

# Must Milton Friedman Embrace Stakeholder Theory?

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## ABSTRACT

Milton Friedman famously stated that the only social responsibility of business is to increase its profits, a position now known as the shareholder model of business. Subsequently, the stakeholder model, associated with Edward Freeman, has been widely seen as a heuristically stronger theory of the responsibilities of the firm to the society in which it is situated. Friedman's position, nevertheless, has retained currency among many business thinkers. In this article, we argue that Friedman's economic writings assume an economy in which businesses operate under the protections of limited liability, which allows corporations to privatize their gains while externalizing their losses. By accepting limited liability, Friedman must also accept a view of business as embedded in social interdependency, which serves as the logical and moral foundation for corporate social responsibility (CSR). To achieve consistency with his economic principles, Friedman must either abandon limited liability or modify his doctrine on CSR and his related shareholder model of business.

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## INTRODUCTION

There have been attempts by various scholars to interpret Milton Friedman's shareholder model in a way that brings it closer to the idea of corporate social responsibility and the stakeholder model most widely associated with Edward Freeman. Indeed, in one article, Freeman "welcomed Friedman to the big tent of stakeholder theorists" because, as Freeman sees it, creating value for stakeholders is the way to maximize profits (2008, p. 166). However, as we see it, rather than bringing Friedman into the stakeholder theory tent, Freeman's argument preserves the core of Friedman's shareholder model by putting emphasis on profit maximization for shareholders while allowing for concern for other stakeholders' interests only insofar as they serve the instrumental purpose of supporting shareholder interests. This view falls far afield of stakeholder theory. However, we think there is another way to move Friedman's shareholder model to Freeman's stakeholder model and that is to recognize in Friedman's position an internal contradiction, which in resolving necessitates that Friedman himself must embrace stakeholder theory. The key is to recognize the place of limited liability within Friedman's own interpretation of modern economics.

Simply put, limited liability allows corporations to privatize their gains while externalizing or "socializing" their losses, and in so doing companies are authorized to, as it were, impose taxes or costs on other people without their direct consent. This "taxation without representation" seems to threaten two concepts that are crucial to Friedman's shareholder model that he draws on in articulating his reason for rejecting corporate social responsibility: private property and voluntary exchange. Therefore, Friedman should either reject limited liability or he should reconsider these assumptions, accepting the consequences that would follow. We argue that Friedman's commitment to a functional model of free market economics is based on the acceptance of the necessity of limited liability, and in so doing, businesses must be seen as participating in an economic ecology of shared risks and benefits that is at the heart of the stakeholder model.

Let us begin by first explaining why private property and voluntary exchange are so important for Friedman's shareholder model and his doctrine on corporate social responsibility. We will

then turn our attention to the idea of limited liability. To the best of our knowledge, Friedman never addressed limited liability explicitly in his writings. However, we will argue that he must have supported this idea based on his commitment to liberalism and the general tenor of his economic ideas in which limited liability is assumed as a cornerstone of the regulatory environment under which businesses operate. We will then explain how limited liability requires a notion of corporate ownership that cannot be seen as simple and absolute but embedded in a complex social matrix in which the management of firms is interwoven with the interests of its stakeholders.

### **FRIEDMAN'S SHAREHOLDER MODEL AND HIS REJECTION OF CORPORATE SOCIAL RESPONSIBILITY**

Friedman's ideas on the responsibilities of business management are generally interpreted as a declaration in favor of profit above all, and in particular, above any pretenses to corporate "social responsibility." This view was expressed in the famous passage in which he stated, "there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits" (Friedman 1970, p. 184). Through these words, Friedman articulated the essential tenet of what came to be known as shareholder theory. According to this theory, among the various actors associated with a business, shareholders have unrivaled primacy, and hence, corporations should be managed so as to maximize their value alone.

The core of Friedman's argument rests on *private* property and the complete control of that property that is conferred by virtue of its private ownership. To Friedman, "the corporation is an instrument of the stockholders who own it . . ." (Friedman 1962, p. 135). As shareholders own the corporation, they should control it. It is their prerogative to run the firm themselves or to hire someone else—a professional manager—to do it for them. This corporate executive is an employee of the owners of the firm, and "he has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires" (Friedman 1970, p. 178), as "the executive is an agent serving the interest of his principal" (Friedman 1970, p. 180). Therefore, the owners'

desires become the manager's goals, "which generally will be to make as much money as possible" (Friedman 1970, p. 178).

