

On Corporate Social Responsibility

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The fact that the actions of corporations affect groups of people other than its stockholders has been apparent for quite some time. Corporations can cripple the economies of local communities through plant relocations, claim the lives of its workers by supporting the demand for unregulated and hazardous working environments, and decimate entire ecosystems through irresponsible production practices. However, the extent to which corporations should be held responsible for their impact on these groups is a topic of ongoing debate. Furthermore, opinions remain divided on which theory best outlines and justifies such a concept of corporate social responsibility. The purpose of this paper is to argue that firms have important social responsibilities that extend beyond mere compliance with the law and that Joseph Heath's market failures approach is the best theory for justifying these responsibilities. First, I will analyze the stockholder theory and explain why it fails to delegitimize corporate social responsibility. Then, I will analyze the stakeholder theory and explain why it is an unsatisfactory model for justifying corporate social responsibility. Lastly, I will analyze the market failures approach, show how it successfully justifies corporate social responsibility, and explain why it is superior to rival interpretations.

Milton Friedman's stockholder theory aims to delegitimize the concept of corporate social responsibility. He states that in the corporate structure, there exists a fiduciary relationship between the agent (manager) and the principal (stockholder) (Friedman 65). The sole role of a manager is to act as an agent who has the responsibility of serving the interests of the principal (Friedman 65). Since the main interest of the principal is to earn maximum returns on their investment, the main responsibility of the manager is to maximize the profit of stockholders. Managers have the liberty to fulfill this responsibility by any means necessary, and are only restricted by the rules of law and ethical custom (Friedman 65). A manager's attempt to direct stockholder funds towards socially responsible ends would constitute an unethical exploitation of stockholders. He suggests that if stockholders wanted to direct their investment funds towards social good, they can do so as rational

autonomous agents (Friedman 66). Since they instead decided to invest their funds in a corporation, they must have done so with the intention of making profit. Therefore, if a manager spends these investment funds on social ends, and not towards generating maximum profit, they are using the stockholders' property (money) for their own means. This behavior amounts to "taxation without representation" as the manager is implicitly assuming the role of an autocratic government by imposing taxes and deciding how the tax proceeds should be spent (Friedman 66). Within a Kantian ethical framework, the managers could be accused of using stockholders as a means to their own end of advancing social good.

While I will positively justify the need for corporate social responsibility later in this essay with an analysis of the market failures approach, I will first explain why Friedman fails to delegitimize it here. Firstly, Friedman states that the law and ethical custom are the only restraints on a manager's freedom to maximize shareholder profits. Friedman seems to respect the primacy of the law in recognition of the fact that it is a reflection of the citizenry's will. Unfortunately for Friedman, the law in Western capitalist societies has recently evolved to weaken managers' responsibilities towards stockholders and strengthen their responsibilities towards other stakeholders affected by corporate affairs (Freeman 70). Increased regulation on consumer goods and services, stricter environmental laws, and greater union rights are all examples of this fact. Thus, in today's world, even managers adhering to the stockholder theory would be obliged to manage their corporations in a socially responsible manner. Secondly, Friedman suggests that it is not the manager's responsibility but rather the responsibility of government to enforce socially minded corporate practices. What Friedman fails to understand, however, is that it is impossible for the government to successfully enforce corporate social responsibility whenever necessary because many corporations have operations in other countries. This is problematic as corporations purposefully expand operations specifically to developing countries to take advantage of their relatively lenient laws on corporate

social responsibility. Unfortunately, these lax regulations facilitate the occurrence of disasters caused by corporate negligence such as factory fires and collapses. Since laws in Western capitalist countries aim to prevent the kinds of aforementioned disasters, Friedman concedes that corporations possess some degree of social responsibility by stating that managers must abide by such laws. However, if that is the case, corporations should be socially responsible in all places at all times. It would be illogical to suggest that corporations are free to be socially irresponsible in Bangladesh but yet are obliged to be socially responsible in Canada. Thus, it is clear that corporations have an obligation to be socially responsible even if the laws of the supervising government do not enforce such behaviour. For these reasons, Friedman's stockholder theory fails to successfully delegitimize the concept of corporate social responsibility.

