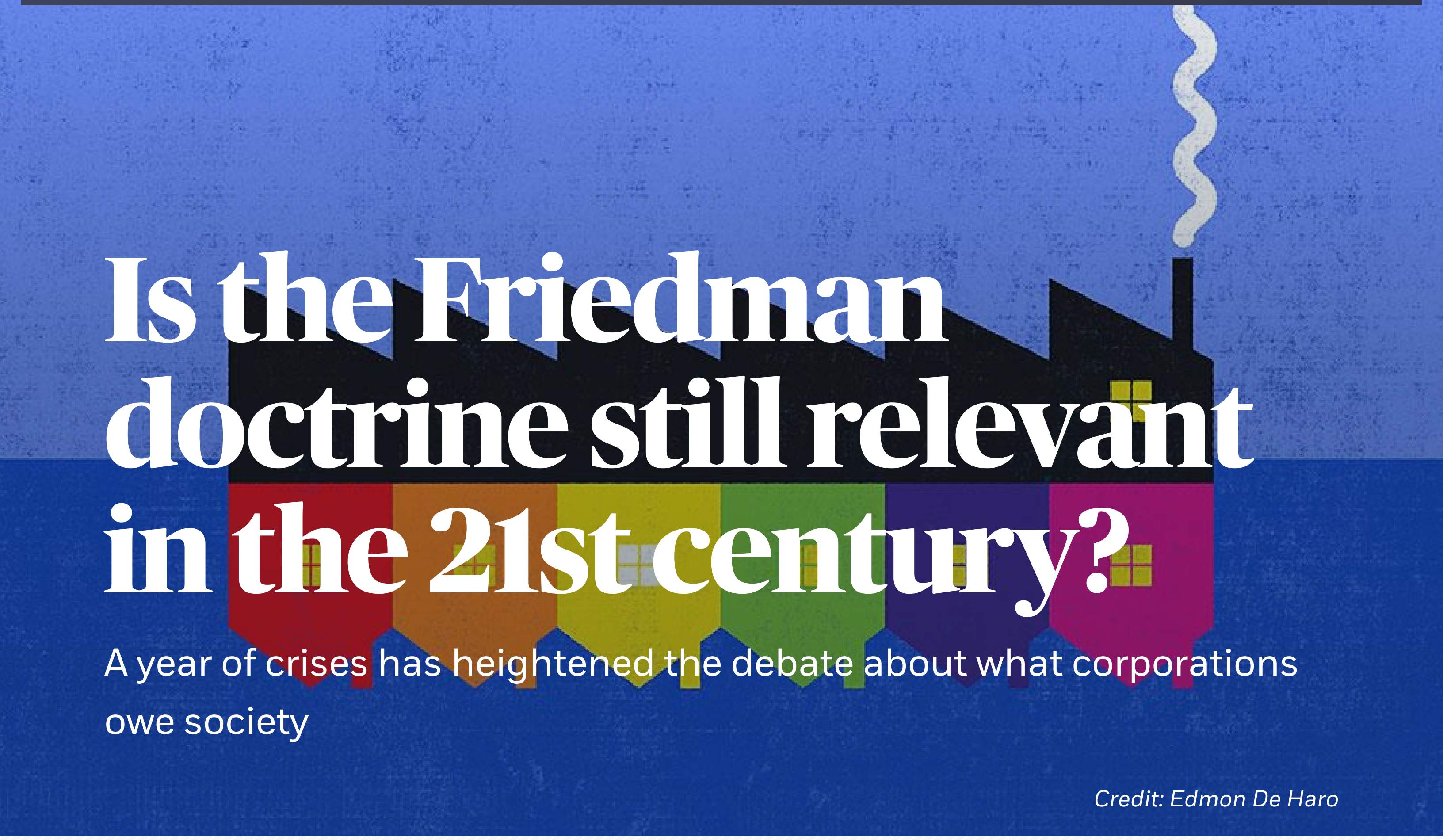

Is the Friedman doctrine still relevant in the 21st century?

A year of crises has heightened the debate about what corporations owe society

Credit: Edmon De Haro

AMY MERRICK | MAY 24, 2021

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When Georgia governor Brian Kemp signed into law in late March a bill containing new regulations about when and how people could vote in the state, it elicited great consternation from opponents worried that the changes would restrict ballot access, particularly for Black voters. Among those voicing their concerns were state and national politicians, activists, and faith leaders—and James Quincey, CEO of Coca-Cola.

