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ESG: MYTHS and REALITIES

Friedman and his ESG Critics

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Introduction

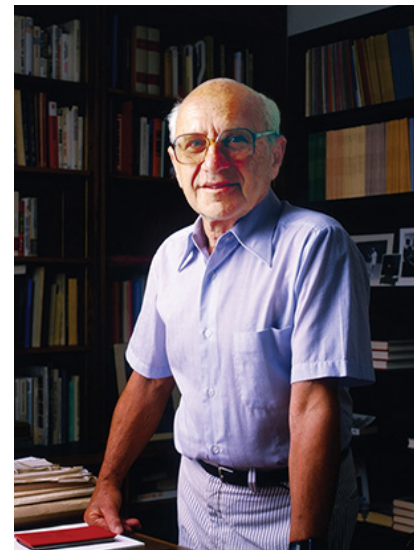
Milton Friedman was a Nobel Laureate and one of the most consequential economists of the 20th century. Notwithstanding his major academic contributions, most notably in monetary policy, the article of his that arguably spawned the largest follow-up literature was his 1970 commentary in the *New York Times* entitled: “A Friedman Doctrine—The Social Responsibility of Business Is to Increase Its Profits.” This short piece generated decades of academic and other studies both criticizing and (less frequently) supporting the main arguments Friedman advanced in the article.

The purpose of this essay is to identify the main criticisms of Friedman’s iconic commentary and to offer brief assessments of those criticisms.¹ The critical literature that Friedman’s article effectively spawned is broadly associated with the ESG² movement, although other labels have been attached to his critics’ schools of thought including stakeholder capitalism, socially responsible business, sustainable capitalism, and The New Capitalism.

The next section of this essay sets out Friedman’s description and defense of shareholder capitalism. It pays particular attention to several nuances of his description and defense that directly or indirectly underlie the more problematic criticisms of his essay.

Friedman’s case for shareholder capitalism

In his 1970 commentary Friedman begins by noting that individuals—and not businesses—have responsibilities against which their actions should be measured. He focuses his attention on corporate executives rather than individual proprietors on the grounds that large corporations are the focus of critics of shareholder capitalism. While this was undoubtedly the case when Friedman wrote the piece, and is still largely the case, the emergence of companies such as Facebook in which the original entrepreneurs remain as CEOs, and often as owners



with controlling shareholder voting rights, has raised some new concerns about corporate governance, which will be discussed later in this essay.

“The corporate executive’s role is to make as much money as possible while conforming to the basic rules of the society...”

Friedman asserted that in a free enterprise, private property system, a corporate executive is an employee of the owners of the business in question, and the executive’s responsibility is to manage the business in accordance with the desires of the owners. Friedman suggests that owners typically want the companies they own to make as much money as possible, which leads to his summary statement about the social responsibility of managers that has been the lightning rod for his critics. Specifically,

as an employee of the shareholders, the corporate executive’s role is 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.

It is relevant to note that Friedman acknowledged that some owners may have objectives other than maximizing wealth, such as supporting particular charitable causes, and he did not explicitly object to the existence of what is today known as Public Benefit Corporations (PBCs)—legal entities with a legal affirmative duty to be “good corporate citizens.”³ However, he cautioned that the more complex the criterion of performance, the more difficult it is for owners to monitor the performance of their managers. In this circumstance, it is easier for managers to suborn the interests of owners, whatever those interests are, in favour of the managers’ own interests. As a consequence, owners will need to monitor managers more, which will impose additional transactions costs on the economy, or they will undertake specific activities as individual proprietors when those activities would be more efficiently done by organizations that employ specialized managers. While Friedman acknowledged that it is not necessarily easy for owners of public corporations to monitor the performance of their managerial agents, it is easier to do so when their criterion of performance is corporate profitability.⁴

Friedman dispensed with the notion that being “socially responsible” in their capacity as executives can be consistent with acting in the interests of shareholders who invest in order to maximize their personal wealth. He stated quite clearly that if the claim that corporate executives have a social responsibility to fill in their role as executives is not pure bluster, it must mean that they must act in some way that is not in the interests of shareholders. In making this statement, Friedman undercut a growing line of argument by managers of leading investment companies such as Blackrock that socially responsible actions by companies is in the interest of those companies’ shareholders.⁵ Put simply, Friedman made the reasonable assumption that if, say, hiring minority employees increases the profitability of companies, executives acting in their role as agents for shareholders will voluntarily hire any and all minority employees whose contribution to corporate profitability exceeds their compensation. In such cases, there is no practical difference between acting socially responsibly and focusing on shareholders’ financial interests.