Unlike Friedman, Edward Freeman believes that a concept of corporate social responsibility is legitimate and suggests that his stakeholder theory offers the best justification for this concept. He argues that managers bear a fiduciary relationship not only to stockholders but also to all stakeholders who have a claim on the firm (Freeman 70). He defines stakeholders as "groups and individuals who benefit from or are harmed by, and whose rights are violated or respected by, corporate actions" (Freeman 72). Like Friedman, Freeman appeals to Kantian ethics to justify his theory, stating that each stakeholder group has a right to not be treated as a means to achieving the ends of another stakeholder group. The stakeholder theory is also distinctly more utilitarian than the stockholder theory as the former takes into consideration the utility of all stakeholders of a corporation while the latter is concerned solely with maximizing the utility of stockholders. Freeman states that it is the responsibility of managers to balance the claims of conflicting stakeholders in order to promote the health of the corporation. Managerial actions advance stakeholder interests if equality among stakeholders is ensured, the consent of stakeholders is respected, and if each stakeholder would consent to the action in ignorance of their actual stakes (Freeman 76).

Freeman's stakeholder theory does not provide a satisfactory justification for corporate social responsibility, however. Suggesting that managers have the freedom to balance the rival claims of various stakeholder groups is practically problematic for two reasons. Firstly, stockholders would likely fire managers operating within the framework of the stakeholder theory. By balancing the interests of all stakeholders, managers would necessarily be unable to prioritize maximizing profits for stockholders. Implementing wage hikes to appease employees or volunteering to internalize production pollution costs to satisfy the local community would increase the corporation's operating expenses and consequently diminish its profits and dividends. Freeman fails to realize that while all stakeholders are affected by a manager's actions, only the stockholders have the power to employ or terminate the manager. Stockholders who consistently receive disappointing returns on their investments are likely to respond by terminating these under-performing managers with less socially responsible counterparts more focused on generating profits (Heath 118). Thus it seems that managers who apply the stakeholder theory towards their managerial decisions are not likely to be managers for very long. Secondly, in a corporation managed according to the stakeholder theory, it would become nearly impossible for any stakeholder group to evaluate the performance of the manager. Joseph Heath correctly states that:

It is difficult enough for shareholders to determine whether managers are actually maximizing profits, given available resources. But when profits can be traded off against myriad other objectives, such as maintaining employment, sustaining supplier relationships, and protecting the environment, while management has the discretion to balance these objectives as they see fit, then there is really no alternative but to trust the word of managers when they say that they are doing the best they can. (Heath 118)

Thus the stakeholder theory model fails to provide stakeholder groups with a mechanism to analyze whether or not management is actually furthering their interests. The most severe problem with the

stakeholder theory, however, is that its definition of stakeholders is both incoherent and flawed. Freeman provides two definitions of stakeholders. His wide definition defines stakeholders as “any group who can affect or is affected by the achievements of the organization’s objectives” (Heath 118). This definition, however, is so broad that it could apply to everyone in society. If this is the case though, managers could not possibly have a fiduciary relationship with stakeholders, as it is impossible to show partiality towards everyone in society. On the other hand, his narrow definition defines stakeholders as “groups that are vital to the success and survival of the firm” (Heath 118). However, a stakeholder group must first be identifiable by management in order for it to be considered vital to the firm. Often times, however, the individuals with the most at stake in a managerial decision are unable to organize themselves into an identifiable stakeholder group. Thus, this definition favors the interests of the most organized and outspoken groups that can best communicate their interests to the firm and not necessarily the interests of the groups with the most at stake in a particular managerial decision. For all of these reasons, Freeman’s stakeholder theory is an unsatisfactory model for justifying corporate social responsibility.