In its traditional form, corporate social responsibility is not directly related to profit; therefore, managers are not legitimized to make these "social" decisions without the owners' approval. In as much as corporate social responsibility involves expenditures, it may thereby represent an arrogation of resources that rightfully belong to the shareholders. Friedman holds that such expenditures constitute a net drain of value, which for shareholders is expressed in the form of lower dividends, for the employees, in the form of lower wages, and for the consumer, in the form of higher prices (Friedman 1973). In each of these cases, the corporate executive would be spending someone else's money for a general social interest and, consequently, "he is in effect imposing taxes, on the one hand, and deciding how the tax proceeds shall be spent, on the other" (Friedman 1970, p. 179).<sup>1</sup> Such a tax, he holds, is wrong in principle and in consequences. It is wrong in principle, because taxes should be imposed by democratically elected government officials, not corporate managers, as they do not have legitimacy for imposing and spending taxes for public welfare. It is wrong in its consequences, because managers are not experts in solving social problems, so their attempts to do so may fail (Friedman 1970).

These unauthorized decisions not only violate property rights and the fiduciary responsibility of managers but also violate the principle of voluntary exchange—because by taking corporate social responsibility actions, managers are imposing on the shareholders the results of some decisions that they probably would not have wanted to make. In this way, from the liberal perspective associated with Friedman, corporate social responsibility infringes on the "foundations of a free society" (Friedman 1962, p. 133).

Friedman is widely understood to be a liberal (see, e.g., Nunan 1988; Danley 1991; Carson 1993; Wolff 2006; Schaefer 2008; Zwolinski 2008.) He describes himself as such in the introduction of *Capitalism and Freedom*: "it is extremely convenient to have a label for the political and economic viewpoint elaborated in this book. The rightful and proper label is liberalism . . ." (Friedman 1962, p. 5). This can be seen in his support of familiar liberal institutions: a limited state, strong private property rights, respect for voluntary contracts, and free markets (Wolff 2006).

According to his views, the most important requirement to build a free society is the defense of freedom: “as liberals, we take freedom of the individual, or perhaps the family, as our ultimate goal in judging social arrangements” (Friedman 1962, p. 12). The freedom in economic relations implies voluntary exchange that means “individuals are effectively free to enter or not to enter into any particular exchange” (Friedman 1962, p. 14). This non-compulsory exchange is only possible if it relies on private property (Friedman 2005). Consequently, he holds that private property and voluntary exchange are cornerstones of the capitalist society (Friedman 1978a).

Extending this view, Friedman holds that when managers engage in corporate social responsibility, they are violating private property rights and the voluntary nature of transactions. This, he argues, undermines the basic nature and character of the capitalist society and puts it on the road toward the socialist state (Friedman 1962, p. 136). Through their adherence to corporate social responsibility, managers are applying the socialist view that political mechanisms, not market mechanisms, are the appropriate way to determine the allocation of scarce resources to alternative uses (Friedman 1970). They become legislator, executive, and jurist simultaneously. As such, they are violating the voluntary exchange on which free markets rest. In a free market, no one can force or coerce any other in any way; all parties get involved voluntarily because they believe they benefit in each decision, based on the information provided by free prices. Friedman’s ultimate purpose in rejecting corporate social responsibility is to protect freedom (Cima and Schubeck 2001).

Before moving forward, it is necessary to clarify what Friedman understands by corporate social responsibility, because the concept to which he referred is very different from how it is understood today, despite the fact that even with the enormous literature on the subject, there is no consensus on its exact meaning (Campbell 2007; Lee 2008; Schwartz and Saiia 2012). Rather, it is more of an umbrella term that overlaps with many ideas pertaining to the business and society relationship (Buchholz and Rosenthal 1997; Matten and Crane 2005). Within this literature, there is a universal consensus that firms have responsibilities to society beyond profit maximization (Carroll 1974, 1999; Garriga and Melé 2004; Rowley and Berman 2000),

and once the responsibilities of business are situated within a social context, a retinue of stakeholders appears, which includes not only shareholders, but also employees, competitors, consumers, suppliers, communities, governments, and the natural environment (Clarkson 1995; Donaldson 1999; Freeman 1984, 1994; Shum and Yam 2011; Wood and Jones 1995).

