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Moral Agency, Profits and the Firm: Economic Revisions to the Friedman Theorem

MORAL AGENCY, PROFITS AND THE FIRM: ECONOMIC REVISIONS TO THE FRIEDMAN THEOREM

Abstract

The paper reconstructs in economic terms Friedman's theorem that the only social responsibility of firms is to increase their profits while staying within legal and ethical rules. A model of three levels of moral conduct is attributed to the firm: (1) self-interested engagement in the market process itself, which reflects according to classical and neoclassical economics an ethical ideal; (2) the obeying of the "rules of the game," largely legal ones; and (3) the creation of ethical capital, which allows moral conduct to enter the market process beyond the rules of the game. Points (1) and (2) position the Friedman theorem in economic terms while point (3) develops an economic revision of the theorem, which was not seen by Friedman. Implications are spelled out for an instrumental stakeholder theory of the firm.

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> "The irrelevance of so much criticism of economic theory does of course not imply that existing economic theory deserves any high degree of confidence. These criticisms may miss the target, yet there may be a target for criticism." M. Friedman, 1953, *Essays in Positive Economics*, p. 41

I. Introduction

Since its first publication in 1970, Friedman's theorem that the only social responsibility of the firm is to increase its profits has been widely critiqued in business ethics literature. Most critiques have targeted Friedman's assertions on business ethics in behavioural ethical terms, for example from the point of view of virtue ethics or Kantian duty ethics (e.g., Desjardins, 1993; Evan and Freeman, 1995). However, the analysis of the relationship between Friedman's assumptions that underlie his theorem and the interpretation of the theorem *in economic terms*, that is, on its own grounds, has remained a problem.

Many previous interpreters viewed Friedman's stance on business ethics as a merely self-interested position that saw business ethics as antithetical to profitability. Such views are widespread and conventionally adopted in business ethics literature when it comes to Friedman's theorem, e.g. Chryssides & Kaler (1993, pp. 231–3), Weiss (1994, pp. 76–7), Mintzberg (1995, pp. 205, 214–15), Hoffman (2002, pp. 716, 718–19). The present paper argues that such views can be revised. It closes a gap in the literature by developing an economic critique that does not reject but revises the Friedman theorem, largely in institutional economic terms. Following Wagner-Tsukamoto (2005), an economic model of three levels of corporate moral agency is presented that puts Friedman's view on business

ethics into perspective. The paper outlines Friedman's understanding of business ethics, firstly, with regard to the free market as interaction mode ("level one" moral agency) and, secondly, with regard to systemic, mostly legal rules that govern market interaction ("level two" moral agency). In these respects, the present paper clarifies and basically agrees with Friedman's view on business ethics. However, from a third perspective the paper disagrees with Friedman, namely his view that market interactions as such should always be conducted in a "moral-free" manner, that merely self-interest should rule managerial thinking, or put differently, that profitability and business ethics that goes through the market process are incompatible. Special conditions are spelled out in which managers have to pursue ethical goals in the market process on grounds of corporate self-interest. The concepts of ethical capital and active moral agency ("level three" moral agency) are put forward to develop such an economic revision of Friedman's theorem.

Implications of this three-level model of moral agency are discussed in terms of the current debate of the Friedman theorem in business ethics literature. Friedman's agency argument and the related discussion of stakeholder management are given special attention.

The resulting economic conception of business ethics differs from the few previous attempts to tie business ethics to profit maximisation, for example, an opportunity cost based approach to revise the Friedman theorem (Primeaux, 2002, p. 244). As noted, the present paper favours the concept of ethical capital and a stakeholder framework to develop revisions. Also, the paper differs from Primeaux regarding the way he analysed Friedman's opposition to business ethics, especially Friedman's assumption that corporate social responsibilities that were profitable could not be viewed as ethical behaviour. As explained later, the paper also differs from Freeman and Evan's (1990) approach to stakeholder management, namely, their proposition of endogenous and exogenous, economic safeguards to contractual management.

