



Episode 1,098: Capitalism, Stakeholders, and “Corporate Social Responsibility”

Guest: Peter Klein

WOODS: I did a whole episode on the corporate social responsibility movement, but I was looking at it, it's nearly three years ago. It was with Jim Otteson, who's been interested in this sort of subject. But three years. And plus, your paper goes well beyond that, so let's get down into it. What is meant by stakeholder, and how does the idea of a stakeholder differ from the idea of a shareholder? I think that's the most fundamental question.

KLEIN: Yeah, we see the term stakeholders used more and more these days, so this is a great opportunity to sort of clear the waters a little bit. We all understand mom-and-pop stores, we understand medium-sized companies, and to some extent, large companies. So a mom-and-pop might be owned by one person or maybe two persons. Call them Mom and Pop. A dentist's office might be owned or an accounting firm might be owned by three or four partners. And of course large corporations are owned by many, many people. Typically those who are the equity holders, the people who own the firm's assets, and we call those shareholders.

So shareholders play a kind of an interesting role in the history of business and business criticism. As you know, back in the 1930s, people like Berle and Means were complaining that large corporations were doing great harm in society because the shareholders, the ones who own the firm and in whose interest the firm should be run, were actually not being treated properly, because in these big corporations you have very powerful senior managers, executives, who are not owners but are hired hands of the owners. And the claim was there are so many owners of a big company like General Motors or Ford, that no owner is in a position to exercise any influence on the company. So it's really managers who are running the show, and the shareholders are just kind of along for the ride. And according to Berle and Means, this was a really inefficient way of organizing an economy, and they wanted big corporations broken up or managed or regulated somehow so the managers would not be sort of running the firm for their own interest or to benefit themselves rather than shareholders.

In the 1950s, we had people like John Kenneth Galbraith saying that large corporations were too powerful. Now we have this whole stakeholder movement, which says, look, a big company like Walmart, let's say, when a Walmart moves into town, it has a big effect on wages in that town, typically driving them up. It can put pressure on mom-and-pop stores to close. It affects the well-being of people who shop at Walmart. All of those people are just as important as the people who own stock certificates, the people who happen to be owners of Walmart, and sort of ironically the reverse of Berle and Means, although it comes from the same sort of progressive instincts. People say what's so special about shareholders? Why should the firm be operated in the interest of shareholders to maximize the profits that go to

shareholders through dividends and capital gains? Why not manage the firm in the interests of – get ready for this – all of society?

So a stakeholder is any person who has an interest in or whose well-being is affected by organization X. And it's kind of funny because we're all stakeholders of hundreds or thousands of organizations and entities, but the stakeholder movement says our voice matters just as much as that of the owners.

WOODS: So that's what's meant by stakeholder?

KLEIN: Yeah, in fact, sometimes in the public policy and political science literature, you hear people say, well, we're all stakeholders of planet Earth, Tom.

WOODS: Oh, for heaven's sake, how is this supposed to work? How do we narrow down – because we could all be stakeholders of everything. How does that help anything? I mean, let's try and take this as seriously as we can. How would you identify and pinpoint who the stakeholders are?

KLEIN: Yeah, it's a great question and you've cut right to the heart of the sort of stakeholder controversy –

WOODS: And it took me two seconds and I know nothing about this.

KLEIN: [laughing] Well, that's because you're you, of course.

WOODS: [laughing] Or it could be that this is stupid. Let's give credit where it's due.

KLEIN: Well, no comment. People who would identify as stakeholder proponents or stakeholder theorists or whatever, if you really push them, they recognize that the major flaw in this argument is the definition of the relevant stakeholders. So as you say, it's kind of like with the economic concept of externalities. If I see an attractive person walking down the street, that gives me some benefit. Does that mean that I should have to compensate that person somehow? But if you really push externalities theory, externalities are everywhere. Externalities are all around us. There's really no way to separate external costs and benefits that ought to be taken into account from those that ought not to be taken into account.

