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SHAREHOLDER CAPITALISM AND STAKEHOLDER CAPITALISM: COMMONALITIES AND DIFFERENCES

A central issue facing business and society is whether firms focus solely on the interests of shareholders or should have a broad set of objectives. The former approach is referred to as Shareholder Capitalism and the latter approach is referred to as Stakeholder Capitalism. This brief explores commonalities and differences between the two.

The two models appear to be starkly different if we take a narrow view of Shareholder Capitalism. However, if the Shareholder model is modified such that profit-maximizing firms have a financial incentive to take into account the preferences of employees, customers, and others for more socially responsible behavior of firms, then the commonalities between the two models are substantial. Firms focused solely on profits will seek to engage stakeholders, especially those with whom they are in either explicit or implicit contractual relationships.

Even with this modified view of Shareholder Capitalism, however, important differences between Shareholder Capitalism and Stakeholder Capitalism remain.

1. SHAREHOLDER CAPITALISM

The rationale behind Shareholder Capitalism is easy to spot. Firms need capital and the suppliers of capital seek returns on their investments. It follows, according to Shareholder Capitalism, that the interests of shareholders are preeminent in market-oriented economies.

The classic statement in support of Shareholder Capitalism comes from Milton Friedman,[1] winner of the 1976 Nobel Prize.[2] Friedman summed up his views about the "social responsibility of business" in <u>Capitalism and Freedom</u> (1962):

> [T]here 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 engage in open and free competition, without deception or fraud.[3]

Given Friedman's view, the firm's sole objective is to maximize profits:

[1] <u>Profits</u> = Function (labor, capital, technology, managerial skill, legal compliance)

Friedman distilled his argument in the context of pollution into four steps:

i. Pollution abatement by firms is costly.

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[1] See Friedman's NYT Essay posted on Canvas.

[2] It was not an accident that the Nobel Committee awarded the prize to Friedman 200 years after Adam Smith's Wealth of Nations was published. Friedman was viewed as the most effective proponent of free markets and their contribution to the well-being of individuals and societies.

[3] Friedman, <u>Milton, Capitalism and Freedom</u>, p. 133, Fortieth Anniversary Edition, University of Chicago Press, 2002.

ii. Firms are subject to rules that require them to limit pollution to a specified level, L.
iii. Firms should meet but not go beyond the legal standard, i.e., they should not reduce pollution to a level below L.
iv. If firms abate more than is required to bring pollution below P^{max}, they are taking profits away from Shareholders. Managers (agents) do not have the right to do so.

Several points are important in understanding Friedman's position:

1. It is up to the government to set rules, e.g., that firms cannot pollute more than L.
2. Firms should follow the rules.
3. The supply of capital to businesses will be reduced if firms deviate from profit-maximization by reducing pollution below the legal limit, L.
4. Friedman did not take into account the possibility (and now the likelihood) that employees, customers, shareholders and others in economic relationships with the firm might want the firm to do better than the legal standard for pollution and that such groups might be willing to give up some of their wages, pay higher prices, etc. to induce the firm to do so.
5. Friedman accepted that shareholders might want to do "good things" with their profits.

As indicated in Point 4, Friedman did not incorporate potential "right-hand side" variables such as the preferences of customers, employees, suppliers and others for doing better than what the law requires. Instead, Friedman's view is based on an assumption that employees, customers, shareholders and others are (i) undifferentiated, i.e,. labor is labor, managers are managers, and (ii) are indifferent to whether the firm pursues social objectives.[4]

2. STAKEHOLDER CAPITALISM

The essence of Stakeholder Capitalism is that firms should pursue multiple objectives. Profit-maximization is one, but many others are relevant, including the welfare of the community and society, environment concerns, education, countering discrimination, and access to health services.[5]

Professor Edward Freeman at University of Virginia led the efforts in recent decades to advocate for Stakeholder Capitalism.[6] Among the supporting rationales, Freeman argues that left to themselves, capitalism and markets will increase consumer welfare and generate gains for many, but will create social and economic divides. He also argues that markets are typically not capable of dealing with problems of environmental degradation and discrimination against less privileged groups. In a 2007 article, Freeman and co-authors state:

> If we rely upon the state to solve stakeholder conflicts, individuals and organizations

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[4] Economists now recognize that employees, customers, and shareholders are often differentiated, including their preferences for various social objectives. As a result, the observed equilibria in markets (labor, goods and services, capital) often involve *matchings* of stakeholders to firms. Lloyd Shapley and Alvin Roth won the 2012 Nobel Prize for their work on matchings in markets.