What Friedman had in mind when he wrote about corporate social responsibility in the 1960s and 1970s pertained more to the idea of having a “social conscience” that would lead efforts from businesses to seek to solve big social problems, such as refraining from increasing the price of the products in order to prevent inflation, hiring hardcore unemployed to provide employment, making expenditures to avoid high levels of pollution, eliminating discrimination, reducing poverty, or acting with the benevolence of a charity (Friedman 1970).

As some researchers see it, Friedman’s concept of corporate social responsibility was so narrow as to be almost a caricature (Mulligan 1986). From another angle, some might see this view of corporate social responsibility as overly broad, because it could mean that for a business to be considered socially responsible, it would need to respond to social problems that were beyond its authority or capability (O’Leary 2004). In short, corporations would be trying to replace the government in its duties.

Although Friedman rejects corporate social responsibility, this position does not thereby give managers license to use any means to achieve owners’ ends. He reiterates his belief that “freedom cannot be absolute. We do live in an interdependent society” (Friedman and Friedman 1980, p. 69). Managers’ pursuit of owners’ ends must conform “to the basic rules of the society, both those embodied in law and those embodied in ethical custom” and it has to stay “within the rules of the game, which is to say, engages in open and free competition without deception or fraud” (Friedman 1970, p. 178). Still, within these bounds, Friedman thinks, managers should strive to do what is best for owners.

According to some commentators, the clause “without deception or fraud” implies a moral minimum that includes truth-telling, promise-keeping, fidelity, fairness, and justice (Cosans 2009; Shaw 1988). This is seen by some as not being a low minimum at all and even a viable ethical standard for business (Gallagher 2005; Mulligan 1986). It goes hand in hand with the

requirement to respect the law. In fact, most laws that regulate interactions between a firm and its stakeholders, regarding investments, accounting, customer protection laws, and the like, are crucial for the maintenance of a healthy business climate, and all are compatible with Friedman's proviso that businesses must avoid deception and fraud (Wagner-Tsukamoto 2007). The limitations that are implied by this proviso are not insignificant; they are, in fact, important constraints. Friedman never goes into details to explicate the meaning or significance of the idea of ethical custom, but it is notable that he does acknowledge the existence of ethical limitations and the need to uphold them.

As a consequence of these constraints, we can surmise that Friedman believes that individuals and corporations must be responsible in the exercise of their freedom and bear the consequences of their own actions (Friedman 1970). These consequences sometimes require compensating the involuntary or unexpected costs or harms they may cause, as when, for instance, a company is responsible for causing damage to a town by polluting a river (Schwartz and Saiia 2012). As such effects constitute costs not previously considered in the terms of the business agreement, they could undermine the principle of voluntary exchange that is so important to Friedman. As we see it, this principle of voluntary exchange—which is to say, nobody can force anyone to participate in a transaction—may be the most important condition for the protection of open and free competition. To avoid imposing involuntary exchanges, either people must be informed about the possibility of externalities in order to take these costs into account in agreements, or they must be adequately compensated when unplanned negative events occur. The problem of externalities raises serious difficulties for Friedman's model, especially when it is considered in light of limited liability.

## **FRIEDMAN AND LIMITED LIABILITY**

In all modern market economies, corporate shareholders have limited liability for corporate wrongdoing<sup>2</sup> in both contracts and torts. Let us first look at contracts.

Suppose a corporation C contracts with a supplier S to pay a certain amount of money later for a shipment of computers now.

The computers arrive, and C finds itself unable to pay. S sues C for damages. If successful, S can collect the full value of the damages from C, but if the corporation is unable to pay the full amount (because it goes bankrupt), the supplier cannot access shareholders' personal wealth to cover the rest. Shareholders' liability for corporate wrongdoing is *limited* to the amount of their investment.

The case of torts, or injuries caused by corporate actions, is similar. Suppose C releases a toxic chemical into the atmosphere that makes many people sick. The persons harmed by C's actions can sue C (e.g., to collect the cost of making them well again) and, if successful, the plaintiffs can receive the full value of their damages from C's assets. But, again, if these assets do not cover the full value of the damages, the injured parties cannot seek the remainder from shareholders' personal wealth.

