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ISSUE

Are Profits the Only Business of Business?

YES: Milton Friedman, from "The Social Responsibility of Business Is to Increase Its Profits," *The New York Times Magazine* (September 13, 1970)

NO: Mindy S. Lubber, from "Corporate Responsibility: Without Outside Pressure, Corporations Will Not Take Meaningful Action on Sustainability," *The Economist* (September 8, 2013)

Learning Outcomes

After reading this issue, you will be able to:

- Explain business's role in our society as a profit maximizer.
- Explain business's role in our society beyond profit maximization.
- Develop arguments and reasons for profit maximization as a firm's sole responsibility.
- Develop arguments and reasons for a firm to go beyond profit maximization.
- Explain about corporate social responsibility.
- Explain about moral and ethical explanation of firms' responsibility.

ISSUE SUMMARY

YES: Free-market economist and Nobel Laureate Milton Friedman contends that the sole responsibility of business is to increase its profits.

NO: Mindy S. Lubber, president of Ceres, argues that activist involvement is necessary for business to take sustainability seriously, but also believes that businesses should be socially responsible and help develop creative solutions.

As Dr. Milton Friedman states in his work from the above publication, a firm's main and pretty much only concern should be to focus on its profits. Most past and current corporate finance textbooks teach students that the most important task of a corporate manager is to maximize shareholder wealth. This differs a bit from profit maximization because profit maximizing behavior is focused on short-term goals, while wealth maximization is focused on a firm's long-term profitability and thus its wealth. This means that firms may even bypass some short-term profits in order to achieve long-term wealth creation. And the opposite is true as well. If a firm focuses its activity on short-term profitability (profit maximization), it might lose focus on the long-run opportunities and become obsolete in the future. We can find examples in the industry where a firm's managers are looking for opportunities to enhance the firm's wealth and shareholder's value; these firms engage in research and development that is costly but promises a degree of success over the long run. On the other hand, some firms focus on the present; these firms might be very successful in the short run but forget to pay attention to the changes in demand and market dynamics. Eventually, they lose their market share, or even worse; they go bankrupt.

But what if the goal of a corporate manager was to maximize the firm's social responsibility, rather than to maximize shareholder wealth, which supports Friedman's thinking? Many CEOs and other top-level managers have made corporate social responsibility (CSR) a priority. According to knowledge@wharton, more than 8,000 businesses around the world have signed the UN Global Compact pledging to show good global citizenship in the areas of human rights, labor standards, and environmental protection. Milton Friedman was, to put it mildly, very skeptical about this goal. He called it a "hypocritical window dressing," where firms try to maximize profits and also to minimize their costs; the act of pursuing the CSR is costly. Higher wages, better labor conditions, and less pollution are all expensive propositions. Minimizing the cost means minimizing CSR as well.

The pros and cons will agree that for firms to be as efficient as they can be, they must try to maximize profits. However, in their journey to accomplish that task, should they also pay attention to CSR, thus acknowledging their stakeholders as well as their shareholders? Firms such as Coca Cola, Visa, and many other do follow these principles, and there are a number of private firms that do not have to meet shareholders' demands, thus focusing their operations toward maximization of CSR.

In summary, it is clear that in the capitalist society, firms can exist only if they make profits. So, the question is whether or not business firms have an obligation beyond making profits. This question will be addressed in the following YES and NO selections on the topic of "Are Profits the Only Business of Business?"

YES

Milton Friedman

The Social Responsibility of Business Is to Increase Its Profits

When I hear businessmen speak eloquently about the "social responsibilities of business in a free-enterprise system," I am reminded of the wonderful line about the Frenchman who discovered at the age of 70 that he had been speaking prose all his life. The 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; 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. In fact they are—or would be if they or anyone else took them seriously—preaching pure and unadulterated socialism. Businessmen who talk this way are unwitting puppets of the intellectual forces that have been undermining the basis of a free society these past decades.