Joseph Heath’s market failures approach is an alternative model that successfully justifies corporate social responsibility. Heath’s model is predicated upon the premise that profit is justified because it promotes the well being of society. Unlike Friedman who simply asserts that profit is intrinsically valuable, Heath explains that profit is only instrumentally valuable in so far as it contributes to the welfare of society as a whole. Heath argues that corporations’ pursuit of profit creates the competition necessary to push prices towards market clearing prices (Heath 117). When market clear, all resources will have generated maximum utility, as they will have been allocated to those who derive the most relative utility from their consumption (Heath 117). This ideal scenario is referred to as a Pareto efficient outcome. Heath goes on to explain that Pareto inefficient outcomes and scenarios of market failure occur when profit stops contributing to the welfare of society as a

whole. Profit stops promoting the well being of society when corporations use non-preferred strategies of competition such as creating negative externalities and exploiting asymmetric information systems between themselves and consumers (Heath 123). These strategies send false price signals within the market that prevent market-clearing prices from being established. In this Pareto inefficient outcome, social welfare is not promoted and thus corporations' pursuit of profit becomes unjustified. Although the government attempts to limit the possibility for market failure through marketplace laws, these regulations are not subtle and sophisticated enough to eliminate all available opportunities for corporations to use non-preferred strategies of competition (Heath 124). Therefore, corporations must exercise ethical discretion by ensuring that they only act in socially responsible ways that use preferred strategies of competition that lead to Pareto efficient outcomes (Heath 124).

The market failures approach is superior to the stockholder theory for two reasons. Firstly, the market failures approach creates a more prosperous capitalist system. Under Friedman's stockholder theory, a manager would be inclined to use non-preferred strategies of competition since doing so would maximize profits for their stockholders. If all managers acted this way however, the harms created would dent the overall utility generated by the system. By using only preferred strategies of competition under the market failures approach, the harms of the capitalist system are minimized and the utility it generates is thus maximized. Secondly, the market failures approach recognizes that government regulation is imperfect and provides a framework for how to promote social welfare in light of this fact. The stockholder theory provides no such framework. Heath's market failures model is also superior to the stakeholder theory in two ways. Firstly, the market failures approach can be practically applied. The stakeholder theory suggests that managers bear a fiduciary relationship to stakeholders but fails to offer a coherent and sound definition of stakeholders. Thus, it is ambiguous as to whose interests managers should be furthering and how. By

contrast, the market failures approach provides managers with clear instructions on how to act on whose behalf. Managers are to make decisions that lead to Pareto efficient outcomes through preferred strategies of competition that do not send false price signals to the market. Secondly, the market failures approach refines the capitalist system while the stakeholder theory negatively reforms it. The stakeholder theory cripples corporations' ability to take necessary business risks and decisions by forcing them to instead become quasi-public institutions that spend time contemplating about how to best appease the different stakeholders they are liable to. Conversely, the market failures approach requires corporations to strive towards achieving a Pareto efficient outcome that represents the best possible pure market equilibrium the capitalist marketplace could achieve. Clearly, the market failures approach is superior to both the stockholder and stakeholder theories of corporate management.

The purpose of this paper was to argue that firms have important social responsibilities that extend beyond mere compliance with the law and that the market failures approach is the best theory for justifying these responsibilities. By refuting Friedman's stockholder theory and analyzing how a Pareto efficient marketplace leads to a more robust capitalist system, I successfully explained the need for corporations to adopt social responsibilities that supersede the scope of the law. By illustrating the numerous practical shortcomings of the stakeholder theory and demonstrating the relative superiority of Heath's model, I showed how the market failures approach successfully justifies corporate social responsibility. Moving forward, politicians, managers and other relevant parties should continue to look through the lens of Heath's market failures approach when analyzing corporate social responsibility and how it can best be furthered.

Works Cited

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