II. Friedman's Theorem And Three Levels of Corporate Moral Agency

Friedman's thesis and discussion of business ethics, which states that the only social responsibility of business ethics is to increase its profits while staying within legal and ethical rules, can be projected to a model of moral agency that distinguishes three levels. Such an economic model of three levels of moral agency of the firm was introduced by Wagner-Tsukamoto (2005) in general, abstract terms. "Level one" moral agency captures the view that self-interested engagement in the market process reflects moral conduct. Through merely self-interested conduct, the firm contributes to ethical achievements such as rising living standards and rising welfare in a society. These ethical outcomes are unintended by the firm. In this respect, "level one" moral agency is of an unintended, passive nature. "Level two" moral agency relates to ethical and legal rules that frame and bind the market behaviour of the firm; morality is then located in the "rules of the game." In this respect, one can speak of passive, intended moral agency of the firm, namely the following of moral rules that are legally imposed on all firms. "Level three" moral agency relates to the firm's active engagement in moral conduct in the market process. The present paper here spells out the creation of ethical capital in the "moves of the game." In this respect, one can speak of active, intended moral agency of the firm. It reflects the voluntary consideration of additional moral rules when a firm interacts with its stakeholders through market processes. This latter issue yields an economic revision of the Friedman theorem. The subsequent discussion in this section examines in detail each of these three levels of moral agency with regard to the Friedman theorem.

A. Level One: Self-interested Market Behaviour as Passive, Unintended Moral Agency

Friedman associated various ethical ideals with the self-interested market behaviour of the firm. He generally endorsed the view that the "invisible hand" of the market best served consumers in getting a desirable product. He reasoned that consumer needs are best satisfied through competition in product markets. He was comparatively implicit on this issue when he spoke of the "free enterprise, private property system" and "Adam Smith's scepticism about the benefits that can be expected from 'those who affected to trade for the public good'" (Friedman, 1970/1993, pp. 249, 252). He was more explicit on this specific issue when he endorsed Adam Smith's view of the "invisible Hand" (Friedman, 1989, p. 14). Besides consumers, groups of investors and employees can all expect to benefit from the self-interested market behaviour of the firm, namely through the creation of jobs and the creation of returns on shareholdings (See also Novak, 1996, pp. 138–53, 163–4). Friedman (1970/1993) only touched upon the former issue while the main bulk of his argument focused on *stockholder* interests, but in rudimentary form he began a *stakeholder* discussion of the firm. In addition to these three key interest groups that can expect to benefit from the market process as such, Friedman (1962, pp. 16, 21) mentioned the preservation of political freedom and the prevention of discrimination (See also Smith, 1990, pp. 21, 27–28, 66). These outcomes of the market process reflect a moral quality of the market.

It is worthwhile noting at this point that these ethical outcomes of the self-interested market behaviour of the firm are unintended by the firm. In this respect, the pursuit of profit through the "moves of the game" is anything other than "wicked and immoral" (Friedman, 1970/1993, p. 253) since it leads to ethical achievements such as rising living standards and

increasing welfare in a society. One can speak of the unintended, passive moral agency of the firm (Wagner-Tsukamoto, 2005). As Friedman was very well aware, this ethical quality of the firm's self-interested behaviour was a guiding principle of Adam Smith's and Mandeville's outline of economics. Their understanding of economics was based on the ethical maxims of the "wealth of nations" and "private vices, public good," as Smith and Mandeville put it (Smith, 1976; Mandeville, 1988). Many writers on business ethics still underestimate or plainly overlook these moral claims that are associated by classical and neoclassical economists with the free market system. Others clearly consider them, for example Chryssides and Kaler (1993, p. 233), when outlining Friedman's view that the common good is best served by people pursuing their self-interest; or Goodpaster and Matthews (1993, p. 271) when speaking of "deliberate amorality" of firms in a market economy being encouraged in the name of the "systemic morality" of the invisible hand.

B. Level Two: The Rules of the Game and Passive, Intended Moral Agency

Issues of a different type of systemic morality arise when the "rules of the game" are looked at. Friedman always qualified his thesis on the social responsibility of firms with regard to legal rules and ethical codes. Friedman (1970/1993) put forward such a qualified version of his theorem on business ethics in two similar forms. The first version read:

> "[The] responsibility is to conduct the business in accordance with their [the stockholders'] desires, which generally will be to make as much money as possible while conforming to the basic rules of society, both those embodied in law and those embodied in ethical custom." (Friedman, 1970/1993, p. 249)

