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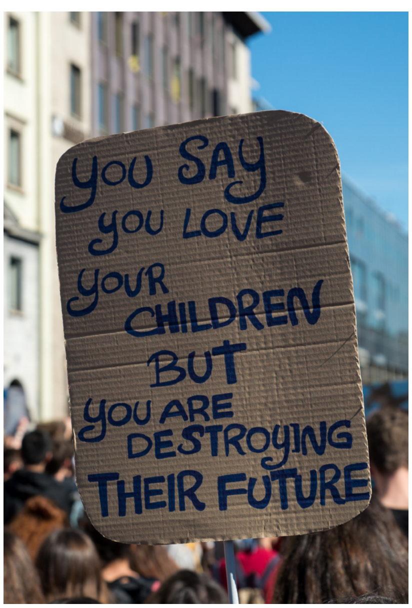
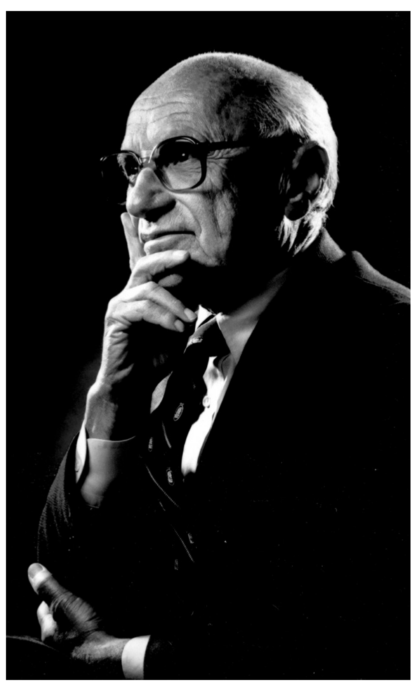
THOUGHT SERIES

Responsibility in Business Does Matter

Milton Friedman said "No". 181 of America's largest company CEOs just said "Yes".

Blaine Townsend, CIMA®, CIMC® | October 2019





In the spring of 1972, the heads of Alcoa, General Motors, and U.S. Steel formed Business Roundtable (BR) – a not-for-profit trade organization for big business in America. For the next half century, BR advocated for lower taxes, weaker labor unions, and free-trade agreements. It opened its arms and warmly embraced economist Milton Friedman's ethos that maximizing shareholder value was the prima facie of a capitalist democracy.[1] Then, something funny happened on the way to the second decade of this century. BR issued a statement, signed by all the 181 CEO members, which said looking at broader stakeholder issues was actually the prudent thing to do.

The statement might be anathema to Milton Friedman. "There is one and only one social responsibility of business," wrote Friedman in a *New York Times* essay in September of 1970, "to use its resources to engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud." The essay was titled, "The Social Responsibility of Business is to Increase Profits."[2] Over the succeeding decades, maximizing shareholder value became the guiding principle of business and a cornerstone to the laissez-faire "free" market economics embraced by U.S. Presidents from Ronald Reagan up until Donald Trump.

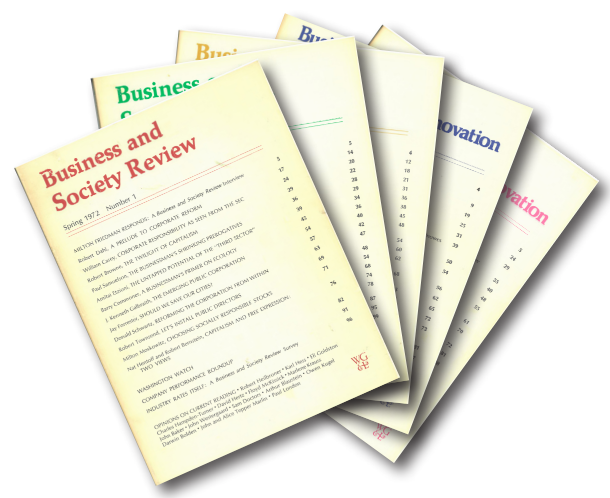
The statement by the CEOs of America's largest corporations was certainly provocative. After all, Friedman is on the Mount Rushmore of influential economists. His work on monetary policy earned him the 1976 Nobel Prize for economics. Many credit his monetary theory for helping America through the subprime crisis of 2007–2008.[3] So why abandon his mantra now? Because Friedman was wrong. Possibly then, but certainly now.