“This legislation is wrong and needs to be remedied,” Quincey declared on CNBC, “and we will continue to advocate for it[s change] both in private and now even more clearly in public.”

Coca-Cola, which is headquartered in Atlanta, was not the only company with leadership who repudiated the law publicly. Delta Air Lines’ CEO, Ed Bastian, issued a memo to employees calling the law “unacceptable” and said that it “does not match Delta’s values.” Shortly after, Major League Baseball announced it would not be holding the All-Star Game in Atlanta, as it had planned to do, in protest of the law.

These reactions followed a letter signed by 72 Black executives urging companies to oppose efforts to restrict voting rights. Customers, too, were encouraging businesses to use their voice and influence to fight such efforts: some Atlanta-area leaders, for example, had earlier advocated a boycott of Coca-Cola for not speaking out more forcefully against Georgia’s law.

The expectation that companies would get involved in a political matter not immediately connected to their operations reflects a sense that businesses are not just money-making enterprises—that they have some responsibility to their communities and to society. If any business had been able to escape a reckoning with this idea prior to 2020, the confluence of crises last year—the COVID-19 pandemic, movements agitating for racial justice (in the United States) and political autonomy (in Hong Kong), and the continued heightening of ongoing concerns such as climate change—made such evasion more difficult to maintain. Not every company chose to engage with the issues affecting their customers, employees, communities, and shareholders, but the ubiquity of those issues would at least have forced many executives to make that choice consciously.

By coincidence, 2020 was also the 50-year anniversary of one of the most famous articulations of corporate social responsibility ever penned: a *New York Times Magazine* essay in which Milton Friedman, the late University of Chicago economist and Nobel laureate, argued that a company’s sole obligation to society is to make money without breaking the rules. “There is one and only one social responsibility of business,” Friedman wrote, quoting his earlier book *Capitalism and Freedom*, “to use its resources and engage in activities designed to increase its profits so long as it . . . engages in open and free competition without deception or fraud.”

“Businessmen believe that they are defending free enterprise when they declaim that business is not concerned ‘merely’ with profit but also with promoting desirable ‘social’ ends,” he wrote in the essay’s opening. “In fact they are . . . preaching pure and unadulterated socialism.”

If stockholders want to pursue a social goal, Friedman said, they are free to pay for it out of their own pockets, using their share of a company’s earnings. In this way, individuals can choose their own priorities, while business managers can avoid having to reconcile shareholders’ competing preferences. Business can stick to its essential function—making money and powering economic growth—and the government and private philanthropy can handle the job of identifying social priorities and devoting resources to them.

This idea, dubbed the *Friedman doctrine* in the essay’s title, has influenced how generations of executives have defined the purpose of their companies. But in recent years, the doctrine has undergone a reexamination by businesspeople, activists, and academics. Some feel Friedman’s conception of the purpose of a business was enlightened in 1970 and is no less so today; others argue that businesses’ disavowal of social responsibility puts communities and even capitalism itself at risk.

Companies hoping to add value through social engagement have to perform a difficult balancing act in an age of intense political polarization.

This debate is hardly without urgency. Contemporary businesses are navigating a fraught landscape in which many of them are being called upon to declare their priorities. Companies in every industry must decide to whom they are responsible, and for what—and, if they choose to look beyond shareholder value in determining their agenda, what that means in practice.

Critics say the Friedman doctrine is too limited for contemporary business. Some argue that shareholder interests go beyond money, and that a single focus on profits shortchanges these other priorities. Others suggest that at a time when corporations have an outsize role in shaping the regulations that govern them, businesses are inextricable from the societies in which they operate, and that it's time to develop principles of shared success.

Some of these critics are companies themselves. The Business Roundtable, a group of large-company CEOs led at the time by Jamie Dimon, chairman and CEO of JPMorgan Chase, issued a 2019 statement that laid out an expansive view of corporate purpose that included providing value for all stakeholders, such as employees and community members.

Defenders of the Friedman doctrine argue that there's nothing in it that indicates companies can't act in a way that benefits the environment, gender equality, racial justice, or any other social concern—only that they should do so not out of a sense of social obligation, but because in so doing they will maximize their long-term value. If investing in social good decreases risk, lowers costs, or attracts customers, those investments are consistent with Friedman's maxim.