The discussions of the "social responsibilities of business" are notable for their analytical looseness and lack of rigor. What does it mean to say that "business" has responsibilities? Only people can have responsibilities. A corporation is an artificial person and in this sense may have artificial responsibilities, but "business" as a whole cannot be said to have responsibilities, even in this vague sense. The first step toward clarity in examining the doctrine of the social responsibility of business is to ask precisely what it implies for whom.

Presumably, the individuals who are to be responsible are businessmen, which means individual proprietors or corporate executives. Most of the discussion of social responsibility is directed at corporations, so in what follows I shall mostly neglect the individual proprietor and speak of corporate executives.

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 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. Of course, in some cases his employers may have a different objective. A group of persons might establish a corporation for an eleemosynary purpose—for example, a hospital or a school. The manager of such a corporation will not have money profit as his objective but the rendering of certain services.

In either case, the key point is that, in his capacity as a corporate executive, the manager is the agent of the individuals who own the corporation or establish the eleemosynary institution, and his primary responsibility is to them.

Needless to say, this does not mean that it is easy to judge how well he is performing his task. But at least the criterion of performance is straightforward, and the persons among whom a voluntary contractual arrangement exists are clearly defined.

Of course, the corporate executive is also a person in his own right. As a person, he may have many other responsibilities that he recognizes or assumes voluntarily—to his family, his conscience, his feelings of charity, his church, his clubs, his city, his country. He may feel impelled by these responsibilities to devote part of his income to causes he regards as worthy, to refuse to work for particular corporations, even to leave his job, for example, to join his country's armed forces. If we wish, we may refer to some of these responsibilities as "social responsibilities." But in these respects he is acting as a principal, not an agent; he is spending his own money or time or energy, not the money of his employers or the time or energy he has contracted to devote to their purposes. If these are "social responsibilities," they are the social responsibilities of individuals, not of business.

What does it mean to say that the corporate executive has a "social responsibility" in his capacity as businessman? If this statement is not pure rhetoric, it must mean that he is to act in some way that is not in the interest of his employers. For example, that he is to refrain from increasing the price of the product in order to contribute to the social objective of preventing inflation, even though a price increase would be in the best interests of the corporation. Or that he is to make expenditures on reducing pollution beyond the amount that is in the best interests of the corporation or that is required by law in order to contribute to the social objective of improving the environment. Or that, at the expense of corporate profits, he is to hire "hard-core" unemployed instead of better-qualified available workmen to contribute to the social objective of reducing poverty.

In each of these cases, the corporate executive would be spending someone else's money for a general social interest. Insofar as his actions in accord with his "social responsibility" reduce returns to stockholders, he is spending their money. Insofar as his actions raise the price to customers, he is spending the customers' money. Insofar as his actions lower the wages of some employees, he is spending their money.

The stockholders or the customers or the employees could separately spend their own money on the particular action if they wished to do so. The executive is exercising a distinct "social responsibility," rather than serving as an agent of the stockholders or the customers or the employees, only if he spends the money in a different way than they would have spent it.

But if he does this, he is in effect imposing taxes, on the one hand, and deciding how the tax proceeds shall be spent, on the other.

This process raises political questions on two levels: principle and consequences. On the level of political principle, the imposition of taxes and the expenditure of tax proceeds are governmental functions. We have established elaborate constitutional, parliamentary and judicial provisions to control these functions, to assure that taxes are imposed so far as possible in accordance with the preferences and desires of the public—after all, "taxation without representation" was one of the battle cries of the American Revolution. We have a system of checks and balances to separate the legislative function of imposing taxes and enacting expenditures from the executive function of collecting taxes and administering expenditure programs and from the judicial function of mediating disputes and interpreting the law.

Here the businessman—self-selected or appointed directly or indirectly by stockholders—is to be simultaneously legislator, executive and jurist. He is to decide whom to tax by how much and for what purpose, and he is to spend the proceeds—all this guided only by general exhortations from on high to restrain inflation, improve the environment, fight poverty and so on and on.

The whole justification for permitting the corporate executive to be selected by the stockholders is that the executive is an agent serving the interests of his principal. This justification disappears when the corporate executive imposes taxes and spends the proceeds for "social" purposes. He becomes in effect a public employee, a civil servant, even though he remains in name an employee of a private enterprise. On grounds of political principle, it is intolerable that such civil servants—insofar as their actions in the name of social responsibility are real and not just window-dressing—should be selected as they are now. If they are to be civil servants, then they must be selected through a political process. 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.