[5] There are many antecedents to Stakeholder Capitalism. In their famous treatise that raised governance issues, Adolf Berle (Columbia University) and Gardiner Means (Harvard University) state that the role of the organization is ''balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupidity (Berle and Means, 1932).'' Berle, A. and G. Means: 1932, The Modern Corporation and Private Property (Harcourt, Brace & World Inc, New York)

[6] See Canvas for citations to Freeman's works.

> never develop the imagination required to create different, mutually beneficial relationships. In addition, the parties are not expected to learn how to resolve issues themselves when the court system was created for such a purpose.[7]

It follows from Freeman's view that businesses must become part of the solution to fundamental problems and commit to a broader set of objectives. This commitment could be viewed as in part self-interest, but Freeman recognizes that the pursuit of multiple objectives requires tradeoffs with shareholder interests. Indeed, Freeman rejects the notion that shareholders should set the rules:

> One group's rights do not prima facie dominate the narrative of capitalism. Rather, each stakeholder should be protected within their voluntary agreements.[8]

The bottom-line view of Stakeholder Capitalism is that there must be multiple bottom lines. In contrast to the single objective, firms should explicitly pursue and report on multiple objectives. The specification of those objectives comes from *cooperation*, *engagement*, and *processes that hold stakeholders responsible* for actions that affect others. In the context of complex relationships, Freeman advocates for "*continuous creation*" of value on multiple dimensions, as indicated below:[9]

[1] <u>Profits</u> = Function (labor, capital, technology, managerial skill, legal compliance, customer preferences, employee preferences, supplier preferences)
[2] <u>Environmental Stewardship</u> = Function (labor, capital, technology, managerial skill)
[3] <u>Community Welfare</u> = Function (labor, capital, technology, managerial skill)

Note that this list of objectives is not intended to be complete.

3. COMMONALITIES BETWEEN SHAREHOLDER CAPITALISM AND STAKEHOLDER CAPITALISM

If the narrow view of Shareholder Capitalism is *modified* to take into account the preferences of stakeholders who are in economic relationships with the firm, then the two views have substantial commonalities.

The profit function in [1] above for Shareholder Capitalism should be modified to include right-hand side variables such as (i) a desire among employees that the firm is a good environmental steward, and (ii) preferences among customers for green products. The result is that these factors are *inputs* into profit maximization rather than separate objectives.

This modification means that the two views lead the firm to alter their behaviors and pursue social objectives. Profit-maximizing firms will not ignore social objectives (as is sometimes claimed by

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[7] R. Edward Freeman, Kirsten Martin, and Bidhan Parmar, "Stakeholder Capitalism," *J. of Business Ethics* (2007) 74: 303-314.
[8] R. Edward Freeman, Kirsten Martin, and Bidhan Parmar, "Stakeholder Capitalism," *J. of Business Ethics* (2007) 74: 303-314.
[9] R. Edward Freeman, Kirsten Martin, and Bidhan Parmar, "Stakeholder Capitalism," *J. of Business Ethics* (2007) 74: 303-314.