Whatever view a manager may take of the Friedman doctrine, few businesses can remain willfully agnostic about whether they have a social purpose, as the experience of Delta and Coca-Cola suggests. If the social responsibility of business was ever a topic mostly confined to boardrooms, classrooms, and luncheon speeches, it has long since escaped those bounds and become a momentous topic not only to managers and shareholders but to their employees, their elected representatives in government, and increasingly, to their customers.

Is social justice value maximizing?

After George Floyd was killed in May 2020 by Minneapolis police officer Derek Chauvin, protests across the US and around the world brought renewed attention to activist campaigns for racial justice. Many companies, believing that their customers and employees would consider silence to be callous, responded with statements supporting the Black Lives Matter movement specifically or racial equality more generally.

Chicago Booth's Pradeep K. Chintagunta studied how the public responded to statements from five companies with broad public recognition: Airbnb, Amazon, Apple, Netflix, and Pepsi. With Yogesh Kansal, a Booth MBA graduate and a project leader at Boston Consulting Group, and Pradeep Pachigolla, a research assistant at Booth and a

Cornell PhD student, Chintagunta analyzed the sentiment of tweets reacting to the corporate announcements.

In a 2020 essay for *Chicago Booth Review*, the researchers explain that consumers responded with negative emotions when companies merely issued general statements of support. The reactions on Twitter became more positive only when the businesses began backing their words with clear financial commitments, such as Netflix's pledge to invest $100 million in support of Black communities in the US.

At first glance, such decisions would appear to be in direct contradiction of the Friedman doctrine: Shouldn't Netflix invest that $100 million with a focus on maximizing its return, and then allow shareholders to use their share of the resulting profits to support racial justice if they desire? But Chintagunta says many customers now expect businesses to demonstrate their values.

"There has been a move for some time, especially among the younger generations, to think about the story behind the brand," he says. "Ultimately, there's only so much you can differentiate based on product features. The solution, increasingly, is to figure out some kind of emotional attachment. One way in which some companies feel they can make that connection is to highlight the fact they're supporting these movements. Now, how authentically that is viewed is a different issue."

Chintagunta sees distinctions between shareholders and other stakeholders as artificial. "If employees and employers work together to make customers happy, shareholders are going to be happy," he says. "You shouldn't think of these as separate silos that you can manage independently."

The conversation with and about brands on social media is a significant shift in the relationship between businesses and their communities, and a potential risk for companies who respond poorly, says Booth's Steve Kaplan.

Although this digital dialogue didn't exist in Friedman's time, Kaplan asserts that the Friedman doctrine of maximizing shareholder value can accommodate shifts in stakeholder perspectives. When customers and employees begin to show greater concern for social issues, as they have over the past few decades, responding to them can boost a company's stock price in the short and long runs. "Milton Friedman was completely right then, and he's still right," Kaplan says. "He didn't say to treat the environment badly. He was very clear that if the world changes—and it has—and customers care more that you're an environmentally good citizen, then being an environmentally good citizen can increase shareholder value."

When analysts start trying to evaluate a business along social or environmental dimensions, their assumptions quickly become murkier.

Yet, companies hoping to add value through social engagement have to perform a difficult balancing act in an age of intense political polarization. In many cases, pleasing one group of stakeholders may alienate another.

After 23 people were killed and more than 20 others injured in an August 2019 mass shooting in a Walmart store in El Paso, Texas, Walmart said it would discontinue sales of ammunition for military-style weapons such as the one used in the shooting. Walmart requested that its customers no longer openly carry weapons in its stores and publicly endorsed certain gun-safety proposals such as strengthening background checks.

Marcus O. Painter of St. Louis University analyzed how customers reacted to the changes. Using geolocation data from smartphones, he finds customer visits to Walmart stores declined 3.3 percent compared with local rivals following the announcement. Visits to Walmart stores actually increased 2.8 percent in counties that were highly Democratic, but that bump was more than offset by an 8.3 percent decrease in customer visits to stores in counties that were highly Republican. Further, the customers in Democratic counties only increased their Walmart visits for a short time, whereas the drop-off in store visits in highly Republican counties persisted.

Shareholder influence

Often, pressure comes not just from customers and social media but from shareholders themselves, as well as from potential shareholders.

