The 'managing for stakeholders model' and a summary of Freeman's article[1]

1. The managing for stakeholders model

Freeman writes, "the primary responsibility of the executive is to create as much value for stakeholders as possible, and that no stakeholder interest is viable in isolation" (p. 56). This, briefly put, is the *managing for stakeholders model*.

What is a stakeholder? Freeman defines *stakeholder* narrowly as "those groups without whose support, the business would cease to be viable," and he defines it more broadly as "a stakeholder is any group or individual that can affect or be affected by the realization of an organization's purpose" (col. 1, p. 63). So, in essence, these are the groups that *have a stake* in a company and how it operates. Hence, they are the company's stakeholders. This doesn't need to be the definitive list, but Freeman's "primary stakeholders" are customers, employees, shareholders (i.e., stockholders), suppliers, and local communities (pp. 61 – 63).

So, again, according to the *managing for stakeholders model*, executives—for instance, the CEO—should seek to create value for each stakeholder.

Typically, we contrast the managing for stakeholders model with the account that Friedman provides in "The social responsibility of business is to increase its profits" (which Freeman calls the "dominant model"). In his article, Friedman writes,

> In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom. (p. 1)

So, while Freeman maintains that executives should manage their companies with the interests of those five stakeholder groups in mind. Friedman argues that executives should only focus on the interests of shareholders (that is, stockholders).

The logic of Friedman's position is easy to see. The shareholders own the company, and their interest is making money (whether that is through dividends or having high profits that

[1] All Freeman quotes and references are from his "Managing for stakeholders."

translate into a high stock price). The executives work for the shareholders. Therefore, the executives should focus exclusively on making the company as profitable as is possible—while, of course, "conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom" (Friedman, p. 1).

The strength of the managing for stakeholders model is, perhaps, somewhat less obvious at first glance. We shouldn't dismiss it, however. As illustrated by the *Dodge v. Ford Motor Co.* case, a CEO might adopt the managing for stakeholders model when he or she is committed to developing a robust company that (1) produces a product that is popular and useful and (2) is successful over the long-term. (In contrast, Friedman's model seems to be oriented toward immediate, high profits for shareholders.) We might, especially, expect that CEOs who have founded the companies that they still run will adopt the stakeholder model. This is not to say that other CEOs won't manage for stakeholders, but the inclination for individuals who have founded the company that they run seems clear. After all, they, presumably, have a special interest in a company that will endure and provide consumers with a unique product.

We must also keep in mind that the managing for stakeholders model still requires that executives try to make their companies successful and, of course, profitable. And it is not a model that rejects making money for shareholders. The shareholders are, after all, one of the stakeholders. The executive must create value for them, but, on this model, he or she must balance the value that is created for shareholders with the value that is created for other stakeholders.

2. Freeman's first argument: "The dominant model simply does not describe how business operates."

Freeman's first argument for the managing for stakeholders model is in the six paragraphs in the section "The dominant model is not consistent with the law" (pp. 58 – 59). In the first five paragraphs, Freeman makes five different claims—which are all presumably true, although he makes each one briefly. These five claims, then, support the conclusion that is given at the bottom of column 1 on p. 59:

> "Laissez faire capitalism" is simply a myth. The idea that business is about "maximizing value for stockholders regardless of the consequences to others" is one

> that has outlived its usefulness. The dominant model simply does not describe how business operates.

Freeman qualifies this conclusion by making a distinction between *descriptive* and *normative claims* (or sentences or statements).

> A *normative claim* (or statement) expresses what ought to be the case.
>
> In contrast, a *descriptive claim* expresses what is the case.

The conclusion of the argument is a descriptive claim, which is justified by the information given in the five preceding paragraphs. The evidence in those first five paragraphs allows us to draw the conclusion that executives don't manage for shareholders only. Various laws require executives to take the interests of other stakeholders into account.

But, perhaps, the dominant model is a normative model. This means that it explains how executives *should* manage their companies—not how they do manage them. (In fact, although the explanation of both models usually includes cases that illustrate their successful implementation, the dominant model and the stakeholder model are normative models. They both describe how executives *should* manage their companies.)

3. Freeman's second argument

Freeman's second argument is on pp. 59 – 60 (in the section "The dominant model is not consistent with basic ethics"). This is not as formal of an argument as the first one, and so I will develop the main idea here.

To begin, the separation thesis states:

> It is useful to believe that sentences like, "*x* is a business decision" have no ethical content or any implicit ethical point of view. And, it is useful to believe that sentences like "*x* is an ethical decision, the best thing to do all things considered" have no content or implicit view about value creation and trade (business). (p. 59) [2]

According to this thesis, moral decisions and business decisions are completely separate (and unrelated). (Or decisions of one kind cannot contain any content about the other.)