This is different outside of the corporate context. Sole proprietors are not granted limited liability for contracts or torts. Suppose a sole proprietor P promises to pay a supplier for a shipment of computers; he receives the computers, but he does not pay. Then he can be sued, and if his business cannot cover the full costs of the damages, his personal wealth can be appropriated. The same goes for torts for the sole proprietor. Suppose P's delivery truck rolls out of his driveway and hits the individual Q's car. P is liable for the full value of the damages to Q's car. Suppose Q's car is extremely rare and valuable, and P's business is on the brink of bankruptcy, so that the cost of repairing Q's car exceeds the value of P's business. P cannot just hand over his business to Q and be done with it. He must make Q "whole," even if this involves paying him out of his personal wealth.

Because limited liability for corporate shareholders in both contracts and torts is a standard feature of all modern economic systems, principals are protected from the harms that their agents might cause. Thanks to this clause, shareholders can invest, receive dividends and gains and yet remain immune from the costs caused by their corporate agents.

However, here is a problem: if Friedman acknowledges a firm's liability to respect the responsibilities inherent in free market exchanges, he must do so fully and not pick and choose where he would like such responsibilities to apply. According to the principle of voluntary exchange espoused by Friedman, if a corporation



inflicts unacknowledged or unforeseen costs on others, it should compensate the affected party in some manner, and failure to do so would impose an extra cost which, in Friedman's terms, constitutes a kind of "illegitimate tax" (Friedman 1970, p. 179) on those harmed. According to Friedman, such "taxation without representation" was precisely the reason to reject corporate social responsibility. However, if Friedman rejects this idea of "taxation without representation," consistency would require that he then also reject limited liability, given the implied "taxes" it imposes.

Assessing the internal coherence of Friedman's views on limited liability poses some challenges because, as far as we know, nowhere does he explicitly address this issue. Nevertheless, we believe that a sound interpretation of his view can be inferred based on various relevant statements that appear in his writings. Given Friedman's philosophical and economic commitments and the implications they have for limited liability, the question is whether he can also maintain his position on corporate social responsibility.

Friedman would claim that limited liability for contracts *can* be justified. To see how, note first that limited liability can be thought of as a term of the contract between the corporation and its creditors, stating that the creditors will not pursue the full value of their claims against it. As Rothbard explains:

On the purely free market, [corporate owners can] simply announce to their creditors that their liability is limited to the capital specifically invested in the corporation, and that beyond this their personal funds are not liable for debts . . . It then rests with the sellers and lenders to this corporation to decide whether or not they will transact business with it. If they do, then they proceed at their own risk. Thus, the government does not grant corporations a privilege of limited liability; anything announced and freely contracted for in advance is a right of a free individual. (2004, p. 1144)

The corporation's creditors might agree to give it limited liability for contracts in order to get a more favorable price for the goods and services it provides, and because it regards the possibility of bankruptcy as unlikely. Friedman is likely to support limited liability for contracts, provided that both parties are in agreement that their contractual relation is governed by limited liability conditions. What about limited liability for torts? It seems that for

a liberal the state's awarding it to corporations is "the illegitimate conferring of a special privilege" (Rothbard 2004, p. 1144). Often, corporations do not have prior contractual relationships with the parties they harm (e.g., downstream neighbors). Those parties are the corporation's "involuntary creditors" (Bainbridge 2001). As a liberal and according to voluntary exchange, it would seem Friedman should be in favor of unlimited liability for firms; corporations have to be liable for the consequences of their actions, even those unexpected, and to pay all its creditors. Since in torts, the corporation has "involuntary creditors," either it should pay the costs directly, or it should take out insurance against them. Nevertheless, Friedman never rejected limited liability explicitly. In fact there are some texts in which he seems to indirectly justify this sort of privilege. Consider what he says in "The Economics of Free Speech":

The social objective of maintaining a free society is so important that a very strong presumption must exist before freedom in either area is restricted to avoid third-party effects. I cannot understand the schizophrenic position that almost any costs may be imposed on third parties to protect one kind of freedom, freedom of speech, but that almost any third-party effect, however trivial, justifies restricting another kind of freedom, economic freedom. (Friedman 1977, p. 16)

What is a "third-party effect"? "Third-party effects" refers to the idea that in order to protect the rights of an individual, the government or another individual may be obliged to bear some cost. For example, a government may have to tolerate the expressions of what it sees as objectionable criticisms because of the free speech rights of the individual. The third-party effect refers to the impingements on one person's liberty that result from the exercise of another person's rights. Friedman does not say that third-party effects are wrong. He laments only that we are very willing to impose third-party effects to protect rights such as free speech but willing to restrict economic freedom even if it has a minor third-party effect. His point seems to be that we should not restrict economic freedom even if it has third-party effects—that is, even if they impose costs on others by violating their rights. He seems to think we should impose such costs for a greater good.