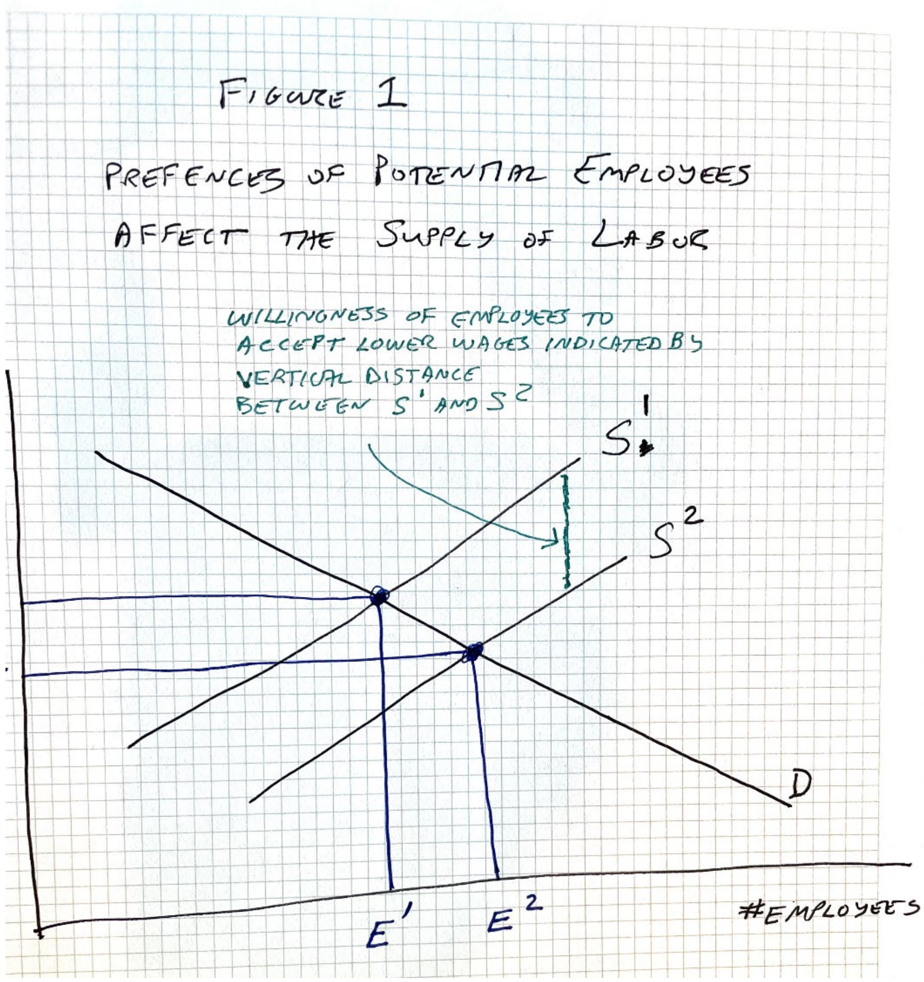
critics of Shareholder Capitalism) and instead will take them into account to maximize the value of the firm.

We should be clear about why and to what extent profit-maximizing managers take into account social objectives that are important to employees, customers, and others. Standard economics explains both why and also provides a framework for understanding the extent to which profit-maximizing firms will adjust their behaviors given the preferences of stakeholders.

Consider employees who have preferences to work for ethical companies that are good stewards of the environment and support their local communities. These preferences affect the salaries that they are willing to accept.

> In State of the World 1, the firm does not take actions to protect the environment or support local communities. Its supply of labor is indicated by S^1.
>
> In State of the World 2, the firm actions to protect the environment and support local communities, the supply of labor is indicated by S^2.

Holding constant the firm's demand for labor (D), the firm benefits from being a good environmental steward and providing support for local communities. As depicted in Figure 1, in State of the World 2, with the corresponding Supply Curve (S^2), the firm can hire more employees at lower equilibrium wages.



The resulting differences the wages that employees are willing is a standard result in economics. They are sometimes referred to as *compensating differentials*. If the firm takes actions to protect the environment, etc. (moving from State of World 1 to State of World 2), then potential employees are willing to accept lower wages, as indicated by the vertical distance between the two supply curves. Conversely, potential employees need to be compensated extra for working for a firm that makes no efforts beyond the legal minimum. This same phenomenon explains why firms sometimes make extraordinary efforts to ensure a safe working environment.

The same logic applies to other stakeholders –consumers, partners, and investors -- who are in implicit or explicit contractual relationships with the firm.

With the compensating differentials, profit-maximizing firms have an incentive to "not just do the legal minimum." The extent of the effect depends on the size of the compensating differentials. The bigger they are, e.g., consumers are willing to pay large premia for products produced by firms that are good environmental stewards, the more powerful are the firm's incentives to pursue environmental objectives. The other factor is the cost of making environmental progress. If it is hard to "move the needle", then even with the incentives associated with compensating differentials, the bottom-line change will be small.

The implications are as follows: Allowing for a continuum of potential efforts to advance objectives that are of interest to employees, customers, and others leads the profit-maximizing firm to choose the effort level at which the marginal gains from hiring more workers at lower wages equals the marginal cost of those efforts. This optimization is expected to involve engagement, communication, and the development of processes that align efforts around social objectives.

Returning to the issue of commonalities between the two models, firms and their CEOs, independent of whether they are pure profit-maximizers, may engage in similar activities to energize stakeholders, communicate their commitment to social objectives, and report to stakeholders on a range of objectives. Firms that fit both models may engage in, for example, design thinking to identify innovations that allow the firm to pursue stakeholder and shareholder objectives more effectively.