In 1970, when Friedman made his assertion, the total market cap of the U.S. stock market represented just one third of GDP — a fairly constant ratio since 1870.[4] In fact, the majority of investors had to hold physical stock certificates. What did Friedman think of trade problems with China? In 1970, America hadn't even spoken to China in twenty years and Nixon was still two years from his historic trip to the China mainland. The percent of manufactured imports from developing nations relative to GDP was at the same level as 1913.[5] In other words, the world was a much smaller place and the capital markets still a sleeping giant.

Today, the U.S. stock market alone is worth $30 trillion dollars, and an astronomical amount of capital flies around the world at the speed of light.[6] The stock market now represents 140% of U.S. GDP, and the global supply chain stretches as far the satellite eyes can see.[7] Friedman just could not have foreseen this kind of global market. His successors eventually labeled it "hyper-globalization."[8]

From today's perspective, Friedman's vision of the "free market" in 1970 seems more like an Ivory Tower utopian vision. It was a place where markets would be free of government intervention

FROM THE FIRST ISSUE OF BUSINESS AND SOCIETY REVIEW, SPRING 1972



"We do not believe that an imposed system of corporate responsibility is either socialistic or a threat to capitalism."

— Theodore Cross, publisher of *BSR*

"The only entities that can have responsibilities are individuals; a business cannot have responsibilities."

— Milton Friedman

and so efficient they could "correct" middling social and environmental problems. For example, in an expansive 1972 interview in *Business and Society Review* (BSR) titled "Milton Friedman Responds", Friedman used breathing as an illustration of how to handle pollution.[9]

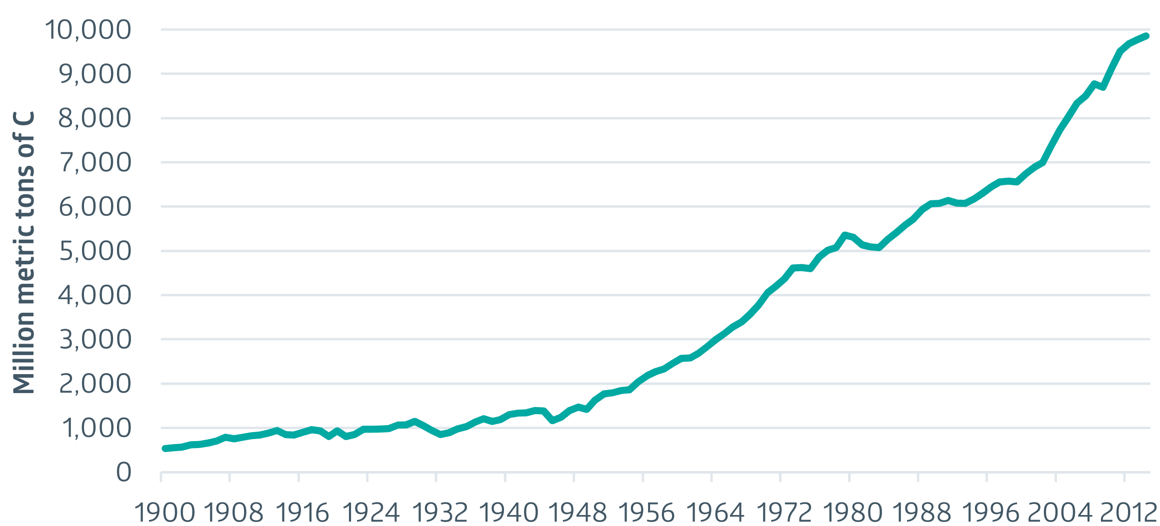
According to Freidman, exhaled breaths release carbon dioxide "but most of us would consider the cost of eliminating that pollution greater than the return." Friedman reasoned that environmental concerns like pollution could be handled by simply deciding "upon the 'right' amount of pollution, that amount which the cost of reducing the pollution to all the people concerned would be greater than the gain from reducing the level." To put it more plainly, Friedman said, "if it's cheaper for the corporation to put the effluent in the water and pay the tax than it is not to pollute or to clean up the river, that is what should be done." In essence, the markets would take care of the problem.

The Age of Hyper-globalization

That thinking proved downright reckless by the time hyper-globalization arrived. According to the Environmental Protection Agency, from 1970 to 2011 global carbon emissions increased by about 90%. They have continued to rise rapidly in the years since.[10] Further, emissions from industrial processes have accounted for 78% of the total greenhouse gas emissions increase from 1970 to 2011. Climate change now poses a grave threat to all species of life on the planet, including shareholders.

