RBC Global Asset Management

The social responsibility of business: a retrospective

The RBC GAM Global Equity team

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Fifty years ago, Milton Friedman published his influential *New York Times* article entitled ‘The Social Responsibility of Business is to Increase its Profits’. In it, he argued that it would be inefficient for business managers to address social causes directly as this would impose opportunity costs on owners. Better, he felt, for managers to focus their attentions on increasing the profits of the business, within the constraints set by society, and allowing owners to distribute the profits as they saw fit. He was also very clear that this expression of self-interest would result in a more responsible, collective social outcome overall.

It is remarkable that half a century on, his article is still being actively debated. Reading Friedman’s words today, it is clear that they were written in a different time, when the ideological struggle between liberal democratic economic thought and communist command economies was more strident. The dilemmas he presents to illustrate his arguments differ from those a modern reader might consider most relevant, such as fighting inflation rather than climate change.

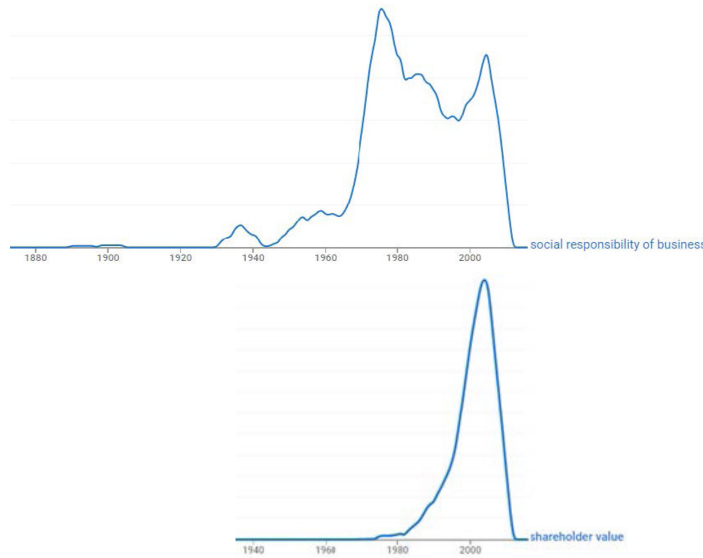
Despite this, the clarity of his argument endures, as demonstrated by the fact that the article is still cited by today’s academics – over 20,000 times and counting according to Google Scholar.

Friedman’s assertion that social value was aligned with increasing profits was appealing to free marketeers. It was a reminder of Adam Smith’s comment in *The Wealth of Nations* (1776) that “by pursuing his own interest [an individual] frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good.”

His ‘doctrine’, as the *New York Times* described it, used the profit motive to increase value accruing to owners and suggested that this led to a socially responsible solution for all. In effect, there was no contradiction between ‘doing well’ and ‘doing good’. Greed was good, as Gordon Gekko was to famously remark 17 years later.

But ideas are like children in many ways: after one introduces them to the world, they take on their own identity and begin to find their own way. That has arguably been no truer than for Friedman’s views on corporate social responsibility.

In an example of how ideas evolve, Friedman’s arguments became foundations for the maximisation of what was to become known as ‘shareholder value’. In a competitive market the firms that could generate shareholder value the most efficiently would enjoy an advantage over less efficient peers. Embraced by capital markets, forensic analysis of shareholder value creation became de rigueur, with consultants spreading the new discipline amongst corporates and investors.



Source: Google Ngrams, October 2020; Google Ngrams documents the frequency with which terms appear in written and online sources

These were important lessons. Follow these principles and investors might identify and own the most efficient firms, capable of generating the most output with the least input, helping them to reach their financial goals quicker and cheaper. For fiduciaries such as plan sponsors and portfolio managers, this aligned with their common law duty to do the best for their clients, and became codified through case law and regulation.

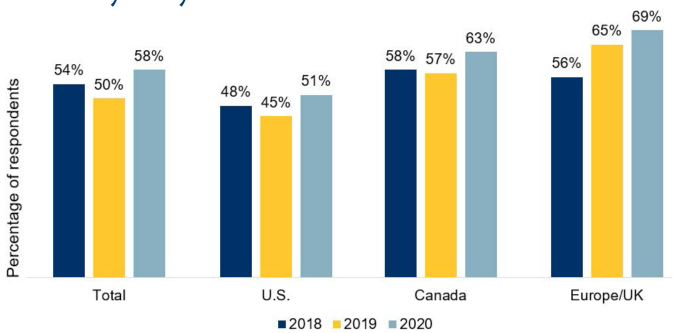
But even ideas can get taken too far, and by looking for the marginal advantage, shareholder value became shareholder primacy. Under such norms it was acceptable for shareholder value to increase even if that accruing to other stakeholders did not.

However, prioritising shareholders over and above providers of other important extra-financial forms of capital did not sit well with everyone. Shareholder primacy seemed to prioritise financial capital over and above the contribution of other forms of capital such as social or environmental. In addition, it lacked any consideration of the sustainability of shareholder value that was derived at the expense of these other providers.

Proponents of a broader appraisal have come to criticise shareholder primacy and with it the Friedman doctrine which has been caricatured as putting profits above all else. This criticism comes in many forms including ESG (Environmental, Social and Governance) and Responsible Investing labels. Such advocates bristle at the suggestion that shareholders acting in their own best interest can lead to better overall outcomes, pointing to the pollution, inequality and exploitation that has seemed to become worse, despite shareholder primacy. Instead, it is argued, explicitly recognising the contribution of non-shareholder forms of capital to maximise value for all stakeholders would provide a more sustainable solution.