This is the basic reason why the doctrine of "social responsibility" involves the acceptance of the socialist view that political mechanisms, not market mechanisms, are the appropriate way to determine the allocation of scarce resources to alternative uses.

On the grounds of consequences, can the corporate executive in fact discharge his alleged "social responsibilities"? On the one hand, suppose he could get away with spending the stockholders' or customers' or employees' money. How is he to know how to spend it? He is told that he must contribute to fighting inflation. How is he to know what action of his will contribute to that end? He is presumably an expert in running his company—in producing a product or selling it or financing it. But nothing about his selection makes him an expert on inflation. Will his holding down the price of his product reduce inflationary pressure? Or, by leaving more spending power in the hands of his customers, simply divert it elsewhere? Or, by forcing him to produce less because of the lower price, will it simply contribute to shortages? Even if he could answer these questions, how much cost is he justified in imposing on his stockholders, customers and employees for this social purpose? What is the appropriate share and what is the appropriate share of others?

And, whether he wants to or not, can he get away with spending his stockholders', customers' or employees' money? Will not the stockholders fire him? (Either the present ones or those who take over when his actions in the name of social responsibility have reduced the corporation's profits and the price of its stock.) His customers and his employees can desert him for other producers and employers less scrupulous in exercising their social responsibilities.

This facet of "social responsibility" doctrine is brought into sharp relief when the doctrine is used to justify wage restraint by trade unions. The conflict of interest is naked and clear when union officials are asked to subordinate the interest of their members to some more general social purpose. If the union officials try to enforce wage restraint, the consequence is likely to be wildcat strikes, rank-and-file revolts and the emergence of strong competitors for their jobs. We thus have the ironic phenomenon that union leaders—at least in the U.S.—have objected to Government interference with the market far more consistently and courageously than have business leaders.

The difficulty of exercising "social responsibility" illustrates, of course, the great virtue of private competitive enterprise—it forces people to be responsible for their own actions and makes it difficult for them to "exploit" other people for either selfish or unselfish purposes. They can do good—but only at their own expense.

Many a reader who has followed the argument this far may be tempted to remonstrate that it is all well and good to speak of government's having the responsibility to impose taxes and determine expenditures for such "social" purposes as controlling pollution or training the hard-core unemployed, but that the problems are too urgent to wait on the slow course of political processes, that the exercise of social responsibility by businessmen is a quicker and surer way to solve pressing current problems.

Aside from the question of fact—I share Adam Smith's skepticism about the benefits that can be expected from "those who affected to trade for the public good"—this argument must be rejected on grounds of principle. What it amounts to is an assertion that those who favor the taxes and expenditures in question have failed to persuade a majority of their fellow citizens to be of like mind and that they are seeking to attain by undemocratic procedures what they cannot attain by democratic procedures. In a free society, it is hard for "good" people to do "good," but that is a small price to pay for making it hard for "evil" people to do "evil," especially since one man's good is another's evil.

I have, for simplicity, concentrated on the special case of the corporate executive, except only for the brief digression on trade unions. But precisely the same argument applies to the newer phenomenon of calling upon stockholders to require corporations to exercise social responsibility (the recent G.M. crusade, for example). In most of these cases, what is in effect involved is some stockholders trying to get other stockholders (or customers or employees) to contribute against their will to "social" causes favored by the activists. Insofar as they succeed, they are again imposing taxes and spending the proceeds.

The situation of the individual proprietor is somewhat different. If he acts to reduce the returns of his enterprise in order to exercise his "social responsibility," he is spending his own money, not someone else's. If he wishes to spend his money on such purposes, that is his right, and I cannot see that there is any objection to his doing so. In the process, he, too, may impose costs on employees and customers. However, because he is far less likely than a large corporation or union to have monopolistic power, any such side effects will tend to be minor.

Of course, in practice the doctrine of social responsibility is frequently a cloak for actions that are justified on other grounds rather than a reason for those actions.