A critical extension of Friedman's point that differentiating between socially responsible business behaviour and profit maximization is meaningless when those objectives involve the same managerial actions is his insight that if firms are performing efficiently, which is a prerequisite to maximizing profits, no managerial action is possible that makes one or more groups better off without making one or more groups worse off. For example, if executives donate company funds to an environmental activist group, it might reduce the profits available to shareholders, or it might mean that consumers will be charged higher prices, or that workers will be offered less compensation. These stakeholders could make their own donations to the environmental group if they wished to do so.



That there is no “free lunch” when it comes to socially responsible behaviour leads to what is perhaps Friedman's strongest defense of shareholder capitalism. Namely, an executive who engages in extracting corporate wealth to support social causes is effectively imposing a tax on one group and providing a transfer payment to some other group. Friedman argues that on the level of political principle, the imposition of taxes and the expenditure of the tax proceeds are governmental functions. When corporate executives impose taxes and spend the proceeds for social purposes, they become, in effect, public employees, even though they remain in name employees of private enterprises. If executives are to impose taxes and make expenditures to promote social objectives, the assessment of taxes and the objectives to be served from the tax revenue raised should be determined by a political process.⁶

The doctrine of social responsibility would therefore extend the scope of government regulation to the everyday activities of privately owned enterprises, as Friedman noted. In this respect, the doctrine of social responsibility does not differ from a collectivist or socialist doctrine. Hence, executives that extol their commitments to socially virtuous behaviour in the hope of gaining some type of short-run financial advantage undermine the foundation of the free enterprise system.

It might be argued that Friedman did not go on to develop the important caveat to his assertion that the responsibility of executives is to make as much money as possible for shareholders, i.e., that in doing so they conform to the basic rules of the society. Laws and regulations are formal rules. Social customs and conventions are informal rules. Even formal rules can be ambiguous or non-transparent, which obliges executives (and their lawyers) to be sufficiently knowledgeable to obey the rules. Conforming to informal rules that can vary by the geographical locations of a company's business activities as well as over time is even more challenging than conforming to formal rules. Friedman's position is therefore

potentially open to the challenge that it is as difficult for executives to identify and conform to the basic rules of society as it is for them to understand the linkages between their decisions as managers and the social consequences of their decisions. Indeed, in many cases, the same knowledge is required.

As we shall discuss in a later section, the arguably more economically sophisticated challenges to Friedman's basic argument in defense of shareholder capitalism directly or indirectly rely on the notion that executives cannot be expected to conform to the basic rules of society for one or another reason unless they are directed to do so by changes in corporate law or by regulations that oblige companies to report whether or not they are meeting ESG-related regulations promulgated by securities regulators and government agencies. We turn next to the arguments of Friedman's critics.

Stakeholder capitalism

One of the early academic schools of thought to criticize the shareholder capitalist model is represented by those advocating a stakeholder model of capitalism. In broad terms, this

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school of thought maintains that corporate executives should consider the interests of a wide range of individuals and groups who are directly or indirectly affected by their decisions including, but not necessarily restricted to, consumers, employees, suppliers, and the communities in which the relevant companies do business.

The stakeholder model is defended by its proponents on both positive and normative grounds. The positive argument is that profit maximization requires corporate managers to treat each of these sets of stakeholders “fairly” and, therefore, an exclusive focus on shareholders will contribute to reduced profitability.⁷ Obviously,

firms in competitive markets must offer consumers and suppliers of inputs “fair” terms of exchange if they are to stay in business, and it hardly took Friedman to make that point. Still, he addresses the positive argument for stakeholder capitalism in his observation that arguments for alternatives to shareholder capitalism based on claims that specific alternatives would profit the adopting organizations are purely rhetorical.

The normative argument for stakeholder capitalism is that managers have an ethical obligation to stakeholders beyond just the shareholders. Those making this argument point to various ethical theories that have been applied to management, and it is beyond the scope of this essay to discuss these theories. The point that might be made here is that to the extent that ethical norms are embedded in social norms, Friedman addresses this argument by acknowledging that executive actions are bounded by the formal and informal rules of society. To be sure, there will inevitably be instances when clear social rules do not exist or are,

at least, matters for interpretation.⁸ In such cases, however, one would be hard pressed to argue that executives flaunted social norms.

A more specific ethical challenge to shareholder capitalism is posed by the claim advanced by some ethicists that it is immoral to treat stakeholders as means to an end, i.e., increased profits, even if executives break no laws or social norms in doing so.⁹ Burton and Dunn (2005) argue that on moral grounds,



managers should “care” for all individuals whose lives are affected (or could be affected) by their organizations’ activities. In cases of conflicting needs, managers should give preference to those stakeholders whose needs are most important on ethical grounds rather than on the direct or indirect contributions individual stakeholders make to the organizations in question.

