The shareholder versus stakeholder debate, rekindled

Is Friedman's profit maximizations doctrine set for a bounce-back? And what does it mean for companies and investors increasingly focussed on ESG goals?

Have we been too early in celebrating the end of the profit-maximizing corporation and the advent of stakeholder capitalism? Perhaps not. After all, some 50 years have passed since Milton Friedman writing in the New York Times had baldly stated that the social responsibility of business is to maximize profits—a long enough period for any theory to start to fray. Importantly, hadn't the all-powerful US Business Roundtable defenestrated Friedman, stating that purpose of the corporation is no longer maximizing returns to shareholders but a commitment to all stakeholders? So why is question?

The debate resurfaced last month after JP Morgan's board rejected the switch to become a shareholder-focused entity. And if maximization interests of shareholders remains the legal touchstone for all board decisions in the US, the philosophical underpinnings will permeate our markets: By one count, foreign institutional investors own 20.6 per cent of the Indian equities.

A more important reason to ask the question is the implication this might have on company strategy, that increasingly focused on going green.

First the facts. JP Morgan's board rebuffed a shareholder proposal by Harrington Investments, a relatively small institutional investor, that the bank be converted into a "public benefit corporation," a Delaware legal structure, one step removed from a not-for-profit. Harrington Investments has mooted this with several other large banks, where it will likely reach a similar fate. To conclude that the rejection points to Friedman's doctrine clawing itself back to the boardroom may not be an entirely correct read. But this rejection is a time to reassess what Friedman said — 50 years on.

The Stigler Centre at the University of Chicago Booth School of Business has published a 28-article series on the shareholder-stakeholder debate. The book has contributions by Nobel Laureates Eugene Fama and Oliver Hart, to luminaries like Michal Lipton, Lucian Bebchuk, Raghuram Rajan, Anat Admati and Martin Wolf, reflecting both its depth and breadth. To be clear, this is not a book review, but it does shine a light on what Friedman said, and helps in reassessing his doctrine particularly in the context of the recent thrust on ESG (Environment, Social and Governance) by investors and companies.

Interestingly, one thing that stands out is that Friedman's was not an unvarnished profit maximizing theorem (in fact, it was not a theorem but an op-ed, albeit one of the more impactful op-eds ever). As Alex Edmans points out, "*Friedman's article is widely misquoted and misunderstood. Indeed, thousands of people may have cited it without reading past the title. They think they don't need to, because the title already makes his stance clear: companies should maximize profits by price-gouging customers, underpaying workers, and polluting the environment.*" And this interpretation is repeated in essay after essay.

One other aspect that needs to be highlighted is that Friedman was writing when the US market was still primarily owned by retail investors. In the absence of a clear consensus regarding the direction the business needed to take, profit maximisation was an idea that was easy to get investors to coalesce around. This is not to say that there is a consensus among intuitional investors regarding a company's goals. It is just that by the time they came to dominate corporate ownership, profit maximization had for all intents and purposes been codified into law.

Giving a pushback to stakeholder capitalism by arguing that that maximising many functions rarely has an elegant solution, is arguing a truism. But it is set to change. Data availability today is at a different scale. And here the big change over the past few years has been data around ESG. Today, there are more data points than anytime in the past. And what gets measured, gets done. It is true that there is still a divergence regarding what and how to measure. An MIT study points out that "a firm's labour practices can be evaluated on the basis of workforce turnover, or by the number of labour cases against the firm. Both capture aspects of the attribute labor practices but they are likely to lead to different assessments." As we reach a consensus around taxonomy, it is safe to argue that this issue will be addressed, maybe not wholly but in large measure.

In his essay Alex Edmans addresses this. He argues that we need to accept Friedman's doctrine just like finance students accept the Modigliani-Miller theorem that the value of the firm is independent of its capital structure *under certain assumptions.* Freidman advocated profit maximization in the long run, under certain assumptions. Profit can be maximized in the long run only if corporations treated all stakeholders fairly. A Stanford Business School survey from 2019 makes the same point.

Finally, it is worth asking if we are over analysing the debate particularly from an American lens, given that that is where a chunk of the institutional ownership resides. To our credit, our Companies Act, 2013, has accorded primacy to stakeholders and not shareholders. Having wholeheartedly embraced CSR and ESG, both are now gathering pace. This is how it was always meant to be.

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A modified version of this blog titled 'Shareholder versus stakeholders, once more' appeared in Business Standard on 10 March 2021. Subscribers to the newspaper can access it here or typing the following url: https://www.business-standard.com/article/opinion/shareholders-vs-stakeholders-once-more-121031000027_1.html

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