To illustrate, 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. Or it may be that, given the laws about the deductibility of corporate charitable contributions, the stockholders can contribute more to charities they favor by having the corporation make the gift than by doing it themselves, since they can in that way contribute an amount that would otherwise have been paid as corporate taxes.

In each of these—and many similar—cases, there is a strong temptation to rationalize these actions as an exercise of "social responsibility." In the present climate of opinion, with its widespread aversion to "capitalism," "profits," the "soulless corporation" and so on, this is one way for a corporation to generate goodwill as a by-product of expenditures that are entirely justified in its own self-interest.

It would be inconsistent of me to call on corporate executives to refrain from this hypocritical window-dressing because it harms the foundations of a free society. That would be to call on them to exercise a "social responsibility"! If our institutions, and the attitudes of the public, make it in their self-interest to cloak their actions in this way, I cannot summon much indignation to denounce them. At the same time, I can express admiration for those individual proprietors or owners of closely held corporations or stockholders of more broadly held corporations who disdain such tactics as approaching fraud.

Whether blameworthy or not, 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. I have been impressed time and again by the schizophrenic character of many businessmen. They are capable of being extremely far-sighted and clear-headed in matters that are internal to their businesses. They are incredibly short-sighted and muddleheaded in matters that are outside their businesses but affect the possible survival of business in general. This short-sightedness is strikingly exemplified in the calls from many businessmen for wage and price guidelines or controls or income policies. There is nothing that could do more in a brief period to destroy a market system and replace it by a centrally controlled system than effective governmental control of prices and wages.

The short-sightedness is also exemplified in speeches by businessmen on social responsibility. This may gain them kudos in the short run. But it helps to strengthen the already too prevalent view that the pursuit of profits is wicked and immoral and must be curbed and controlled by external forces. Once this view is adopted, the external forces that curb the market will not be the social consciences, however highly developed, of the pontificating executives; it will be the iron fist of Government bureaucrats. Here, as with price and wage controls, businessmen seem to me to reveal a suicidal impulse.

The political principle that underlies the market mechanism is unanimity. In an ideal free market resting on private property, no individual can coerce any other, all cooperation is voluntary, all parties to such cooperation benefit or they need not participate. There are no "social" values, no "social" responsibilities in any sense other than the shared values and responsibilities of individuals. Society is a collection of individuals and of the various groups they voluntarily form.

The political principle that underlies the political mechanism is conformity. The individual must serve a more general social interest—whether that be determined by a church or a dictator or a majority. The individual may have a vote and a say in what is to be done, but if he is overruled, he must conform. It is appropriate for some to require others to contribute to a general social purpose whether they wish to or not.

Unfortunately, unanimity is not always feasible. There are some respects in which conformity appears unavoidable, so I do not see how one can avoid the use of the political mechanism altogether.

But the doctrine of "social responsibility" taken seriously would extend the scope of the political mechanism to every human activity. It does not differ in philosophy from the most explicitly collectivist doctrine. It differs only by professing to believe that collectivist ends can be attained without collectivist means. That is why, in my book "Capitalism and Freedom," I have called it a "fundamentally subversive doctrine" in a free society, and have said that in such a society, "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."

Milton Friedman (1912–2006) is a graduate of University of Chicago and Columbia University. In 1948, Friedman joined the faculty at Chicago and stayed there until his retirement in 1977. After his academic work at the University of Chicago, he served as a senior fellow at the Hoover Institution at Stanford University. He was also president of the American Economic Association in 1967 and won the Nobel Prize in economics in 1976. He served as a columnist for *Newsweek*, wrote popular books, participated in educational television series, and delivered addresses to numerous groups.

Mindy S. Lubber

NO

Corporate Responsibility: Without Outside Pressure, Corporations Will Not Take Meaningful Action on Sustainability

A question I am often asked is how, as an outsider to industry, Ceres can claim to be able to bring value to companies that focus on their bottom line every day.