It is tempting to dismiss Burton and Dunn’s normative argument as being an impractical principle upon which to base the management of a company. However, it is unnecessary to do so. Whatever the ethical criterion, welfare tradeoffs across individuals inevitably will arise which will oblige managers to impose the equivalent of taxes on some in order to benefit others. Burton and Dunn’s normative critique of shareholder capitalism is therefore rebutted by Friedman’s argument that unelected private sector managers have no legal standing to redistribute income based on whatever “moral model” they choose to invoke.

Ruggie, Rees, and Davis (2020) do not challenge the stakeholder model on ethical grounds. Rather, they offer a normative interpretation of ethical behaviour that they claim “harmonizes” the interests of various stakeholders. Specifically, they advocate embedding human rights due diligence processes into corporate decision-making and oversight systems in order to identify and mitigate adverse human rights impacts connected to corporate operations and business relationships. The authors do not make the case that corporate boards and managers can avoid making welfare tradeoffs in pursuit of human rights. Moreover, they argue in favour of regulations to ensure that human rights are not violated by corporate activities. As such, their stakeholder capitalism paradigm does not rebut Friedman but, rather, implicitly acknowledges the primacy of laws and regulatory rules when it comes to addressing broad public policy issues such as human rights.

ESG

Contemporary proponents of ESG reforms to shareholder capitalism can be viewed as putting forth a more expansive version of the stakeholder capitalism model. Specifically, they include the natural environment as a key stakeholder. This position is also associated with



the model of sustainable capitalism which Rull (2011) characterizes as one that prioritizes caring for the natural environment because it is the primary provider of resources to sustain human life. Others have added a social element to this position by arguing that sustainable development involves the simultaneous pursuit of economic prosperity, environmental quality, and social equity.

While Friedman understandably does not explicitly address the specific contentions of ESG proponents in his 1970 commentary, he clearly acknowledges the obligation of executives to follow laws and regulations meant to address environmental externalities. In this regard, a potentially important source of intellectual conflict between Friedman's model of shareholder capitalism and proponents of ESG-oriented management is whether companies should go beyond existing laws and regulations in their efforts to practice "sustainability." For example, former US Vice-President Al Gore, a prominent advocate of environmentalist causes, asserts that while businesses cannot be asked to do the job of government, companies and investors ultimately must mobilize the financial, physical, and human capital required to overcome the unprecedented environmental challenges the world faces (see Gore and Blood, 2011).

As in the case made for stakeholder capitalism, many ESG proponents argue that private sector companies would be more profitable or pose less risk to their shareholders if they adopted ESG "best practices" more intensively, i.e., beyond what is required by laws and regulations. For example, the International Business Council (IBC) of the World Economic Forum posits that aligning corporate goals to the long-term goals of addressing environmental sustainability as well as economic and social inequities will prove profitable for those businesses that do so (see World Economic Forum, 2020).

The doing-well-by-doing-good argument embedded in much of the ESG literature is nuanced by claims that inefficiencies in product, factor, and capital markets may contribute to a disconnect between the ESG best practices and risk-adjusted returns to owners of companies. Specifically, managers may be inadequately informed about how implementing ESG best practices will improve their organizations' financial performance, while investors are insufficiently informed about what specific companies are doing with respect to ESG practices such that shareholders of high performing companies by ESG standards are not rewarded with higher risk-adjusted equity values for being owners of those companies.

The argument that inefficient product, factor, and capital markets might lead to executives "underinvesting" in ESG disclosures and initiatives is a contentious one with which Friedman would probably have disagreed. At the least, he would likely have argued that social

activists and government officials are less likely than corporate executives to identify the profit-maximizing amount of ESG activity for individual companies, and he would also likely have argued that mandating expansive and standardized ESG disclosures from private sector participants amounts to activists seeking to attain by undemocratic procedures what they cannot attain by democratic procedures including acquiring sufficient ownership shares in companies to vote in board members who support the activists' goals.¹⁰

Whether capital markets are inefficient in rewarding shareholders of companies that implement practices that ESG activists favour, including going beyond existing laws and regulations to reduce their carbon footprints, appoint members of minority groups to board and senior executive positions, and so forth, is ultimately an empirical issue. In this regard, it is suggestive that empirical studies of the relationship between ESG rankings of companies that specialized rating agencies perform and shareholder returns provide no consistent support for the claim that the returns to shareholders of highly ranked ESG companies exceed the returns to shareholders of less highly ranked companies.¹¹ However, if a substantial number of investors are willing to accept below-market returns in exchange for financially supporting companies that are sufficiently ESG-compliant in their opinion, companies taking the lead in ESG initiatives will have strong incentives to disclose their ESG practices, since doing so should reduce their costs of capital.