And with stakeholder issues, you have the same problem. I think most people in this field who are proponents of stakeholder ideas would say, okay, yeah, to say that all of society is a stakeholder in Apple really doesn't – there's not much that you can do with that. But to say that only Apple shareholders should matter, well, that's not right either. They say there's some kind of a middle ground. So typically they would identify certain groups, such as employees of Apple, customers of Apple, key suppliers of Apple, and maybe people who live within a certain distance of Apple factories, Apple facilities. That's sort of what most people would use as their operating definition of the relevant stakeholders, but of course, you know, that's pretty arbitrary because you could draw that circle narrower, you could draw it wider, and it's hard to come up with a sort of a clean rationale for doing that.

WOODS: Yeah.

KLEIN: But I think in practical terms, what goes under the guise of stakeholder theory is really the sort of more or less conventional attempts to give workers more bargaining power, force companies to put worker representatives on the board, force companies, if they want to close a manufacturing plant in company X, they've got to compensate people in the community who might lose their jobs, and so forth. So it's really just an umbrella term for saying certain people ought to have a voice who in a shareholder model would not have a voice.

WOODS: Now, does this mean that they're proposing that there shouldn't be shareholders or that stakeholders should also have a say?

KLEIN: No, that latter. These are not kind of radical socialist or collectivist proposals to get rid of the company or even to get rid of shareholders. They're really proposals to kind of make shareholders less powerful. So again, for example, in many countries, like in Germany, the corporate legal system requires that the board of directors of public companies includes certain groups. You have labor representation, you have representatives of suppliers, and so forth. There are some people who would say that community people have to be on the board. So the sort of policy implication would be certain rules affecting corporations, corporate law that say that companies, they can't just maximize shareholder welfare; they should be legally required to let certain other people participate in corporate decisions.

WOODS: All right, so this isn't a matter of we're going to recommend this as a potentially desirable way for corporations to organize and to govern themselves; we want this to be imposed on them.

KLEIN: Yeah, well, I guess to be fair, I would divide people in the stakeholder community into different groups, maybe three groups. So there is a group who says exactly what you say. Corporations should be legally required to take the interest of these other stakeholders into account.

There's another group that has sort of a more mild view. That groups would say, well, gosh, it would be nice if we ought to urge people to... etc. So you might have seen – I mentioned this in my little Mises blog entry – that the guy who's one of the biggest private equity investors, CEO of BlackRock, made a statement about a month ago saying that the companies that we invest in, we really want to see them taking into account the interests of other stakeholders and being more socially responsible and so forth. That was not, as far as I read his statement, a call for any particular form of government intervention, but simply his statement that, hey, I as an investor, I'm only going to invest in companies that take the interests of other stakeholders into account.

And there's even a third group that I would describe as maybe positive stakeholder researchers rather than normative ones, who don't make any particular recommendation, but who claim that, well, if you look at companies in the real world, those that pay their workers better, that listen to their workers, that give suppliers a voice, and so forth are actually more profitable than firms that aren't. So I think these two latter groups, we certainly wouldn't have any problem with them participating in these conversations and making whatever recommendations or observations that they want. But from a policy point of view, yeah, of course I would be concerned about those who want to legally mandate certain kinds of board structures or whatever.

WOODS: Isn't this another case where a proposal that sounds benign to the average person winds up putting libertarians – and I know you're not arguing this as a libertarian, per se, but as an economist. But you are a libertarian in your personal life, so isn't this another case of something that sounds really good, like maternity leave, paid maternity leave, things like that, where the economist has to make kind of a belabored response to show what the negative consequences are, and he's fighting against the instincts of everybody who listened to it and said, "What's the harm in that?" And I think they would. They'd hear "stakeholder" and they'd say, "What's the harm in that? What's the problem?"

KLEIN: So it's a good point. It might be useful to sort of reason by analogy. Think about like safety rules. So any time there's some kind of airplane crash or some kind of tragedy involving commercial aviation, of course we see calls to give the FAA more power, to give regulators more power, and so forth. But if you just think it through a little bit, it's pretty obvious that airline companies have very strong incentives not to kill their own customers. An airline that operates safely is going to be much more profitable in the long run than an airline that cuts corners and doesn't do proper inspections and so forth, so there's no conflict of interest between the well-being of the company and its shareholders and the well-being of its customers. You want to make the customers happy so that they'll continue to patronize your products and services.