Going back to the example of pollution, absent a contract, when a corporation pollutes, it is imposing a third-party cost on others. As Friedman says: “[t]he man who pollutes a stream is in effect forcing others to exchange good water for bad” (Friedman 1962, p. 30). Some liberals, such as Rothbard, think this matter should be resolved in a free market: let those who wish to pollute and those who will be affected by the pollution come to terms about how much pollution and at what price. Friedman, as we noted above, could be in favor of this route. James and Rassekh asked Friedman what the company president should do if he comes to the realization that the firm’s manufacturing operations, and those of competitors, discharge a harmful pollutant, and the pollutant is not subject to the country’s environmental regulations. They reported that in a private correspondence Friedman replied (May 23, 1996) that if he were the president, he “would be very unwilling to continue running that enterprise as [he] had before without that information being made available . . . [The] appropriate course of action is to make publicly available the information” (James and Rassekh 2000, p. 671).

However, he thinks that it is not feasible for the afflicted party, acting individually, to avoid the exchange or to enforce appropriate compensation (Friedman 1962, p. 30). It is all but impossible for individuals to avoid corporations’ pollution or even to get compensation without suing them. Moreover, the difficulties are compounded when the victim is a group in which the members are unaffiliated other than by a common problem. When the wind blows pollutants thousands of miles and mingles those from one plant with those from another, how is the aggrieved party to act? Friedman recognizes that some negative externalities cannot have a free market solution and he thinks that the resolution does have to be through governmental arrangements. However, he suggests imposing effluent taxes rather than emission standards. In this way, corporations retain the freedom to pollute, but their pollution would be taxed, with the level to be determined by the government, because the results will be more effective (Friedman 1973, p. 29).

These effects are externalities, and Friedman accepts that government intervention is the most effective way to handle them (Cima and Schubeck 2001; Cosans 2009; James and Rassekh 2000), even though the outcome imposes third-party effects on other people. The key point is that Friedman recognizes that such

market imperfections must be handled by government. He defines the functions of government in *Capitalism and Freedom*:

A government which maintained law and order, defined property rights, served as a means whereby we could modify property rights and other rules of the economic game, adjudicated disputes about the interpretation of the rules, enforced contracts, promoted competition, provided a monetary framework, engaged in activities to counter technical monopolies and to overcome neighborhood effects widely regarded as sufficiently important to justify government intervention, and which supplemented private charity and the private family in protecting the irresponsible, whether madman or child—such a government would clearly have important functions to perform. (Friedman 1962, p. 34)

In this work, Friedman set out a detailed agenda on how rules of ethical conduct, mostly enshrined in law, should be established. He attributed a key role to government in fostering competitive markets, enforcing law and order, and enforcing private contracts. He viewed government as the essential “. . . forum for determining the ‘rules of the game’ and as an umpire to interpret and enforce the rules decided on.” He went on to reason that “. . . we cannot rely on custom or a [social] consensus alone to interpret and to enforce the [customary] rules—we need an umpire” (Friedman 1962, p. 25). The purpose of the umpire is to interpret the rules, enforce compliance, and where needed to interpret them. From this, it becomes clear that when Friedman spoke about the need of business to act in accordance with the “rules of the game,” this should be seen as not only including customary business practices, but also, and of primary importance, is the formal role adopted by government setting out the rules of the game (Wagner-Tsukamoto 2007).

