# Stakes vs. Shares: Why Ownership Isn’t Everything

According to Milton Friedman’s **shareholder theory of corporate governance,** the employees of a firm are morally obligated to pursue the long-term financial interests of the firm, even in cases where this conflicts with other, socially valuable goals. These “socially valuable goals” might include things as diverse as reducing pollution, maintaining a high level of product safety, increasing diversity in the workforce, and so on. In the last 40 years, the **stakeholder theory of corporate governance** has emerged as a powerful competitor to this thesis, and in many ways now represents the “standard” view of business ethics taught in business schools and non-profit “leadership” programs. Moreover, its influence is not limited to textbooks: ads for executive-level positions routinely mention the importance of working well with various “stakeholders,” and stakeholder language is regularly used by journalist, advocacy organizations, and even politicians and regulators.

In this lesson, we’ll consider the basics of stakeholder theory as they are presented by **R. Edward Freeman,** the business ethicist who originally formulated the theory. We’ll consider *what* stakeholders are, *why* businesses might have obligations to them, and *how* they can meet these. We’ll also be looking at some potentials objections and alternatives to stakeholder theory.

## Shareholder Theory: The Basics

Stakeholder theory, at its most simple, claims that corporations (and businesses/organizations more generally) have a fiduciary relationship to all of those who have *stake* in these decisions, and not merely those who own stock. These stakeholders certainly include stockholders, but they *also* include employees, consumers, suppliers, and the community at large. These groups are ALL the “principals,” and the management of the firm is morally required to act as an agent on behalf of ALL of their interests. Freeman and others have offered numerous arguments for this view; however, we’ll just be looking at a select few.

**Argument 1: Argument from the History of Law.** Freeman thinks that most of us are *already* committed to a stakeholder theory, according to which businesses cannot simply pursue their own self-interest, to the exclusion of everything else. One category of evidence for this claims concerns the way the law has changed in the last 50 years. The U.S. congress, together with state legislatures and courts at all levels have limited business’s pursuits in *lots* of ways: we have passed consumer safety laws, minimum wage laws, pollution regulations, anti-discrimination laws, and many other things. Freeman suggests that we have done this, at least in part, because we recognize that businesses should *not* be left free to pursue their profit to the exclusion of everything else. Instead, we think that the people who are affected by the business (its “stakeholders”) have some right to make claims.

**Argument 2: Argument from Economics.** Economists have become increasingly well-aware of various **market failures** that can prevent free-market economies from serving the public good. These include rent-seeking behavior by monopolies and oligarchies, moral hazards (when firms are able to take “risks” that other people will have to pay for), and negative externalities (when firms are able to impose “costs” on others, such as pollution). Our attempts to address these problems—for example, by fining companies who pollute—again suggest that firms are not *just* responsible to their shareowners, but to all those affected by their actions.

## Who Counts as a Stakeholder? What Difference does it Make?

Freeman differentiates between two definitions of *stakeholder*: a **narrow** definition that includes “groups that are vital to the survival and the success of the corporation” and a **wide** definition that includes “any group or individual who can affect or be affected by a corporation.” He initially focuses on the narrow group, and notes that it includes (at least) the following groups:

Figure 1 The narrow stakeholders of the firm include those groups that are \*necessary\* to the success of the firm.

**Owners** includes anyone who has a financial stake in the company. This includes not only stock holders but also creditors +and (in some cases) employee groups or even governments. This group provides the corporation with the financial resources it needs to function, and they often depend on the corporation providing some kind of financial return. Stockholders, for example, can be hurt by a failure to plan for the future, while creditors can be hurt by bankruptcy filings. A firm that respects its owners will not only seek profits, but will also take account of their particular needs and wants. For example, many retirees (who depend on stocks and bonds to maintain a basic livelihood) are understandably much more risk-averse than other sorts of owners might be.

**Employees** are those who depend on the firm for work. This includes both normal employees, as well as temps, independent contractors, and so on. Just as the firm depends on the labor of the employees, the employees depend on the firm for continued employment. This is especially true of long-term employees who have spent their working careers developing *firm-specific* skills that allowed them to aid the firm, but which would not help them find employment if they were to lose these jobs. A firm that respects its employees will seek to minimize turnover, provide fair compensation to those laid off, actively work to prevent discrimination and bullying, and so on.

**Suppliers** provide raw materials for the firm. They depend on the firm’s purchases, and the firm depends on them to provide quality products. A firm that respects its suppliers will, among other things, seek to build long-term relationships rather than exploit short-term market efficiencies to take advantage of suppliers (e.g., forcing them to sell goods for below cost).

**Customers** purchase the firm’s products, and the firm’s well-being ultimately depends on their doing so. Treating customers as stakeholders requires making commitments to things such as product safety and reliability, to customer service, and to honest advertising.