This benign view of the principal-agent relationship in large companies has unsurprisingly been challenged by what might be identified as the latest school of thought to challenge the shareholder capitalist model. This school maintains, among other things, that managers of large companies can operate free of direction from shareholders as well as from social norms more generally. The essay now turns to this set of Friedman's critics.

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Market power and the political influence of large companies

Recent criticisms of stakeholder capitalism centre around the assumption that executives of large companies enjoying dominant market positions are essentially responsible to no one but themselves. Moreover, executives of such companies have sufficient political and economic influence to shape formal laws and informal social customs to the advantage of their shareholders and to themselves personally, as well as to charge above-competitive prices and pay below-competitive wages.

Posner (2019) provides one illustration of this line of argument. For example, he asserts that established businesses will make the greatest profit by eliminating competition and not,

presumably, by trying to be as efficient as possible. Simple models from industrial organization economics show that a single seller of a product (a monopolist) will maximize profit by restricting output and charging a price above the competitive level. Other things constant, this imposes welfare losses on consumers that exceed the increased profits to shareholders. In simple terms, monopoly pricing is not in the social interest.

It would unduly expand the size of this essay to discuss the relevance of the monopoly model to stakeholder capitalism, let alone to public policy. Suffice it to say that many economists believe that government-imposed barriers to entry are typically required to protect the pricing power of firms from competition provided by new entrants that would be attracted by the profits earned by incumbent monopolists.¹² In this circumstance, it is appropriate to criticize the government for creating or perpetuating the market power of specific firms rather than the executives of those firms.¹³

To be sure, Posner implicitly acknowledges the potential complicity of government in making it legally possible for large companies to create and exploit their market power. However, he sees this outcome, in many cases, to be the result of lobbying and other interventions by representatives of large companies into the political process. He cites, as examples, lobbying efforts by companies to restrict foreign competition through, say, tariffs or to raise the costs of rivals through regulations that are particularly onerous for rivals to meet. Posner concludes that if the purpose of a business is to increase its profits, as Friedman argued, then it is clear-headed and justifiable for a business to use its political influence to dismantle the free market, which Friedman certainly would not have approved of.



Posner goes on to provide examples of business activities that (by implication) violate social norms, but which managers of powerful businesses can and do engage in regardless. One example is Facebook (now Meta) which Posner asserts broke its promises to respect its customers' privacy. He also mentions Twitter and Google (now Alphabet) as generating ad revenue by facilitating the transmission of hate speech. He cites Exxon and other oil companies for propagandizing

against climate science and tobacco and software gaming companies for pushing addictive products on to children.

These specific condemnations of corporate behaviour can be debated. For example, hate speech for some is healthy debate for others. In any case, Friedman certainly never claimed in his op-ed that corporate executives were paragons of virtue. What is implicit in Friedman's shareholder model is that actions taken by managers that are manifestly in opposition to social norms will be punished in the marketplace over time. Indeed, the bad publicity

surrounding Meta’s privacy practices has arguably contributed to a substantial reduction in the capitalized value of that company since Posner’s article was published.

A more direct and potentially meaningful critique by Posner addresses the essence of the shareholder model, i.e., that business executives are the employees of the shareholders. According to Posner, business executives are employees of corporations, but the executives enjoy *de facto* control of the enterprise when it comes to key strategic decisions. Shareholders are entitled to vote on certain major corporate decisions, but CEOs typically bat away shareholders, particularly when the latter propose that corporations should act in a socially responsible way.

“According to Posner, business executives are employees of corporations, but the executives enjoy *de facto* control of the enterprise when it comes to key strategic decisions.”

The principle-agent problem in the context of large, publicly owned companies was identified and discussed long before Friedman wrote his essay.¹⁴ The practical relevance of the problem remains a subject of debate. However, if it was a practically relevant problem in the past, it is less so in the present. In particular, the growth of indexed investment funds and indexed Exchange Traded Funds (ETFs) at the expense of individual retail investing has resulted in the effective concentration of proxy voting power in the hands of a small number of leading institutional investors such as—in the United States—Blackrock and Vanguard Asset Management. The relevance of Posner’s claim that the separation of ownership and management particularly disadvantages shareholders who support ESG causes is especially suspect given the emergence and rapid growth of ESG-themed investment funds and ETFs. The promise to buy large equity positions in ESG-compliant companies or to sell equity positions in non-compliant companies is a powerful market force that fund managers can use to modify the behaviour of corporate executives, particularly those whose compensation is tied in a significant way to their company’s stock price. Ironically, the growing concentration of investment capital in the hands of a relatively small number of institutional and professional money managers has recently led to concerns that those investors exert too much rather than too little influence on corporate executives.