The ultimate justification for limited liability in torts is efficiency<sup>3</sup>; it is understood as being the system that overall delivers the best consequences. In many of his writings, Friedman makes it clear that he is a consequentialist (Danley 1991). For example, in a 1978 article in *Newsweek*, he says:

Capitalism, socialism? They are neither moral or immoral, humane nor inhumane. We have to ask what are their results. We have to look at what are the consequences of adopting one or another system of organization. From that

point of view, the crucial thing is to look beneath the surface. Don't look at what the proponents of one system or another say are their intentions, but look at what the actual results are. (1978a, p. 84)

He repeats these sentiments in an interview almost 30 years later:

Maximizing profits is an end from the private point of view; it is a means from the social point of view. A system based on private property and free markets is a sophisticated means of enabling people to cooperate in their economic activities without compulsion; it enables separated knowledge to assure that each resource is used for its most valued use, and is combined with other resources in the most efficient way. (Friedman et al. 2005)

In these and other passages, Friedman expresses his firm commitment to private property and an extensive freedom to exchange as an essential means to prosperity (Friedman 1978b, p. 100). And here again the decisive validation for this system is efficiency.

However, the important question remains: should not Friedman reject limited liability to maintain coherence with his rejection of corporate social responsibility? Either that or he should reconsider his basic assumptions, particularly regarding the private nature of the corporation and voluntary exchange. However, throughout Friedman's writings, there is nothing to suggest anything but a full acceptance of limited liability in contracts as well as in torts. As the costs associated with contract failures and torts can be recognized as externalities or market failures, the government is entitled to intervene to solve these problems.

We would surmise that the lack of explicit commentary by Friedman on this vitally important universal element of the free market economy is reflective of the fact that it was taken for granted. If he were to reject it, it would require that he propose a dramatic reconfiguration of how our economy operates. Instead, throughout his voluminous writings on economics, limited liability remains assumed and unchallenged. If there were another system besides limited liability that delivered better results, it is not obvious what it is or how it could be implemented, and Friedman does not suggest any alternatives. Limited liability remains unchallenged in his writing, because it is accepted as the most efficient and effective means for supporting a functional free

market economy that balances the needs and interests of the commercial sector with an appropriate degree of government intervention.

### **FROM A SHAREHOLDER MODEL TOWARD A STAKEHOLDER MODEL**

The introduction of limited liability in the economic system implies that if shareholders have limited liability, then those who have full liability are stakeholders of the firm, which not only includes shareholders themselves, but ultimately society as a whole. When firms go bankrupt, their stakeholders bear the costs. Suppliers lose money they are owed by the firm, as well as any future business from it; the community in which the firm is located loses tax revenue; many of the firm's employees lose their jobs; customers may lose, if there are no readily available substitutes for the products or services the firm provides; and if the firms are "too big to fail," the entire society has to bail them out with its own money, through their taxes.<sup>4</sup>

The logic of ownership implies that the owners can receive the benefit but they also should bear all of the costs, expected and unexpected. However, we might say that because stakeholders have no choice but to bear the costs when a firm goes bankrupt, the stakeholders should also enjoy some proportional measure of consideration from the firm when it is solvent. In particular, when the firm is solvent, stakeholders' interests should be considered as ends by managers, in order to avoid the unfair consequence that only gain can be privatized while losses can be "socialized."

Let us examine this idea in a bit more detail. If A has exclusive ownership of  $x$ , then A also has exclusive rights to the benefits of  $x$  as well as the exclusive responsibility to bear the liabilities of  $x$ . If A cannot account for the liabilities of  $x$ , then A cannot claim exclusive ownership of  $x$ , and A should share some of the power and rights to  $x$  with the others who must bear the liabilities (Hoffman and Fisher 1984).

This argument is similar to the principle of the "Symmetry of Gains and Losses" of Sollars, which is based upon a notion of fairness. Referring to the shareholders and the managers who act

on their behalf, Sollars states, "Those who have a chance of receiving arbitrary gains resulting from actions deliberately taken in their behalf must also be subject to the possibility of bearing the arbitrary losses that might be associated with such actions" (2001, p. 334).

If we consider that ownership implies that anyone owning property can exclude other people from the benefit as long as these owners are not excluded from the cost, we arrive at a position close to stakeholder theory, according to which, instead of striving to maximize shareholder wealth, managers should strive to balance all stakeholders' interests (Freeman 1984).