Rule-following behaviour, namely with regard to ethical and legal rules, is meant to constrain the profit maximising behaviour of the firm. Morality is codified in laws that constrain business behaviour (Brennan and Buchanan, 1986; Buchanan, 1991; see also Hayek, 1960, 1979). Such a constraint is overlooked by some writers on business ethics when critiquing Friedman's theorem, for example, Mulligan (1986, p. 265), Desjardins (1993, p. 137), Mintzberg (1995, pp. 214–15) and Smith (2002, pp. 232, 235). Mintzberg, for instance, claimed that Friedman saw only a black-and-white world regarding the enactment of corporate social responsibility, namely socialist nationalization versus the free market. The latter refers to "level one" morality as discussed above. But what Mintzberg overlooked are Friedman's suggestions on "level two" business ethics, specifically business laws that restrict and induce moral behaviour. Mintzberg's (1995, pp. 214–15) discussion of how to handle business ethics through the concepts of "restriction" and "inducement" can be easily reconstructed through the idea of the rule-following behaviour of the Friedman theorem. Friedman thus had clearly left the dichotomized, black-and-white world Mintzberg attributed to his writings.

In general, Friedman's suggestions on the obeying of legal and ethical rules reflects no small "moral agenda" as Novak (1996, p. 141) noted. (See also Carroll, 1991, p. 43; James and Rassekh, 2002, p. 255.) What the legal rules amount to is comparatively clear. However, questions arise regarding what Friedman meant exactly by ethical custom and where ethical custom stood in relation to legal rules, especially whether rules on ethical custom were of a primary or secondary order in relation to legal rules.

Legal rules can be viewed as codified ethical custom, as ethical rules that have been laid down in laws which come with proper sanctions. They reflect the enactment of moral minimum standards for all players. Smith's (1990, pp. 56–7, 70) position can be clarified in

this respect with regard to legal rules. Business ethics resides not only in the invisible hand of the free market system but also in business laws. Hence, Friedman's reference to ethical custom could be viewed as a residual of not yet codified and sanctioned laws. The question is whether on grounds of economic pressure in market processes ethical custom stands a chance to "survive." If ethical rules are costly and unprofitable, they are easily undermined by free competition. Compliance with legal rules, assuming their proper economic sanctioning, stands in this respect a much better chance of surviving market forces.

Friedman's second presentation of his thesis on business ethics does help to some extent to clarify this issue whether ethical custom was of primary or secondary importance as compared to legal rules.

> "There is one and only one social responsibility of business – to use its resources and 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 and fraud." (Friedman, 1970/1993, p. 254)

Here Friedman spells out the substance of the "rules of the game," of both legal and ethical ones: the engagement in open and free competition, and the avoidance of deception and fraud. Each of this broad group of constraints is subject to legal regulation, although grey areas remain. In particular, Friedman's reference to the avoidance of deception and fraud is inclusive. For example, most laws that regulate interactions between a firm and its stakeholders – laws as diverse as investor/stockholder laws, accounting laws, customer protection laws, etc. – can be linked to Friedman's general reference to the avoidance of deception and fraud. It becomes clear that Friedman's reference to rules of ethical custom does not invoke some idealistic agenda for corporate social responsibility, for instance, truly

altruistic philanthropy. Rather, Friedman's reference to ethical custom is likely to relate to not yet codified ethical conduct and grey areas of self-interested behaviour. Friedman (1989, p. 17) gives an example of the selling of US savings bonds which may come close to deception and fraud but could not be legally objected to. Some behavioural business ethics researchers, e.g. Birsch (1990, p. 31), here interpreted "ethical custom" in a rather broad, altruistic manner that is incompatible with Friedman's position.

Friedman (1970/1993) was comparatively implicit regarding the systemic quality of business ethics and the rules of the game. Undeniably it is fair to say that Friedman was a stern critic of government intervention in markets, for example, the maintenance of state monopolies for providing certain goods (e.g. postal services) or the nationalisation of entire industries (e.g. electricity, railway, etc.). In these respects, Friedman argued against government regulation, but one cannot *generally* state that Friedman suggested that the moral ends of the market were best accomplished when government regulation is minimal. Indeed, Friedman (1962) set out a detailed agenda for how rules, mostly legal rules, of moral and ethical conduct should be established. He attributed a key role to government in fostering competitive markets, enforcing law and order and enforcing private contracts (Friedman, 1962, p. 2). He viewed government as the essential "… forum for determining the 'rules of the game' and as an umpire to interpret and enforce the rules decided on." (Friedman, 1962, p. 15) He interpreted the "rules of the game" as the "unintended outcome of custom" that has been codified by government (Friedman, 1962, p. 25). He went on to reason that "… we cannot rely on custom or a [social] consensus alone to interpret and to enforce the [customary] rules – we need an umpire." (Friedman, 1962, p. 25) The purpose of the umpire is to modify rules, to interpret rules, and to enforce compliance with rules. From this it becomes clear that in Friedman's view legal rules and the role government adopts are of primary importance when it comes to setting out the rules of the game: ethical custom is of a