The recent subprime mortgage meltdown is a painful example of how companies and whole industries can delude themselves into ignoring even the most fundamental issues. If anyone outside the financial markets had been scrutinizing the risks from easy mortgages, they could have helped avert millions of foreclosures and an economic recession, and saved themselves a fistful of dollars.

It is the same with global climate change, which presents far-reaching risks and opportunities that many companies—their heads stuck in the sands of the quarterly business cycle—are not grasping on their own. Outsiders warned Ford and General Motors for years that their gas-guzzling high-polluting cars were too big, but the carmakers did not listen. Now their large sports utility vehicles sit unsold in car lots and the company's very survival is at stake.

Outsiders—investors, environmentalists, public interest groups, other industry experts—have an essential role in pressuring companies on their handling of environmental and social threats. They should be asking tough questions; they should be offering creative, out-of-the-box ideas; they should be demanding real action; and they should be holding companies accountable.

Last year's buyout of TXU is a good example of how outside pressure can yield positive benefits. For years, the Texas utility battled with environmentalists over carbon emissions and other pollutants. When it proposed in 2006 to build 11 new coal-fired power plants, the battle became a full-blown war. When TXU's stock price sagged and two private equity firms began their bid to buy the company, we saw a significant shift in business strategy: making environmental factors a part of due diligence. After extensive discussions with Environmental Defense and the Natural Resources Defense Council on the judiciousness of the planned coal binge and possible green alternatives, the buyers scrapped most of the coal-fired power plants and agreed to cut global warming pollution and boost energy efficiency efforts. The result? A better place for their bottom line.

There are many other examples of positive results from outside pressure: companies like Nike, which responded to public-interest pressure on workplace issues by providing first-in-the-industry disclosure about the names and locations of its 700-plus contract factories; Bank of America, which heeded the advice of investors in setting a greenhouse gas reduction target in its lending; McDonalds, which teamed up with environmental groups in sourcing sustainable fishery stocks; and Dell, which listened to advocacy groups and investors by supporting electronics recycling legislation and improving the energy efficiency of its products. These efforts are all the result of listening and responding to outside parties in making smart business decisions that lower costs, reduce regulatory, reputation and litigation risks, and build long-term shareholder value.

But some forms of outside pressure work better than others. I prefer relationships between outsiders and companies that are steady and long-lasting, not one-night stands focused on one problem and one project only. That is one reason why the jury is still out on the TXU buyout. Yes, it is great that eight coal plants were not built, but let us hope that advocates keep the pressure on so that the company's owner's green commitments stand the test of time. The fact that the company is now privately held makes the task especially challenging since there is no public transparency.

For years, Ceres has used stakeholder teams consisting of investors, environmentalists and other outside experts to engage with companies on environmental and social challenges they face. Through conference calls and face-to-face meetings, these teams advise companies on sustainability reporting, emerging issues and specific performance improvements. Companies value this level of candour from outside experts who may have been adversaries in the past. These relationships often begin with one issue, but the dialogue broadens and expands over time to include much, much more. This kind of constructive long-term engagement with executives and board members is the best way to drill sustainability deep into the core of corporate decision-making. It creates a platform for measuring year-to-year progress on environmental performance and exposing potential "greenwashing."

An example of what I am talking about is our relationship with the apparel company, Timberland. Ceres has a long track record of working with apparel companies (including Nike) on workplace conditions at their overseas factories. Timberland is among the companies that have been responsive to our concerns on the issue. In just the past few years, this New Hampshire company has disclosed the name and locations of its 300 contract facilities and boosted its assessments at those sites, which has led to improvements in workplace conditions. But, with help from our stakeholder team, Timberland is now taking sustainability in exciting new directions. The company recently launched first-of-its-kind packaging with nutritional labels, detailing how and where each Timberland product was made and its impact on the environment. The company is also participating in our new Facility Reporting Project, a valuable way for companies to evaluate and address how individual facilities are affecting their local communities.

Still, outside engagement is hard, hard work with numerous challenges. The three keys for success are goal setting, continual performance improvement and accountability.