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[2] Freeman calls this the "separation fallacy," but we should be neutral in how we label it, at least until we have shown that it is a fallacy.

There are some categories that are completely and always separate—which means that, at some fundamental level, they can't go together. For instance, *time* and *color* are separate in this way. If I ask, "What time is blue?" or "What color is 4:00 pm?" I will get an odd look because I am combining two categories that don't (and can't), on any level, go together. They are separate. Freeman uses a similar strategy to demonstrate that moral decisions and business decisions are ***not*** completely separate. He poses these questions:

(a) Who is harmed or benefited by this business decision?

(b) Whose rights are enabled and whose values are realized by this business decision (and whose are not)?

(c) What kind of person will we become if we make this business decision?

These questions make sense. (That is, they aren't nonsense like "What time is blue?"). This means that moral decisions and business decisions are not fundamentally separate. But even though they are not separate in this sense, it is still possible to make a business decision while ignoring its moral implications (and vice versa).

So, why should we consider the moral implications of the business decisions that we make? One answer is because the "responsibility principle" is true. This is the principle:

> Most people, most of the time, want to, actually do, and should accept responsibility for the effects of their actions on others.

A couple of things should be said about this principle. First, it is not a complete moral principle, and it can't be used to determine which actions are morally correct and which ones aren't. It is, however, related to morality and to being a moral person. It seems to be a principle that has to be in place for people to care about morality.

Second, notice that it has three parts. The first two are (1) most people want to accept responsibility for the effects of their actions on others, and (2) most people do, actually, accept this responsibility. These are descriptive (or empirical) claims. They seem to be correct, but we would have to do a study to confirm them. The third part is that (3) people should accept responsibility for the effects of their actions on others. This is a normative claim. It may be correct as well, but we can't verify it by doing a study or an experiment. We would have put together an argument that justifies it. We won't do that now, though.

We have shown that moral decisions and business decisions are not fundamentally separate, and we are assuming that the responsibility principle is correct. Hence, we need a better model for how executives should run their businesses than just 'make as much money as possible without breaking the law.' The managing for stakeholders model is one option (although perhaps not the only one).

Before leaving this section, notice that the managing for stakeholders model is not intended to be a moral theory (like utilitarianism or Kantian ethics). Rather, it's a very general model for how CEOs should manage their companies. And it's a model that acknowledges the responsibility principle and directs CEOs to care about the interests of a broad range of people—not everyone, but these groups at least: customers, employees, shareholders, suppliers, and local communities.

4. Freeman's final set of arguments

Freeman concludes his article with a series of short arguments for the stakeholder model based on different moral theories. An interesting point to note here is that every economic system (e.g., capitalism, socialism, feudalism, mercantilism) needs a justification. They aren't—and shouldn't be—in place for no reason. Similarly, if we believe one of these systems is justified—say, capitalism—then we still need to justify its specific features. That's what the managing for stakeholder model offers: a justification for how executives should manage their companies (assuming that capitalism itself is adequately justified). The justifications that are offered, either for an economic system or for a feature of an economic system, might not be *moral* justifications, but a moral justification would seem to be the most compelling.[3] I will only cover one argument here: a defense of the stakeholder model based on utilitarianism. (Freeman doesn't offer an argument based on Kantian ethics, but such an argument could be made and would probably be important as well.)

4.1 The utilitarianism argument

According to utilitarianism, the morally correct action is the one that produces the greatest amount of happiness (or benefit or utility) for all involved.

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[3] Of course, there are many practical justifications that can be given for these systems, but, at the most basic level, it would probably seem odd to have only a practical justification for an economic system (e.g., it's quicker or easier to do things a certain way) and not a moral one (e.g., it makes everyone's life better, or it's fairer).

Simple economic models tell us that everyone benefits when each producer or seller of a good acts in his or her self-interest. Adam Smith famously made the point in his *The Wealth of Nations*,

> Man has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence [i.e., kindness] only. He will be more likely to prevail if he can [point their self-interest] in his favour, and [show] them that it is for their own advantage to do for him what he requires of them. Whoever offers to another a bargain of any kind, proposes to do this. 'Give me that which I want, and you shall have this which you want' is the meaning of every such offer; . . . It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their [self-interest], and never talk to them of our own necessities but of [the] advantages [to them]. (1776/1979, pp. 26 - 27)

The baker, for instance, doesn't provide us with bread because he wants us to be nourished or well-fed. Rather, the baker wants to make money. Feeding us—and doing so more cheaply than the other bakers so as to attract our business—makes the baker money. That we are happily well-fed is, actually, none of his concern. (Or, at least, it doesn't need to be.)

Utilitarianism provides a suitable justification for this process that Smith had it mind: every producer and seller is only trying to make money, while every consumer is buying at the lowest price. As long as there isn't cheating, deception, or discrimination, everyone, apparently, benefits more with this system than they would with any system that tried to distribute goods some other way.