Eyub Yegen, a PhD student at the University of Toronto, analyzed the effects of privatization and the role of institutional investors on prisoner welfare. The number of inmates in private prisons increased by 47 percent in the US from 2000 to 2016, and in shifting from public to private management, a prison could face cost-cutting incentives that would have negative effects on prisoner well-being. Consistent with this notion, Yegen finds that privatization was associated with an increase in inmate suicide rates of up to 15 percent.

Yegen also finds that long-term institutional investors, such as mutual funds, changed the practices of publicly traded companies that manage private prisons. A 1 percent increase in institutional-investor ownership reduced prisoner suicides by up to 1.2 percent, he finds. But improvement only came from the growing involvement of investors with a long holding horizon, who were more likely to focus on long-term performance. Ownership by investors with a short holding horizon, who were more likely to favor short-term cost cutting, did not reduce suicide rates.

“Although privatization of prisons leads to a reduction in the quality of lives of prisoners, the social costs of privatization are mitigated by the monitoring role of institutional investors,” Yegen writes.

This causal effect is apparent in part because of a change to the tax code in 2012, when publicly traded prison-management companies were reclassified as real-estate investment trusts by the Internal Revenue Service. This change led to a big increase in holdings of prison-management companies by exchange-traded funds, which passively track market indices such as the real-estate industry.

Yegen argues that everyone should care about the welfare of prisoners, but his research indicates that institutional investors are also protecting the long-term value they receive as shareholders by reducing litigation and reputation risks. The effect of institutional-investor ownership on reducing prison suicides strengthened, he finds, following periods with a higher-than-average number of lawsuits filed against prisons.

Yegen’s research reflects a belief among some shareholders that attention to social outcomes is simply good business. This notion has become increasingly mainstream—or at least increasingly visible—in recent years as some of the most influential figures in investing and management have issued reminders that synergies between business and the community are more prevalent than may be commonly assumed.

BlackRock CEO Larry Fink, whose company has $9 trillion in assets under management, wrote an open letter to CEOs in early 2020. In it, he said:

> *The importance of serving stakeholders and embracing purpose is becoming increasingly central to the way that companies understand their role in society. . . . Over time, companies and countries that do not respond to stakeholders and address sustainability risks will encounter growing skepticism from the markets, and in turn, a higher cost of capital.*

Markets are showing their taste for social responsibility. In the US, one-third of the $51.4 trillion in assets under professional management, or about $17 trillion, is now invested with an eye on environmental, social, and governance (ESG) issues, a 42 percent increase over 2018.

Chicago Booth's Lubos Pastor, with University of Pennsylvania's Lucian A. Taylor and Robert F. Stambaugh, modeled how investors' appetite for "green" stocks affects asset prices and businesses. The model projects that as investors' preference for socially responsible companies goes up, so do those companies' stock prices. This run-up in prices leads to higher realized returns but lower expected future returns for investors. Consistent with the warning in Fink's letter, more demand for green stocks leads to a lower cost of capital for ESG-aligned companies, and in turn, more investment by those companies, while the inverse is true for "brown" (socially detrimental) companies. Because greener companies have higher market values, even managers whose only concern is maximizing value are motivated to pursue socially beneficial ends. (For more on this research, read "When green investments pay off.")

Regulators are also pushing companies to review ESG concerns as a way to develop resilience against external shocks. In July 2020, the Hong Kong Exchanges and Clearing began requiring listed companies to provide a statement from their boards outlining their discussion of ESG issues and to disclose any significant climate-related concerns affecting their operations. "We look at ESG and sustainability as a risk-management exercise," Katherine Ng, chief operating officer and head of policy for the listing department of the HKEX, told attendees of a Chicago Booth CSR conference. "It helps in identifying a business's strengths and weaknesses, as well as recognizing and mitigating material risks. Enshrining ESG principles in business strategy makes a company more agile and better prepared to deal with sudden change in the future."

What do shareholders want?

In his *Times* essay, Friedman wrote, "In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires," which Friedman concluded "generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom."

But a 2017 paper by Chicago Booth's Luigi Zingales and Nobel laureate Oliver Hart of Harvard asserts that it may be an error to assume shareholders care only about profits. If they care (even slightly) about some social objective, and if a business has a comparative advantage over individuals in pursuing that objective, shareholders may want the business to pursue a social goal, even if it means giving up some profit. "Consider the case of Walmart selling high-capacity [ammunition] magazines of the sort used in mass killings," they write. "If shareholders are concerned about mass killings, transferring profit to shareholders to spend on gun control might not be as efficient as banning the sales of high-capacity magazines in the first place."