secondary nature. It can be viewed as future input to legislation and regulation processes. This clarifies expressed concern in the business ethics literature about what Friedman actually meant by ethical custom, for example, by Chryssides and Kaler (1993, p. 231). It is very clear that Friedman did not mean an agenda of social responsibilities. This would also be incompatible with his other views on business ethics. Hence, one can probably rightly reduce Friedman's key thesis on business ethics to playing the market game within legal rules, as done by Goodpaster and Matthews (1993, p. 271). In the terminology of the present paper, "playing the market game" as such reflects "level one" moral agency while "playing the market game *within legal rules*" reflects "level two" moral agency.

One area where Friedman could have sharpened his systemic understanding of business ethics with regard to the rules of the game is the role of economic sanctions. In competitive processes firms can only be expected to obey costly legal rules on economic grounds if the gains from breaking a rule are lower than the economic sanctions that are imposed for rule breaking. The sanctioning of laws is clearly an economic issue, too.

Also, Friedman (1962, p. 30) realized that so-called "neighborhood effects," by which he meant external, social costs for society caused by private enterprise, such as the costs of pollution, should be best handled through government intervention and the creation of new rules of the game. (See also Smith, 1990, pp. 91–2.) This clarifies Steiner and Steiner (1994, p. 122) who suggested that Friedman overlooked external costs. Friedman's position on "neighborhood effects" also refutes suggestions that he restricted the role of government to only make laws that prevented fraud, deception and coercion, as put forward by Desjardins and McCall (1990, pp. 14–15, 18–19).

C. Level Three: Active, Intended Moral Agency and the Creation of Ethical Capital

Friedman limited his understanding of corporate social responsibility to "level one" and "level two" moral agency. He justified such a limitation of the scope of social responsibility of the firm on two grounds. First, regarding other acts of social responsibility, for example, reducing pollution beyond what was required by law, he argued that such behaviour was antithetical to profitability and hence should not be taken up by a company. Second, as far as business ethics was reconcilable with the profit motive, Friedman (1970/1993, p. 253) defined this as self-interested behaviour that should not be viewed as ethical behaviour. This reflects the principle that good must not be done for reasons of profits, as Chryssides and Kaler (1993, p. 231) and many other behavioural writers on business ethics here agree with Friedman. For the latter, Friedman gave as an example investments in the amenities of local communities that yield corporate goodwill, such as higher employee motivation and thus higher productivity and ultimately higher profits.

Regarding the first argument, Friedman did not see that consumers, stockholders, or employees – he explicitly discussed these groups – might appreciate offerings from a company and could "pay back" a company in some way once it engaged in active moral agency that surpassed moral minimum standards laid down in laws. Friedman was here stuck in the view that ethical "activists," such as pressure groups, tried to lobby stockholders, customers or employees against their will to contribute to social causes and he viewed this as unwelcome "taxation" of the mentioned groups (Friedman, 1970/1993, p. 252). He asked who is paying for costly, unwelcome business ethics and he could only view business ethics in this respect as taxation. Friedman did not see that at least some stockholders, consumers or employees might be ethically minded enough to prefer investing in, buying from or working for a company that showed more ethical awareness than required by law and that showed

more ethical awareness than competitors. In other words, some consumers, employees or stockholders might be happy to "self-tax" themselves in order to enact their ethical decisions.

With regard to ethical goodwill generated by a company, Friedman did not see that it could transfer into ethical capital that could be traded with ethically high-minded stockholders, consumers or employees. Ethical capital indicates an agent's economic willingness and resourcefulness to pay for moral agency of the firm that exceeds standards laid down in laws. In this respect, Friedman did not see a payoff rationale of business ethics being "sold" on the stock market, labour market or consumption market like any other product or service. For example, ethically minded investors accepting lower returns for ethical investment decisions made by a company or ethically minded consumers being willing to pay a higher price for a product that lives up to high ethical standards (Wagner-Tsukamoto, 2005; also Wagner-Tsukamoto, 2003; Wagner-Tsukamoto, forthcoming). In this way, at least in niche markets, ethically minded corporate behaviour can be expected to be viable, and *contra* Goodpaster and Matthews (1993, p. 271), moral judgment is then integrated with self-interested corporate strategy. Friedman's theorem, once revised in economic terms through the idea of ethical capital, allows for the integration of moral judgment with corporate strategy and the pursuit of competitive advantage and profit maximisation. Stewart (1996, p. 56) overlooks this issue, that business ethics may be good for business, when critiquing Friedman's position.