It's a little bit like that with some of these stakeholder issues. So yeah, I mean, it's not the case that – let me put it this way: a typical large company, if they want to attract and retain good workers, they're not going to compensate their workers in sort of the bare-minimum fashion, paying less than what rival firms are paying, offering fewer benefits, less comfortable working conditions, fewer holidays, and so forth. No, of course it is typically in the interests of companies to make their company an attractive place to work, just as airlines want to make traveling on the plane something that customers appreciate and would be willing to pay for again.

So from the perfectly reasonable notion that companies do in fact take into account a variety of interests not in opposition to the bottom line, but because taking these interests into account contributes to the bottom line – from that, we get people saying, well, gosh, if it weren't for the kind of laws that I'm describing, these companies, they would exploit their workers until their workers dropped dead on the shop room floor, so we've got to have laws that – you know, in the old-fashioned way, we have all the New Deal era kind of labor legislation, Progressive Era labor laws. So this is kind of an extension of that, people thinking if we don't require companies to let the union boss sit on the board of directors, they're just going to abuse and exploit their workers, as with those arguments of old.

WOODS: Let me read just a sentence or two from your paper. You write this:

"When people argue about whether shareholders should be privileged over other stakeholders, or whether this or that group should get more decision or income rights, they are essentially dealing with broad questions about ownership." And then the first of these is, "Who owns the firm, and what implications does this have for how firms are run, or should be run?"

Now, of course implicitly, that is the question that's being dealt with, but I think these folks have an answer to that question, which is that it's too narrow to focus exclusively on who owns the firm. This is backward, laissez-faire thinking, and that's gotten us to a point where these companies care only about the bottom line and they don't take into account the

interests of all these other people who are affected. So in a way, focusing on who owns the firm is precisely what has taken our eye off the ball of what should really matter. Isn't that what a stakeholder advocate would say?

KLEIN: Probably so, and we're arguing explicitly against this view in the paper. The main point of the paper is pretty simple, and it builds on insights that are on Mises and Rothbard but without all the implications drawn out. And the argument is essentially this: that ownership is not just kind of an arbitrary legal or political condition, but ownership is itself a kind of an economic input or an economic function. And that function is not, as in the popular imagination, just to sit back and appropriate all the profits and all the benefits that accrue to owning some valuable resources, but rather, ownership is kind of a responsibility. What it means to own a productive asset or resource is to have kind of the ultimate responsibility for deciding how that resource or asset is going to be used under different conditions.

If you rent a house or an apartment, you have certain specified rights and responsibilities. You can enter the apartment when you want and maybe there are some restrictions on when the owner can come into the apartment or under what circumstances you can move the furniture around the way you want. Maybe you're allowed to put nails in the wall, maybe not. That depends on the contract. Maybe you're allowed to paint the walls, but most often not if it's a rental property. But there are clearly things that a renter is not allowed to do, like sell the property, radically reconfigure the house. You can't rent a home and then add on a spare bedroom without the permission of the owner. So the economic function of ownership is to make these kind of ultimate decisions about how the resource should be used under different kinds of conditions.

And we argue that people in the stakeholder debates completely ignore this problem because they think ownership is just kind of, well, to be the owner is to be the rich person who gets the proceeds, not recognizing that ownership is a responsibility, a burden, if you like, and it is associated with this particular kind of decision-making. So we say the right question is, for improved economic performance, for the efficient allocation of resources in a society or a community, what kind of ownership arrangement makes sense? And we argue that certain individuals and groups are better or less well-suited for performing this ownership function, and the task of corporate law and the way that boards are organized and so forth should be done in a way that puts this ownership function in the hands of individuals and groups best suited to exercise it. And we'd argue that people who live in the local community, people who are employees, critical suppliers of an organization are not well-suited to perform this ownership function.

WOODS: And why is that? What is it that makes somebody else better able to do it than these folks?