> Question: Does the fact that profit-maximizing firms will incorporate into their decision-making objectives such as environmental stewardship and support for communities mean that Shareholder Capitalism and Stakeholder Capitalism converge?

Yes, they converge but not fully. They converge to an extent that is determined by (i) whether stakeholders in economic relationships with the firm care about various social objectives, and (ii) their willingness to accept lower wages (in the case of employees) or pay higher prices (in the case of consumers.)

Other commonalities between the two approaches are that firms meet legal requirements and in some contexts going beyond legal requirements to strengthen their *social license* to operate." Shareholder Capitalism would endorse investments in a firm's social license because it is correctly viewed as an input into profit-maximization. Firms with stronger social profiles may have lower entry costs and less friction with government regulators.

While sometimes it is argued that Shareholder Capitalism is inherently "short-term" oriented and that Stakeholder Capitalism is concerned with long-term objectives, there is no real basis for these claims. Whatever the objectives, firms are expected to value the gains over time. In neither case does the value of the enterprise have a fixed time-horizon. The effective time horizon depends on the discount rate, but there is no reason to expect that the approach a firm takes will imply a different discount rate. The safer assumption, therefore, is that common to both approaches is long-term value creation, appropriately discounted.[10]

One last commonality is, whatever their objectives, firms are subject to internal and external constraints. Public companies have boards of directors with powers to choose senior executives and develop compensation schemes. In general, firms face competitive constraints in the markets in which they operate. If one consumer products company emphasizes environmental stewardship, they may lose some customers to rivals who offer lower prices. Other constraints derive from the *market for corporate control*. Firms that are viewed as trading off profits for social objectives may attract activist investors. Lastly, public firm face competition from alternative ways of organizing commercial activities. These include private companies and non-profits.

[10] Put differently, the Discounted Cash Flow (DCF) model applies.

4. DIFFERENCES BETWEEN SHAREHOLDER AND STAKEHOLDER CAPITALISM

The most important difference between the two approaches concerns whether firms pursue a single objective, profit-maximization, or they pursue multiple objectives.

The second most important difference is that profit-maximizing firms are expected to expend less efforts on social objectives than firms that pursue these objectives independently of profit-maximization. The reason is that profit-maximizing firms will expend resources only to the point where they benefit financially in their relationships with employees, customers, and other stakeholders. By contrast, firms that follow the stakeholder model will make efforts to generate higher levels of various types of social goods.

A third potential difference is that the internal and external constraints on firm behavior are likely to have a more binding effect on firms that follow the Stakeholder Capitalism model.

5. SUMMARY DIAGRAM

The *Production Possibility Frontier* (PPF) – a standard economics tool – is useful for analysis of Shareholder Capitalism and Stakeholder Capitalism. Given their capabilities, firms can generate different combinations of profits and social goods (G). For expositional simplicity, social goods are represented as a single output.

Figure 2 on the next page shows profits (Π) on the vertical axis and social goods (G) on the horizontal axis. Maximum profits ((Π^{max}) is where the PPF reaches its highest point. The maximum amount of social goods (G^{max}) that the firm can generate is where profits are zero.

The insight that profit-maximizing firms will benefit from producing a positive level of social goods is reflected in the part of the PPF that has a positive slope.

> Over the range of 0 to G^, profits increase because employees, customers, and others compensate the firm for producing more social goods. The firm's overall labor costs are reduced due to lower wages or increased productivity. Similarly, the firm's sales are enhanced by consumers who are willing to buy more from them and pay higher prices.

What happens if the firm produces G^ but no more than that level of social goods? It maximizes profits. If the firm produces more than G^, then it faces a tradeoff between social goods and profits, as indicated by the negative slope. Put more starkly, the part of the PPF to the right of G^is the range where the firm *sacrifices* profits for social goods.[11]

The firm may be able to produce a higher level of social goods, G^+ provided that it is not constrained by its board of directors or by activist investors. The constraint on public firms in shown in Figure 2 as a horizontal line at Π^{min}.

In sum, firms that follow the stakeholder model will produce a higher level of social goods than firms that follow the shareholder model.

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[11] The extent of product market competition and competition from privately held companies influences how fast profits decline to the right of G^.

FIGURE 2

FIRM'S PRODUCTION POSSIBILITY FRONTIER (PPF)
FOR GENERATING PROFITS (π) AND SOCIAL GOODS (G)