## Consequences for Managers

Just as in the shareholder theory, managers play a special role in the stakeholder theory of corporate governance. They have a fiduciary duty to serve as agents for ALL of the stakeholders. Freeman notes that the particular *way* that managers do this will depend quite a bit on the nature of their firm, and on the particular way they conceive of their duties to their stakeholders. In any specific case, management will need to adopt a **normative core** that specifies how the interests of stakeholders ought to be balanced. The content of this normative core will depend, among other things, on how the management (and their stakeholders) view justice. So, for example:

* A normative core based in **liberal egalitarianism** might place great emphasis on making sure that just *procedures* were always followed, and that great care was taken to make sure that the stakeholders who “lost” in any transaction were as well off as they could be, given the circumstances.
* A normative core based in **libertarianism** might emphasize the importance of respecting each stakeholders’ legal and moral rights, and in making sure they were fairly compensated for their contributions. Great care would be taken to avoid monopolistic behavior (which goes against libertarian principles about the rights of others), and to appropriately compensate stakeholders for any harm done.
* A normative core based in **communitarianism** might emphasize the interdependencies of the stakeholders, and would seek to cultivate a healthy corporate and community “culture” in which stakeholders could pursue their notions of the good life.

This brief sketch is obviously lacking in detail, but the underlying idea is that merely knowing *who* the stakeholders of your firm are doesn’t (by itself) tell you how you ought to make decisions. In order to determine *this,* you’ll also need to have a (more substantive) notion of what ethics and justice require. This is, in essence, the takeaway of stakeholder theory: in order to be successful, the management of a firm actually has to *care* about “doing the right thing” and must take practical steps to figure out what this means for their firm.

## Criticisms of Stakeholder Theory

Just as with shareholder theory, not everyone has been convinced by stakeholder theory. Most criticisms have focused on the theory’s (intentional) *vagueness,* and its failure to specify what exactly is required of managers, and what isn’t. A few worries:

**OBJECTION 1: Stakeholder Theory Makes It Impossible to Hold Management Accountable.** On stakeholder theory, management is supposed to somehow “balance” the competing interests of large number of diverse groups. They are supposed to be **multi-fiduciary agents.** The problem is that this sort of structure makes it almost impossible to define “success” or “failure,” or to say what exactly would count as managerial incompetence or corruption. For example, on the shareholder view, a manager who took out huge loans to finance raises for his/her favorite employees or to buy gifts for suppliers without any clear reason for doing so (besides “they are nice people”) would be morally (and probably legally) blameworthy. On the stakeholder view, though, its much tougher to say what’s wrong with this, since there’s no clear criteria for how to balance the manager’s obligations toward different groups.

**OBJECTION 2: Stakeholder Theory Makes Markets Less Efficient.** Firms that adopt stakeholder theory might, in comparison to those that adopt shareholder theory, be both less profitable and more “risky.” After all, shareholders and bondholders never know which “stakeholders” new management will decide to favor, or how they are going to do so. This might hurt economic growth, and everything that comes with it (such as high employments and high average returns on investments). This will actually *hurt* many of the firm’s stakeholders.

**OBJECTION 3: There is No (Good) Reason to Favor Narrow Stakeholders.** A firm’s “narrow” stakeholders are those they interact with regularly, so there might be good *emotional* reasons for caring about them. However, its difficult to see why this matters from a moral point of view. For example, suppose a firm closes a plant in Detroit, with plans of opening a new one in Vietnam. (Narrow) stakeholder theory says that the firm should care about the negative effects in Detroit, but not the (positive) effects in Vietnam. This seems arbitrary from a moral point of view, however. After all, why should American workers count for “more” than Vietnamese workers? And if we adopt wide stakeholder theory, where management has to be a fiduciary agent for *absolutely everyone,* we risk making the notion of a fiduciary agent *meaningless.* This would be akin to telling a doctor: “don’t worry too much about the health of your own patients in particular; just try to do whatever helps promote the health of the whole world.” It’s unclear why any patient would trust such a doctor.

## Review Questions

1. Stakeholder theory is motivated by the idea that, since business decisions often affect many people *besides* the owners, the managers of businesses should take account of these peoples’ interests. To what extent do you think this argument works?
2. Apply stakeholder theory to a recent, real-world business decision from the news (such as a layoff, issue regarding product safety/pricing, or whatever). Do you think that this decision respects the relevant stakeholders? Why or why not?
3. While shareholder and stakeholder theory are the two dominant modes of thinking about the responsibilities of managers, they both have well-known problems. Which view, if either, do you favor? Why? Can you think of an alternative view?

## For Further Reading

* Agle, Bradley R., Thomas Donaldson, R. Edward Freeman, Michael C. Jensen, Ronald K. Mitchell, and Donna J. Wood. 2008. “Dialogue: Toward Superior Stakeholder Theory.” *Business Ethics Quarterly* 18 (2): 153–190.
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