According to the Environmental Protection Agency, from 1970 to 2011 global carbon emissions increased by about 90%. They have continued to rise rapidly in the years since.

TOTAL CARBON EMISSIONS FROM FOSSIL FUEL CONSUMPTION & CEMENT PRODUCTION (1900—2014)



Source: Boden, T.A., G. Marland, and R.J. Andres. 2017. Global, Regional, and National Fossil-Fuel CO2 Emissions. Carbon Dioxide Information Analysis Center, Oak Ridge National Laboratory, U.S. Department of Energy, Oak Ridge, Tenn., U.S.A. doi 10.3334/CDIAC/00001_V2017

By maximizing shareholder value over all else, the global "free market" system has put massive stress on human and natural resources. The economic cost of climate change was clearly not factored into the economic models at the University of Chicago in 1970. How could it have been? The first Congressional hearing on climate change was not until 1988, and it was more than a decade before the issue became part of the mainstream conversation and a focus of economists.

In the BSR interview, Friedman also made the case that labor mobility would provide a self-correcting mechanism to handle areas made undesirable by pollution or bad working conditions. He used Gary, Indiana, a company town for U.S. Steel, as an example. "If Gary is an unpleasant environment, nobody will run a grocery store there unless he can earn sufficiently more there than he can elsewhere to compensate for enduring the pollution (from U.S. Steel)." He dismissed the notion that labor mobility is a challenge for poor people (who are more severely affected by environmental issues). "There is enormous mobility of labor at the very lowest levels – not only in this country, but all over."

Friedman's observation about labor mobility seems more consistent with the post-war era of upward mobility in the United States than anything that has come since. In reality, labor mobility has proven to be a vexing issue in the era of hyper-globalization, and the bottom of the social pyramid has suffered as a result. In the exploding global economy, the global poor are too often forced to move out of desperation rather than for a "first world" job change. Within global supply chains, migrant workers often face exploitation working in poor conditions without legal protections, or even worse, fall victim to human trafficking.[11] There are now an estimated 43 million people worldwide enslaved through forced labor, forced marriage, child labor, human trafficking, and debt bondage.[12]

Negative Externalities: Where is that "Invisible Hand"?

Again, the global markets were different in 1970. Maximizing shareholder value in the era of hyper-globalization has often meant a race to the bottom on environmental, ethical and social standards. But Friedman wasn't wrong about the bottom-line. By maximizing shareholder value, the "free market" grew at a staggering pace, and there certainly was an increase in shareholder value - at least in an accounting sense. However, the negative externalities (or cost to society) of this race to the bottom were conveniently left out of the equation: most notably, the massive, irreversible loss to natural systems.

The externalities, however, are not limited to environmental issues or public health issues (think tobacco and opioids, to name two). There is the long-term social burden of an ever widening gap between the rich and poor. Like carbon emissions, the Gini coefficient, which measures the wealth gap, has risen rapidly since 1970.[13] There is also the "loss" of personal privacy, as Big Tech companies Friedman could not have envisioned legally harvest and monetize vast amounts of personal data. This would seem inconsistent with his belief that the free market would provide protection for individuals as long as companies obeyed the law.

We have learned in the past half century that what is legal and what is right are often two different things. The social contract breaks down when laws are influenced heavily by the industries they are supposed to police. This presents a Catch 22 in Friedman's view of the world. Lobbying efforts imply companies actually play a heavy role in government intervention which he detested, but lobbying is also clearly done to maximize profits. In 2018, special interests spent $3.8 billion to influence law makers.[14] With respect to Big Tech and personal privacy, it is clear that heavier

Load sixteen tons, and what do I get?
Another day older and deeper in debt.
Saint Peter don't call me cause I can't go.
I owe my soul to the company store.

— "Sixteen Tons", Merle Travis

regulation is likely. The markets provided zero protection for individuals who have lost (perhaps forever) control over their personal information.

This corporate influence over regulation created a system where maximizing shareholder value happened in a veritable vacuum without real checks and balances. Since nature abhors a vacuum, many of the world's natural resources and ecosystems are severely stressed as a result. This outcome comes with an incalculable monetary cost that ultimately will be paid by everyone. By some estimates, climate change alone already costs the U.S. economy $250 billion per year.[15] That number would have represented roughly one quarter of U.S. GDP in 1970.