This outcome—where happiness is maximized for everyone—occurs in the type of market that Smith describes: many individual sellers producing and selling products while competing with each other to have the lowest prices and the best quality. This scenario is relatively rare, however. The alternatives are varied and complex, but consider a simple one: a monopoly. If one seller has a monopoly, then he or she won't offer the best quality product at the lowest possible price. Doing so isn't in the monopolist's self-interest. In this case, although consumers will have to buy from the monopolist if they need or want the product, it is unlikely that happiness (or benefit) will be maximized for everyone involved.

Another important difference between Smith's example and what we typically encounter today is that Smith's butchers, brewers, and bakers were small enterprises. They probably had few if any employees who weren't family members, they didn't have shareholders, they lived in the communities in which they operated, and they couldn't (even if they wanted to) do much damage to the environment. Most companies today are much different.

We won't go through a full analysis here, but, today (and having in mind companies with shareholders), it's at least plausible that a greater amount of happiness (or benefit) is created for everyone involved when executives manage for all stakeholders (or at least all primary stakeholders) rather than only trying to make as much money as possible for shareholders.

We must keep in mind that the shareholder model does not instruct executives to create value solely for consumers or solely for employees or just for local communities. Doing so would not serve the interests of the other stakeholders, and it could put the company out of business. Rather executives must balance the interests of shareholders, employees, customers, suppliers, and local communities and create value for all of them. In 1944, as World War II was drawing to a close, the corporate executive William Benton summarized the idea this way in an article in Fortune magazine,

> "Today victory is our purpose," Benton wrote. "Tomorrow our goal will be jobs, peacetime production, high living standards and opportunity." That goal, he wrote, depended on American businesses accepting "necessary and appropriate government regulation," as well as labor unions. It depended on companies not earning their profits "at the expense of the welfare of the community." It depended on rising wages. (from Leonhardt, 2018)

Every company is different, and an accurate analysis depends on the number of people affected, as well has how they are affected. The table below, however, sketches out what the primary stakeholders might derive from the managing for stakeholders model and from Friedman's model (where executives are only focused on making as much money as possible for shareholders).

It might be argued that, when employing the dominant model, more money will made for shareholders if customers and employees are treated well. This is plausible, but there is one feature of the dominant model that makes it somewhat unlikely. Generally, employees, customers, suppliers, and local communities seek long-term, stable benefits from their engagement with a business. Shareholders might expect the same when executives manage for stakeholders, but many (or most) shareholders prefer immediate, high returns. Hence, it is consistent with the dominant model that executives do whatever will, in the short-term, increase profits. And the simplest route to that outcome is keeping costs as low as possible while making revenues as high as is possible. This suggests that customers and employees are likely to derive more benefit when executives manage for stakeholders (rather than just for shareholders). Shareholders, meanwhile, may derive more benefit under the dominant model, although they can still benefit under the stakeholder model.

stakeholders	**stakeholder model**	**dominant model (i.e., Friedman's model)**
shareholders	good returns on their investments	very good returns on their investments, especially in the short-term
employees	good pay, benefits, and treatment	whatever maximizes revenue (probably less benefit here than with the stakeholder model)
customers	good prices, good customer service, quality products, etc.	whatever maximizes revenue (probably less benefit here than with the stakeholder model)
suppliers	–	–
local communities	some benefits	whatever maximizes revenue; probably incur some costs

Gauging the costs and benefits to suppliers and local communities is trickier. Two points are worth exploring, though. First, assuming that a supplier is independent of the company to which it provides products (that is, it isn't supplying to one company only, and it has options to sell elsewhere), the company has an incentive to treat each of its suppliers relatively well: it needs to have an ongoing relationship with the supplier. (That is, it gets the products that it needs from a supplier, and it will need to get them again in the future. For all the company knows, this process will be repeated indefinitely.) Hence, it will most likely pay promptly and be fair in its dealings (although of course, there can be exceptions). This suggests that, whether an executive is managing for all stakeholders (including suppliers) or is managing for the explicit benefit of shareholders only, suppliers will gain about the same benefit.

An *externality* is the effect of creating, selling or buying a product on a third party who was not involved in the buying or the selling. For instance, if a widget manufacturer decides that the cheapest way to manufacture widgets includes polluting a local river, then, although that manufacturer and the widget buyers gain a benefit from the polluting, other people (who have nothing to do with the widgets) are negatively affected. They now have a polluted river. This is an *externality* (or more precisely a *negative externality*).

Negative externalities can be a significant problem for society, and a company that is only trying to maximize the benefit for shareholders has an incentive to create negative externalities. To the extent, then, that managing for stakeholders requires executives to try to minimize negative externalities, local communities are likely to fair better under the managing for stakeholders model.

References

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