In the case of climate change, stakeholders will never be satisfied with companies making simple pledges toward carbon neutrality. It is relatively easy to buy carbon credits and renewable energy certificates (RECs) and then claim you are 100% powered by wind energy. But, as we all know, there is a vast gap between theoretical credits and RECs that are purchased and wind farms that are actually built.

Businesses that are really serious about tackling climate change need to go much further. Energy efficiency and other measures that directly reduce greenhouse gas emissions in their operations and supply chains should be a priority at all companies. Businesses should also work with outside experts to develop smart creative solutions that distinguish them from their peers. Several leading banks, for example, worked closely with environmental groups to develop and adopt the Carbon Principles, a tougher set of standards for scrutinizing loans for coal-fired power plants. Dell is working with outside groups and other companies, including TXU, to make it easier to site renewable energy projects and infrastructure in states such as Texas.

These collaborations are all works in progress. Stakeholders are ever mindful of pushing companies harder and making sure there is no backtracking.

Outside pressure may be resisted by corporations blinded by the age-old way of doing things. But they should listen: it just might save their company.

Mindy S. Lubber is president of Ceres, the leading coalition of investors, environmental organizations, and other public interest groups working with companies and investors to build sustainability into the capital markets and address sustainability challenges such as global climate change. She also directs the Investor Network on Climate Risk (INCR), a network of more than 95 investors representing nearly $10 trillion in assets that coordinates U.S. investor responses to the financial risks and opportunities of climate change. She was recently voted one of "The 100 Most Influential People in Corporate Governance for 2009" by *Directorship Magazine*, who noted Ceres's substantial influence in its field. Before coming to Ceres, Ms. Lubber was the Regional Administrator of the U.S. Environmental Protection Agency and Founder/CEO of Green Century Capital Management, an investment firm managing environmentally screened mutual funds.

EXPLORING THE ISSUE

Are Profits the Only Business of Business?

Critical Thinking and Reflection

1. As a shareholder of the XYZ Corporation, would you be willing to receive a smaller dividend so that a portion of the firm's profits could be allocated for saving endangered species? Explain.
2. According to Dr. M. Friedman, a firm's main goal is to maximize shareholders' wealth; if so, why do you think so many firms contribute large amounts of funds toward other causes and not the shareholders?
3. Explain the concept of a socially responsible firm and the concept of goodwill.
4. Should firms correct any negative externalities they might be creating on their own, such as pollution, or do you think we need to have government regulations, which will reinforce social responsibility?
5. We live in a global economy; thus how will the firms in poor nations be able to act socially responsible (think pollution) compared to their partners in wealthy nations? Remember—we all share the same air.

Is There Common Ground?

There are different types of firms. Some are private, some are public, some are for profit, and some are non-for-profit. Some are very large and have offices and plants on multiple continents, and some are small and operate in one location only. All of these firms, no matter where they are located will be subject to their government's regulations and probably at multiple levels from local, state, and federal governments. All of them will purchase inputs for production such as land, labor, capital, and managers. They will, in most of cases, purchase water, electricity, and a number of other items that will benefit that community.

Are firms responsible for going above and beyond the aforementioned responsibilities? If a firm is only focusing on shareholder wealth maximization, generating profits is crucial and thus cost minimization is an important part of the equation. Will they, therefore, divert their interests away from the socially responsible causes?

It is in the firm's interest to present itself to the stakeholders and shareholders as a responsible, law abiding, moral, and ethical enterprise because these are also profit-maximizing attributes. Firms are very careful about their image in the markets, and it is quantified on the balance sheet as a non-tangible asset: goodwill. McDonald's wraps its food in recyclable and biodegradable paper products because it is good business. It might be costly in the short run, but shareholder wealth is based on the firm's profits over the long run using the "time value of money" concept. Shareholder wealth maximization and social responsibility might have more in common than we think.

Create Central

www.mhhe.com/createcentral

Additional Resources

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Profit Maximization Vs. Corporate Social Responsibility

www.tkf.org.in/blog/profit-maximization-vs-corporate-social

'Leveraging Corporate Responsibility': The Stakeholder Approach to Knowledge

wharton.upenn.edu/article/leveraging-corporate

TheRacetotheBottom: Social Responsibility—Profit Maximization

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