Friedman never thought that managers should ignore other stakeholders' interests. However, as mentioned, for Friedman, concern for stakeholder interests is considered only to the extent that it is instrumental to the interests to shareholders qua "owners," and then, the motivation for this concern is "not social responsibility. It's just capitalism" (Freeman 2008, p. 165). For that reason, most interpreters reject the idea that Friedman could defend the stakeholder model, because his priority is so thoroughly oriented toward shareholder interests (Bowie 1991; Mulligan 1986; Wagner-Tsukamoto 2007). However, as we noted at the outset of this article, Freeman himself believes that Friedman can be included in the stakeholder model: "So Milton Friedman, I would argue, could have written this paragraph: 'The primary responsibility of an executive is to create as much value as possible for stakeholders' because that's how you create as much value as possible for shareholders . . . . So, I'm going to welcome Milton Friedman to the big tent of stakeholder theorists . . . I think maximizing profits is more like creating value for stakeholders than others might read in *Capitalism and Freedom*" (Freeman 2008, p. 165).

We are inclined to agree with Freeman, but not for the reasons he stated. We argue that managers should be responsible to those groups that are affected by the firm's actions, which is the core idea of the stakeholder model (Armstrong 1977). We believe that the key for rehabilitating Friedman is not through profit maximization but by demanding an internal consistency with his other basic ideas assumed by his economic theories, such as the place of limited liability, the role of government, and the need for fairness in the regulation of markets.

To fully understand this idea of fairness, we need to have a broader understanding of the nature of the corporation as a nexus of contracts.<sup>5</sup> From this perspective, the corporation is viewed as a party to a variety of contracts, formal and implied, with suppliers of various sorts. Employees supply labor in exchange for wages, towns supply water, sewer services, etc. in exchange for tax revenues, and so on. According to this argument, shareholders supply equity capital to the firm, but instead of seeking a specific amount of money in return (as other capital suppliers do, viz., bondholders), they ask for the value of their investment to be maximized. They ask that, after the firm satisfies its other contractual obligations (to employees, the town, etc.), there be as much money left over for them as possible. Note that, on this argument, it is not claimed that shareholders or indeed anyone owns the firm, because the firm is not a thing capable of being owned (Bainbridge 1993). Each owns a specific input and exchanges it with the firm for some sort of payment in return.

What shareholders own is corporate stock with the right to some of the firm's residual earnings (Boatright 2004; Hansmann 1996). Schrader (1987) explains how the first of Friedman's assumptions, that the corporation is simply an instrument of the shareholders, represents a remarkably naive view of the modern corporation. Big corporations are led by managers without taking into account shareholders' approval, at least in the daily decisions. It could be argued that shareholders should be seen as lenders more than owners, and besides they have their portfolios very diversified, committing only a small portion of their wealth to any one firm (Green 1993; Stone 1975).

Some might think that Friedman's naive view of corporate ownership would suffice to dismiss his rejection of corporate social responsibility and its ally, stakeholder theory. However, let us not forget that by owning shares, shareholders are entitled to benefits, rights, and some control that other stakeholders do not have. They have the benefit of increased equity and dividends, the right to vote in shareholder meetings, which may include shareholder resolutions, and—at least theoretically, the power to elect the directors. These benefits, rights, and controls may not be as all-encompassing as Friedman's idea of shareholder ownership suggests, but they are not insignificant either. Moreover, they are "owned" exclusively by shareholders. However, the harms and



costs that may be caused by the corporations in which these shareholders have invested are borne involuntarily by stakeholders who do not share in such benefits. This is not only a violation of ethical principles of fairness and human rights, it is also inconsistent with the logic of private property ownership and Friedman's principle of voluntary exchange.

We are not suggesting that we eliminate limited liability; this seems essential to the functioning of all modern economies. What we are saying is that to avoid violating the above ethical principles and internal inconsistencies in Friedman's own theory of economic freedom, he must move toward the stakeholder theory. In so doing, corporations will have to take into account all stakeholder interests, as opposed to only furthering shareholder interests.

Furthermore, this is a position with which Friedman ought not to feel totally uncomfortable. He does speak of abiding by ethical custom, although he does not clearly define what he means by this. He also says that a company should inform those who are or will be affected by its pollution, and implies that some accommodation with those affected should be made. These reflections are certainly compatible with a stakeholder model.

Friedman rails against those who would restrict economic freedom because of third-party effects, but he modifies his position by saying that these restrictions are wrongly justified for "almost any third-party effect, however trivial." However, what about nontrivial third-party effects such as a nuclear power disaster or a financial collapse due to the selling of sub-prime mortgages? We can only assume that Friedman would call upon the government to find solutions and pay reparations. But where the money would come from throws us right back into the thicket of problems with which we have been dealing.