Friedman is right in advocating for *shareholder primacy*, or the concept that companies should operate for the benefit of the people who pay for the cost of any social agenda, Zingales and Hart argue, but it's a mistake to define that benefit in entirely pecuniary terms. It's better for managers to focus on maximizing shareholder welfare more generally, they say, rather than shareholder value specifically.

Friedman's concern for free society, and how the notion of corporate social responsibility could undermine it, reflects the Cold War era in which he was writing.

Brad M. Barber and Ayako Yasuda of the University of California at Davis and Adair Morse of UC Berkeley looked at investment in certain venture-capital funds to explore just how much pecuniary value investors might be willing to give up. They find that investors in dual-purpose VC funds (which aim to have a positive social impact as well as generate financial wealth) willingly sacrificed returns for the sake of creating social benefit.

Barber, Morse, and Yasuda analyzed investments by nearly 3,500 investors in more than 4,600 VC funds, 159 of which they identified as dual-purpose or impact funds. They find that impact funds realized an internal rate of return that was 4.7 percentage points lower than that of traditional funds. However, they also find that investors in impact funds were willing to pay for the opportunity to provide social impact. How much they were willing to pay varied considerably across investors—North Americans exhibited a lower willingness to pay for impact than European, Latin American, and African investors, for instance, perhaps reflecting regulatory differences in what factors investors such as pension funds are allowed to consider—but the researchers find that on average, the impact investors were willing to give up 2.5 to 3.7 percentage points on the internal rate of return when they made their investments.

Drawing the conclusion that shareholders' desires "generally will be to make as much money as possible" may be too broad, the research suggests. But acknowledging shareholders' competing priorities comes with its own set of problems—namely, if companies aren't evaluating themselves solely on the profits they generate, how can they gauge whether they're truly serving the interests of their shareholders?

Measuring success

One advantage of focusing on shareholder value is that it is relatively easy to quantify. When analysts start trying to evaluate a business along social or environmental dimensions, their assumptions quickly become murkier.

"Once you leave shareholder value, it's a morass," argues Kaplan, who is skeptical of the array of standards. "People are saying we should care about these other things, but they have no way to measure their value nor trade them off against each other."

Money managers who review companies according to ESG factors have many approaches. Some of the most popular standards come from organizations such as the Global Reporting Initiative and the Sustainability Accounting Standards Board, which help businesses measure their impact on issues such as climate change and human rights. But there are many other reporting frameworks, and new ones are being developed all the time.

Despite these efforts to develop rigor, the competing measurement systems hold back investors. In its 2020 Global Sustainable Investing Survey, BlackRock finds that more than half of clients surveyed cited "the poor quality or availability of ESG data and analytics" as the largest barrier to broader adoption of sustainable investing.

However, an analysis conducted by Booth's Rustandy Center for Social Sector Innovation suggests the metrics around corporate environmental and social performance may be gradually coalescing. Rustandy Center research professional Jingwei Maggie Li, Booth PhD student Shirley Lu, and Rustandy's Salma Nassar examined the 2017 CSR disclosure reports for each of the 327 companies in the S&P 500 that released one, hand-collecting information about what data the companies disclosed. After dividing the metrics into nine subcategories (such as diversity, energy use, greenhouse gas emissions, and safety), they find that seven of the nine featured at least one metric disclosed by 100 or more companies. They also find evidence that companies are more likely to disclose information about the areas of CSR for which their industries have a larger negative impact: a far greater percentage of companies in the utilities, shipping containers, and automobiles/trucks industries disclosed metrics on their greenhouse gas emissions than did companies in the insurance or retail industries. The researchers conclude that the analysis shows that for each social or environmental category, companies are agreeing on a few key metrics.

In July 2020, researchers at Harvard added a new resource, publishing their assessment of the environmental impact of 1,800 companies as measured by the Impact-Weighted Accounts Project. They find that nearly all companies in environmentally intensive industries such as airlines, paper and forest products, and electric utilities would lose more than a quarter of their earnings before interest, taxes, depreciation, and amortization if they were financially responsible for the environmental harm they create from their operations. In some industries, such as chemicals, apparel, and construction materials, the researchers find a significant correlation between greater environmental damage and lower stock-market valuations—tying their results to the effect on shareholder value.