Intended or not, Friedman's statement on social responsibility became a war cry for both sides of the argument. So much so, that this mantra motivated traditional socially responsible investors for decades, and perhaps helped lead to the rise in environmental, social and governance investing (ESG). ESG broadened the lens in which institutional investors analyzed companies and did, in fact, look beyond traditional financial metrics. Where the Wall Street lens focused on Friedman's view of the world – accounting profit – the ESG lens focused on broader stakeholders, which may be material to financial outcomes. Where the Friedman view of the world focused on maximizing profit for the shareholder, ESG focuses on the idea of a "Triple Bottom Line" and creating a more sustainable economic system. On a resource-constrained planet approaching eight billion in population, this certainly seems an intuitive if not prudent approach for a long-term investor or a corporate CEO.

Would Friedman have changed his tune about maximizing profits in the era of hyper-globalization? Or would his take on ESG have been the same as it was on social responsibility in business? "Utter hogwash" is what he called social responsibility in the 1972 interview with BSR. Perhaps he too would have come around after seeing the havoc the ethos of maximizing profit for the shareholder has wreaked on the planet — not just at an environmental or human level but also with respect to real long-term economic loss and increased investment risk. Regardless, when the CEO members of BR declared an equal commitment to stakeholders, not just shareholders, it vanquished the idea that maximizing profit should be the sole focus of business. And that is not hogwash at all.

Sometimes the hardest thing and the right thing are the same.

— "All At Once", The Fray

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Blaine serves as a Senior Vice President and the Director of Bailard Wealth Management's Sustainable, Responsible and Impact Investing (SRII) group. Blaine is on both Bailard's fundamental and SRII investment committees, conducts social research, oversees corporate engagement efforts and maintains client relationships.

Blaine began researching and writing about corporate social responsibility in the late 1980s. He started his career in Socially Responsible Investing in 1991 at the Muir Investment Trust, the nation's first environmentally screened bond fund. In 1996, he opened the California office for Trillium Asset Management, which he led for thirteen years. While at Trillium, Blaine managed socially responsible and sustainably focused portfolios, served on the firm's investment committee and worked on corporate engagement efforts on a host of social and environmental issues from deforestation to media reform. Blaine also led the effort to create the "Joan Bavaria Awards for Building Sustainability in the Capital Markets", which are presented each year at the Ceres annual conference and was part of the working group that created OpenMic to address net neutrality and media reform. In 2009, he joined Nelson Capital Management, where he was a partner and a senior portfolio manager. He also served on the firm's leadership team and investment committee. Blaine chaired the company's corporate engagement committee and was on the Extraction-Free and Animal-Welfare model teams. Blaine joined Bailard in 2016.

Blaine holds a BA from the University of California, Berkeley and CIMC® and CIMA® credentials. His writings on social investing have appeared in numerous publications including the *San Francisco Chronicle*, *Houston Chronicle*, *San Jose Mercury News* and London's *Environmental Finance* magazine. Blaine has three children in college and lives with his wife and two dogs in San Rafael, California. He has an eclectic taste in music and is an avid sports fan.

FOOTNOTES

1 https://www.nytimes.com/1970/09/13/archives/article-15-no-title.html

2 https://countryeconomy.com/gdp/usa?year=1970

3 "Review" in *Journal of Economic Literature* (December 2012). 50#4. pp. 1106–09.

4 EHES Working Papers in Economic History|NO.136, Kushinov and Zimmerman (Univ. Bonn)

5 How Economists Like me Got Globalization Wrong, Paul Krugman

6 https://gvwire.com/2019/06/24/stock-markets-value-under-trump-has-grown-by-6-9-trillion-to-30-6-trillion/

7 https://www.nasdaq.com/articles/us-stock-market-now-worth-30-trillion-2018-01-18

8 "The Hyperglobalization of Trade and Its Future", 2013, PIIE, Subramanian and Kessler

9 Business and Society Review, Spring 1972, Issue 1: Milton Friedman Responds

10 https://www.epa.gov/ghgemissions/global-greenhouse-gas-emissions-data

11 https://laborrights.org/issues/migrant-labor

12 https://www.antislavery.org/slavery-today/modern-slavery/

13 https://www.investopedia.com/terms/g/gini-index.asp

14 https://www.opensecrets.org/news/2019/01/lobbying-spending-reaches-3-4-billion-in-18/

15 https://www.sciencedaily.com/releases/2018/09/180924112802.htm

DISCLOSURES

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