KLEIN: Yes, it's a great question, and we're building here on some arguments that are in the law and economics and the corporate law literature. We draw in particular on a very good scholar at Yale University named Henry Hansmann. And Hansmann's argument is essentially that ownership is best assigned to groups that are small and have a relatively homogeneous interest. So it's very difficult for groups to make decisions, as we all know. The great thing about corporate shareholders compared to workers or suppliers is the very fact that they're not personally vested in the company. They don't work there, they may not live in the same town. Their interest is very narrow and well-specified, namely increasing the profitability of the organization.

If you have, for example – take key suppliers, people who supply materials or wholesale goods to Walmart, let's say. Well, a Walmart supplier has multiple interests. This supplier wants Walmart to be successful and prosperous because that means there's a market for the supplier's wholesale products. But of course the wholesaler also wants to get the highest possible price when he sells his stuff to Walmart. So if he were on the Walmart board, he would be wearing two hats at the same time. In his Walmart board member hat, he would be wanting Walmart to pay the lowest possible prices for the goods and services that it acquires and resells, because that means for profit for Walmart. In his capacity as a Walmart supplier, he wants Walmart to pay the highest possible prices for those goods, because that earns him more profit as a supplier. So he really doesn't know what to do. His interests in Walmart are very complex. It's hard for him to separate them. It's hard for him to make decisions that are in the best interest of Walmart because of these complicated objectives. Whereas a Walmart shareholder has only one objective: for Walmart to be efficient and profitable.

WOODS: Let's say a little something about the corporate social responsibility movement, because before I really knew anything about it, I just assumed it meant that corporations should take some of their profits and donate them, or to be more aware of the effects of the things they might do, like maybe polluting a lake or whatever. Or maybe hire a more diverse staff, things like that. But how closely wrapped up is the corporate social responsibility movement after all with this stakeholder movement? Are they one and the same thing?

KLEIN: Yeah, I would say they're slightly distinct movements but clearly closely connected. They come out of the same overall spirit, the view that, left to their own devices, corporations would run roughshod over the interests of many sort of persons in society. So corporate social responsibility is the idea that companies should not simply try to maximize their profits, but they should try to maximize or increase the benefit of society. Again, you can sort of throw up your arms. Now we're back to where we started the interview. What in the heck does that mean, and how in the heck would that work?

The practical forms that it takes are some of the things you mentioned, so large companies setting up a charitable foundation, a 501(c)(3) or whatever that donates to charitable causes; corporations deciding what to build, how to operate in a way that protects the environment; paying higher wages than necessary because it helps lift some employees out of poverty, and so forth – basically the idea that companies should take society's interests into account rather than just their own. I mean, you and I would both say how do we know what is socially responsible? Who counts as being part of the relevant society or not?

Again, I think what CSR really is is an excuse for people with a political ideology, typically people more on the left end of the spectrum, who want to impose their own personal preferences on big companies. Don't pollute in this way, don't use resources in this way, pay your workers these wages, don't close your factories here or there. I mean, it's really kind of a squishy idea from an analytical point of view.

WOODS: I noticed in your paper a reference to Friedman, and I realized that was Milton Friedman, who apparently had something to say on this subject. What was that, and how helpful was it?

KLEIN: Yeah, well, I'm not a huge fan of Friedman on all topics, but on corporate social responsibility, I think he really hit it out of the park with his famous 1970 *New York Times*

piece, "The Social Responsibility of Business Is to Increase Its Profits." That's sort of a deliberately provocative title which drove a lot of people completely batty, and even today within the stakeholder and the CSR communities, Friedman's name is sort of mentioned – you know, people might mention it under their breath as being kind of the great Satan in this area.

The article makes a very simple point, one that nonetheless has been greatly misunderstood. So what most people in the CSR community think is that, well, Friedman was arguing that capitalism shouldn't care about the well-being of poor people and so forth. You can imagine the standard interpretation. If you read the article, Friedman actually makes a completely different point. Friedman doesn't take any position on whether how and whether individuals in society should act in a socially responsible manner. What he does say is that it's not the business of company managers to make those decisions on behalf of the firm's shareholder.