But many shareholders are naturally reluctant to give up competitive advantages derived from their interests in shareholder value-maximising firms to instead pivot towards other capital providers. Indeed, they have at times been explicitly prevented from doing so by their legal duty to put clients' interests first.

Percentages of respondents who incorporate ESG into their investment process to meet a fiduciary duty



Source: RBC GAM Responsible Investment Survey, October 2020

This has been the case in the U.S. especially, where any failure to put clients' interests first would likely attract litigation and present career risk for professional investors. There is therefore a reluctance to incorporate ESG principles into investing that lasts to this day.

This debate between shareholder and stakeholder value is not just academic. The fissure between them was exposed by the recent publication of proposals by the U.S. Department of Labor that, if enacted, would prohibit benefit plans subject to ERISA rules from investing in ESG strategies if this meant subordinating their interests to non-pecuniary goals.

But is it fair to write off Friedman's article as an expression of unenlightened 'old-think'? Although his 1970 article was penned in an age before the 'ESG' moniker even existed, it is clear from the images chosen by the *New York Times* picture editor to illustrate his article - which emphasized issues such as industrial pollution and long-term unemployment - that he was writing at a time when ESG issues were sadly just as relevant as they are today. Indeed, replying to criticism from the CEO of Whole Foods 35 years later, he sought to demonstrate that there was in fact no contradiction between his view that the social responsibility of business was to increase its profits, and that of firms choosing to engage in activities that enhance their standing in their communities, such as those Whole Foods itself engaged in. He repeated his 1970 words that "it may well be in the long-run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government. That may make it easier to attract desirable employees, it may reduce the wage bill or lessen losses from pilferage and sabotage or have other worthwhile effects."

His use of the words 'long-run' is significant. Friedman is arguing that if shareholders benefit in the long run from firms investing in their communities to generate 'other worthwhile effects', then it is in their self-interest to do so. Moreover, it is the pursuit by every person of their self-interest in this way that delivers a benefit to society.

Seen in this light, Friedman's essay is less controversial. There is no contradiction between his view of social responsibility and responsible investing in theory. However, how his suggestions were applied in practice, with ideas of shareholder value giving way to shareholder primacy, reveal obvious shortcomings. The biggest of these is time horizon. We just haven't been very good at behaving with the 'long run' in mind. This is despite the concept of shareholder value taking into account the long term since share prices reflect the net present value of all future cash flows. The encouragement from investors for businesses and their managers to secure a marginal advantage over competitors has arguably caused time horizons to diminish. Firms faced certain short-run costs but uncertain future benefits, meaning that for the impatient or the unsure manager, curtailing such activities could be presented as a rational choice. This may support short-term cash flows and maybe even their chances of career advancement, but meant that long-term value-creating opportunities were lost.

This speaks to perhaps one of Friedman's strongest arguments in his 1970 essay: that of the agency problem. He is very strict in his treatment of managers who prioritise their own aims and ambitions above those of a firm's owners. Such actions are not necessarily in the long-term interest of shareholders and so represent a misallocation of resources.

Unfortunately, this is a topic that remains highly relevant. As the presence of Governance in 'ESG' testifies, we do not appear to have solved the agency problem in the intervening 50 years. Indeed, it is possible to argue that investors have been willing participants, to the extent that they have approved management pay incentives that have rewarded short-term outcomes above long-term consequences.

A possible criticism of Friedman's point of view on this important topic is that he is too quick to dismiss the possibility that investors could agree on measures of success that were broader than just simply increasing profits. Today, a growing number of companies describe themselves as being 'purpose-led', for example, embracing missions that encompass extra-financial goals. Although Friedman admits this is a possibility, he considers it to be confined to that of the sole trader, considering common agreed extra-financial goals across multiple shareholders to be unrealistic.

The increasing profits objective thus becomes a common denominator for Friedman that also conveniently offers an efficient solution by providing the means for individual shareholders to address their individual aims. But for his argument to hold it is a necessary condition that profits have to be judged over the long term. Any short-term assessment will encourage management decisions that may not be in the long-run interest of investors and thus of society.

That this hasn't always occurred in the last fifty years is not the fault of Friedman. One might suggest that his argument may have been enhanced had it been more explicit in highlighting the need for a patient appraisal of long-term profits. But even then, this may not have been sufficient to prevent the repurposing of his arguments to 'shareholder value', which was perhaps a helpful innovation, and thence to 'shareholder primacy' which, arguably, was not.

But the essay nevertheless remains relevant and poses some interesting - and maybe uncomfortable - questions about social responsibility for today's reader: in particular, the agency problem and getting alignment across many investors and managers. These issues are topical for investors seeking to target extra-financial components of an investment return – what has become known as 'impact investing' – where measurement and balancing profit with purpose is often problematic. Another persistent challenge is matching costs and benefits over time so that management decisions may be judged fairly. That too requires long-term thinking and patience from engaged investors.

In conclusion, Friedman's essay has clearly been influential and provided intellectual foundations upon which others subsequently built. Over time those foundations have gradually become obscured, with the result that they were judged by what was built upon them rather than on their own merits. By revisiting the essay, fifty years after its publication, hopefully this retrospective has been able to peel back some of the scaffolding and show that the foundations still have integrity. It is to be hoped that the present body of academic opinion will sweep away the flawed shareholder primacy construction that was temporarily built upon them and instead construct a more sustainable ESG replacement that recognises the importance of long-term value creation.

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Jeremy is a Senior Portfolio Manager and is the Consumer Specialist on the Global Equity team. Jeremy joined RBC Global Asset Management with the team in early 2014 after having spent more than seven years with them at First State in the same capacity. Previous experience includes roles at Credit Suisse Asset Management and Schroders Investment Management

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