In moving toward stakeholder theory, Friedman would acknowledge that the interests of all those who might be affected by a corporation's activities should be taken into consideration and with the goal of finding a fair accommodation. Such a strategy would also seem to be the best way to recognize and prevent nontrivial externalities from occurring at all.

In limited liability companies, shareholders spread or externalize the risk, and those who by default are the "holders" of that risk have a legitimate and authentic interest in the company.

Stakeholder theory follows from a recognition of the interest that members of the public have as holders of the risk associated with limited liability companies. If Friedman acknowledges the rights shareholders have as owners, he should also recognize that other communities are indirect owners by virtue of the risks they assume by living in a society in which companies are afforded limited liability protections.

Our position is in agreement with Ghoshal's that "the notion of actual ownership of the company is simply not compatible with the responsibility avoidance of 'limited liability' " (Ghoshal 2005, p. 80). Accepting limited liability, Friedman has no other choice than to move from a shareholder model toward a stakeholder model, not because that model produces more profit for shareholders, as Freeman argues, but because the logic of private property ownership and the unfairness of bearing involuntary liabilities demand it.

## CONCLUSION

In this article, we argue that Friedman cannot maintain his position against corporate social responsibility if he wants to sustain other key economic principles on which his theories depend, most notably, the principle of limited liability. If Friedman accepts limited liability, which must be the case given his other views on the economy, he would have to move from the shareholder model to the stakeholder model.

This is due to the fact that limited liability is a fundamental element of the free market system that allows corporations to "socialize" or externalize their losses while privatizing their profits. This "privilege" constitutes a kind of tax on other people without their direct consent, which violates the voluntary nature of the exchange. In this way, various constituencies are made the bearers of business risk and, in effect, forced into a stakeholder relationship with the business. Limited liability reveals the contradiction that exists between the exclusive claim on profits by a business and the potential costs associated with business risks borne by the business's stakeholders.

By accepting limited liability, Friedman affirms a view of the corporation as embedded in an interdependent relationship with

its stakeholders. And yet, by accepting limited liability, Friedman demonstrates that his commitment to private property and voluntary exchange is not absolute. Moreover, as these two principles constitute the cornerstones of his rejection of corporate social responsibility, we see an internal contradiction. By accepting limited liability, Friedman must also accept a view of private property and voluntary exchange that are embedded in a context of social interdependency, and it is this interdependency that serves as the logical and moral foundation for corporate social responsibility. To restore consistency to his economic principles, Friedman must refuse limited liability or modify his doctrine on corporate social responsibility.

Although Friedman neither accepts nor rejects explicitly limited liability, nevertheless it is clear from his writings that limited liability is assumed. Insofar as the acceptance of limited liability implies the stakeholders are going to bear some of the costs, they should also reap some of the benefits.

Therefore, by accepting limited liability, Friedman has no other choice than to move from a shareholder model toward a stakeholder model, and in so doing, integrate corporate social responsibility into the corporate ethos. This acceptance of corporate social responsibility has nothing to do with the generation of greater profit for shareholders, as Freeman argues, but because it follows from the logic of private property ownership and the requirements of fairness that accompany the acceptance of risk distribution inherent in a system involving limited liability.<sup>6</sup>

## NOTES

1. As some interpret this, such actions should be named embezzlement (Green 1993).

2. A good historical sketch of limited liability can be found in Sollars 2001.

3. In fact, a variety of writers have argued that limited liability for corporations in both contracts and torts is justified on consequentialist grounds (Boatright 1996). Perhaps the most prominent of these writers are Easterbrook and Fischel (1991), although their argument may be incomplete. They compare a scheme of limited liability (in contracts and

torts) to a scheme of unlimited liability. However, they do not consider the relative merits of proportional liability. For a discussion of this idea, together with an argument that it is fairer, and just as efficient as, limited liability, see Sollars (2001).

4. The truth of this idea was made painfully evident by gargantuan bailouts of banks made by the U.S. government in the wake of the 2008 Global Financial Crisis. This bailout literally put a tax on the entire American population and the serious weight of its repercussions will continue to be felt for generations to come.

5. The modern theory of the firm as a nexus of contracts was originated with Ronald Coase's seminal insight in which he explains that firms exist as less costly alternatives to market transactions. (Ronald M. Coase, "The Nature of the Firm," *Economica*, N.S., 4 [1937], 386-405).

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