In other words, Friedman's argument was not one against social responsibility, per se. His argument was the purpose of the corporate manager is to run the firm as efficiently as possible, generate as much profit as possible, because where does that profit go? Well, it goes to the shareholders in the forms of dividends and capital gains. Then he argued the shareholders can make their own decisions as individual investors, as citizens. They can donate to the Red Cross; they can give their money to the Mises Institute; they can write a big check to Tom Woods. They can pick whatever charities, philanthropic activities, community events, their church, and so forth. They can be socially responsible with their own money, as they see fit. When companies take actions to try to achieve social responsibility at the expense of profit, essentially the managers are taking money out of the shareholders' pockets and putting it in their own pockets and then spending it on the things that they the managers think are socially responsible. And Friedman thought that was not consistent with the role of the manager and in fact would lead to lower levels of social responsibility on the whole.

And I think this is the kind of argument that libertarians can certainly get behind, that none of us is opposed to any kind of philanthropic activity, per se, but we don't like the government doing it or us without any choice by taking our money through taxation and so forth. I am more likely to invest in a company that makes as much money as possible, returns that money to me, and lets me decide how I want to be socially responsible than a company that is less profitable than it could be and some executives are making decisions about their own pet projects, which, as you can imagine would be unlikely to be the same ones that I would have chosen.

WOODS: Right, right. So you just get the sense that the reason they want to impose these ideas on corporations is that corporations have a lot of money, and that's where the money is so that's where they're going. It reminds me of Walter Block's point about the living wage, and he would say, okay, the living wage idea is that we're going to force employers to pay people more so that people will be wealthier, and this way we'll help the poor. But the question of why in particular the burden of helping the poor should fall on the employer when the employer is the only person on earth who is actually improving the welfare of the person is not clear. And so Walter's argument is, if you want to help the poor, why don't you just go ahead and do it? Why go through this convoluted series of steps where we have to advocate for the employer to pay them more, and then that money will get to them? Why don't you just give them some money? Why don't you go do something about it?

KLEIN: You're right. It's exactly the same argument, and most people who are proponents of this or that CSR legislation or whatever, what they really mean is I personally want to force other people to pay for my pet projects, and I don't believe that the shareholders of company X are as wise and farsighted and generous as I am, and if left to their own devices, they would not spend their money on the "right" — I'm doing air quotes here — the "right" socially responsible activities, so I've got to force them to do it. I'm going to pick the socially responsible activities, and I'm going to insist by legislation or by practice that the companies invest in the things that I think are important. So yeah, it's another version of that same kind of argument. *I want to be virtuous spending someone else's money.*

WOODS: Right, right. All right, I'm going to link to your paper at TomWoods.com/1098, and people can actually read it for themselves. It's an academic paper they can download instantly, and it's written — it's not written like, let's say, a Tom Woods email. It's written in a more restrained and scholarly way, but with all the power and passion that you associate with a Tom Woods email at the heart of it. But you're on your best behavior.

KLEIN: Yeah, that is the most flattering description I've ever heard of anything that I've written.

WOODS: [laughing]

KLEIN: But I would suggest to your readers, this paper was solicited as a chapter that's coming out in an academic book on stakeholder theory — and by the way, a real outlier. I think my coauthor, Nicolai Foss, and I are the only authors in the book who do not identify as strong proponents of stakeholder ideals.

WOODS: Wow, good for you guys. I'm glad you guys exist then.

KLEIN: [laughing] Yeah. But my point to your listeners is it is an academic paper, but I think that it's pretty readable and that the arguments should be accessible to anybody who's interested in this topic. It doesn't use a lot of specialized jargon or language or diagrams or whatever that you need to be a specialist to understand, so I would be very happy to receive any comments and feedback from your listeners.

WOODS: Great, okay, so linking to it on the show notes page. And I saw this announcement about the paper, and I'm always looking for episode topics, so I thought, Peter, if you announce a paper, you know the email from Woods is coming, so I was really glad.

KLEIN: That's the only reason I write papers.

WOODS: [laughing] Well, listen, it was great to talk to you, and thanks again.

KLEIN: Likewise. Okay, see you, Tom.