Government and the law

In laying out his doctrine, Friedman made a sharp distinction between the role of business and the role of government. It's the government's function to identify social priorities and craft fiscal policies to achieve them, he argued. When executives levy de facto taxes on shareholders or other stakeholders by making suboptimal decisions that may reduce profits, raise prices, or lower wages, "they are seeking to attain by undemocratic procedures what they cannot attain by democratic procedures."

"The main thing that Friedman is worried about is that we would not want to be in an environment where the CEOs of companies, just because they happen to be the CEOs, are deciding for us as a society, as an electorate, which social objectives we care about and which we don't," Chicago Booth's Marianne Bertrand said at a 2018 event hosted by the Rustandy Center and Booth's George J. Stigler Center for the Study of the Economy and the State. She explained:

> *We hope that we have a political process in place where the preferences of the electorate about spending on schools or spending on alleviating homelessness would be expressed through the political system, but I think there is a concern that without some guidance as to what social goals companies should be pursuing, especially when those social goals are no longer fully aligned with long-term valuation, we might give corporations too much power.*

However, there is reason to think that, in their concern for their bottom line, companies are subverting the government's role in another sense. Corporations spend billions each year lobbying to change the regulators and the rules in their favor. Even when they break the law, harming employees with wage theft or customers with unsafe products, they are rarely criminally prosecuted, instead paying fines assessed through opaque out-of-court settlements, notes Anat Admati of Stanford. She points to the striking example of PG&E, a California utility, which pleaded guilty to 84 manslaughter charges for its role in a 2018 fire that destroyed a town. Its penalty? The company paid the maximum fine under California law of just $4 million.

With her colleague Greg Buchak, a Chicago Booth PhD graduate, Admati is gathering data to analyze how corporations fare in the justice system depending on the type of law, offender, harm, or jurisdiction, among other factors. “Friedman effectively presumes that law enforcement works properly,” Admati wrote in an October 2020 article for *ProMarket*, which was later published in a *ProMarket* e-book consolidating perspectives on the Friedman doctrine. “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.”

Friedman in the 21st century

Friedman freely acknowledged in his *Times* essay that executives may make decisions that are mutually beneficial to the business and to its stakeholders. He gave the example of a small-town company:

> *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.*

He argued, though, that ascribing those decisions to “social responsibility” was simply “a cloak for actions that are justified on other grounds.”

What’s wrong with applying a little marketing spin to self-serving corporate decisions? To Friedman, the effects of such disingenuous gloss couldn’t be more detrimental: “The use of the cloak of social responsibility, and the nonsense spoken in its name by influential and prestigious businessmen, does clearly harm the foundations of a free society,” he wrote.

His concern for free society, and how the notion of corporate social responsibility could undermine it, reflects the Cold War era in which he was writing. In September 1970, socialism still loomed as free markets’ most pernicious competitor, creating extraordinary political and military tension. In China, Mao Zedong was still chairman of the Chinese Communist Party; in Cuba, the missile crisis was still a fresh memory; in Vietnam, the US was still fighting a war to prevent Communism from expanding its influence. It was in this context that Friedman fretted that to suggest business had a social responsibility was to preach "unadulterated socialism."

However, 30 years after the fall of the Berlin Wall, the menace of Communism is much diminished. "If the specter of global Communism stiffened Milton Friedman's spine, and gave him good reason for being intellectually mulish, the shade has departed, and to suggest that it remains in any manner that remotely resembles the world Friedman knew is to trivialize the devastation it visited," writes Booth's John Paul Rollert in a 2019 essay for *Chicago Booth Review*. "Today, only a person committed to plugging his ears against the appeals of history would suggest that the threats to capitalism of Friedman's day remain our own."

Today, Rollert wrote, "the greatest threats to capitalism come from within." The contemporary era is one of numerous systemic concerns—climate change, inequality, and global pandemics, to name a few—and the free-market system is often blamed for many of them. Engaging with them may not only be good for individual businesses, but for capitalism itself.

In 2018, Marc Benioff, the CEO of Salesforce, wrote an op-ed in the *New York Times* advocating for a proposed tax on big business in San Francisco, which would be used to help the city's homeless population. "Companies can truly thrive only when our communities succeed as well," he wrote. "The business of business is no longer merely business. Our obligation is not just to increase profits for shareholders."

At a time of widespread crisis, companies may not have to choose between shareholders and the community. In the 21st century, enriching one may require boosting the other.

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