It is unclear from his essay how Friedman would address the issue of corporate lobbying that Posner raised. Friedman would likely not deny that corporations participate in the political process to gain economic advantages for themselves and that this sometimes results in political outcomes that make the country as a whole less well off. However, Friedman would likely argue that the underlying problem is not corporate lobbying but rather it is the expansive size of government in the economy that makes it financially worthwhile to enlist government to pass laws and implement regulations that profit those companies who lobby successfully. The suborning of stakeholder capitalism by political rent-seeking opportunities is precisely the slippery slope to socialism that Friedman warned against.

Concluding comments

Friedman's defense of shareholder capitalism remains controversial. However, more than 50 years after he wrote his famous commentary, most economists continue to support his main insights. In particular, most economists tend to agree that major externalities such as

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climate change are public policy issues and that it is misguided to blame companies for what amount to political failures to create the right public policies.¹⁵ Financial economists also tend to agree that while corporate governance is imperfect, the shareholder capitalist model addresses issues created by the separation of ownership and management more effectively than alternatives, and they reject initiatives proposed by ESG advocates such as restrictions on corporate buy-backs of stock and legal mandates requiring companies to register and operate as public benefit companies.

Perhaps the least productive contributions to the debate surrounding shareholder capitalism are claims such as those by the Business Roundtable (2021) that it is in the financial interests of businesses to implement ESG initiatives and abandon the focus on shareholders. Such claims ultimately rest on the notion that managers will ignore or be ignorant of profitable opportunities that lie outside traditional areas of business practice. There is simply no consistent evidence to support such claims.

Given the length of time that Friedman's critics have been at work and the depth and breadth of their attacks on his defense of shareholder capitalism, the continued robustness of his fundamental insights is nothing short of remarkable.

Endnotes

- 1 Fraser Institute will be publishing a series of essays that identify and evaluate in detail the major criticisms of Friedman's defense of shareholder capitalism. For an earlier essay that identifies and rebuts positions of some of Friedman's most well-known critics, see Henderson (2020).
- 2 The acronym ESG stands for Environmental, Social, and Governance imperatives for socially responsible management.
- 3 For a discussion of PBCs, see Mayer, Strine, and Winter (2020).
- 4 Indeed, later authors recognized that constraining the principle-agent problem as Friedman described it was an important benefit of shareholder capitalism. See, for example, Mehrotra and Morck (2017).
- 5 A later section of the essay will discuss this argument further.
- 6 Friedman noted that, as a practical matter, corporate executives will typically not have the information to understand how their actions will contribute to the achievement of any specific social end.
- 7 The classic reference in the stakeholder capitalist literature is Freeman (1984).
- 8 An example might be the case where a manager is confronted with the choice of hiring a minority candidate for a job when that candidate is not necessarily best qualified for the job.
- 9 An example would be providing after-sales service to consumers in order to create customer goodwill that results in increased profits but terminating the after-sales service if it is found to be unprofitable.

- 10 Indeed, a growing number of corporate proxy fights revolve around the ESG positions taken by prospective board members.
- 11 See Cornell (2021) for a review of the relevant literature. Forthcoming essays to be published by the Fraser Institute will discuss in more detail the theoretical and empirical linkages between ESG rankings and shareholder returns.
- 12 The seminal article in this literature remains Demsetz (1973).
- 13 For a relatively recent discussion of trends in industrial concentration and changes in industry competitiveness, particularly in online business sectors, see Varian (2019).
- 14 The earliest seminal contribution to this literature is Berle and Means (1932). One claimed manifestation of the separation of ownership from management that goes back to Berle and Means but that persists to the present is that managers aim for short-run profits at the expense of long-run profits, since the tenure of managers is relatively short. For a rebuttal of this claimed principal-agent problem, see Asness's comments in Strain, Asness, Lipton, and Hubbard (2021).
- 15 See Hubbard and Strain's comments at Strain, Asness, Lipton, and Hubbard (2021) among others for this defense of Friedman's thesis. Still, many ESG critics maintain that companies have the financial and technical resources to address public policy issues that governments have failed to address and, therefore, that companies should address those issues.

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