In the late 1960s and early 1970s ethically minded stockholders, consumers and employees may have still been quite rare. In this respect, one may have to forgive Friedman for his antithetical views on the compatibility of profitability and corporate social responsibility in the market process. But more recent developments in the late 1980s, 1990s up to the present day have demonstrated that ethically aware investors, consumers and employees do exist, at least in certain markets. Mulligan's (1986, p. 265) "futility" critique of

Friedman rightly makes this point. The green consumer movement is an excellent example. In many markets, environmentally-oriented consumers are willing to pay a price premium for organic products, for products that are easily biodegradable, for products that are made of recycled material, etc. (Wagner, 1997; Wagner-Tsukamoto, 2005). In such markets the Friedman thesis that the *only* social responsibility of business is to increase its profitability while obeying laws needs to be more widely interpreted than originally envisaged by Friedman. In such markets it is mandatory for a firm to get involved in ethical corporate behaviour that goes beyond what is legally required. In such markets, competition focuses on the creation of ethically appealing products and services. In this sense, ethical capital needs to be created and "sold" to investors, consumers or employees in order to stay competitive. Here, one can speak of active, intended moral agency of the firm that works right through the "moves of the game" ("level three" moral agency). This directly turns around some of Friedman's (1970/1993, p. 250) arguments on corporate spending on the reducing of pollution. Key empirical examples of firms that engage in active moral agency are Fair Trade organizations, the Ecover company, or The Bodyshop. A key difference between firms that engage in active moral agency ("level three" moral agency) and "level one" moral agency is the matter of intent. "Level one" moral agency only captures *un*intended ethical outcomes that result from corporate activity, such as rising welfare in a society that is due to self-interested corporate activity. Clearly, rising welfare in a society over time can be viewed as an ethical achievement of the market economy. However, this is an achievement which is not intended by firms when they engage in competitive activity. In contrast, active moral agency ("level three" moral agency) is *intended* by the firm *in the market process*. Companies like Ecover, Fair Trade organizations (e.g. Café Direct) or The Bodyshop not only sell products on the basis of profitability but also on certain ethical grounds (e.g. environmental protection, welfare of farmers in developing countries, animal rights issues, etc.). And such ethical

grounds are pursued *voluntarily* by these firms. This distinguishes active moral agency ("level three" moral agency) from passive, intended moral agency ("level two" moral agency). A compatibility between profitability and ethical corporate activity that goes through the market process was not seen and not covered by Friedman's position on the social responsibility of firms. It is characteristic of Friedman's thinking that the market process itself remained free from moral issues (apart from ones that were legally imposed, "level two" moral agency).

The concepts of ethical capital and active moral agency drive an economic revision of the Friedman theorem. Of course, active moral agency still has to be profitable (otherwise firms like Ecover, Fair Trade organizations, The Bodyshop, etc. would go out of business – but still, as outlined above, "profitable" active moral agency ("level three" moral agency) is conceptually and ethically different from "profitable" passive, unintended and intended moral agency ("level one" and "level two" moral agency). And the Friedman theorem in its original version only covered "level one" and "level two" moral agency. In order to align "level three" moral agency with the Friedman theorem, one has to revise Friedman's position. Simply expressed, one has to show Friedman that it is feasible for a firm to be *both* profitable and ethical *in the market process*. This is the crucial point which leads to an economic revision of the Friedman theorem through the concept of active moral agency (conceptually grounded in a consequentialist, outcome ethics). The concepts of active moral agency and ethical capital differ from previous attempts to revise the Friedman theorem in economic terms, for example, through concepts of opportunity cost based decision-making that were linked to behavioural ethics (Primeaux, 2002). Primeaux proposed that a company should look "beyond bottom-line accounting profits to identify what those profits represent" (Primeaux, 2002, p. 247). From here Primeaux moved on to a behavioural ethics approach to suggest that people and things should be considered as valuable in themselves, as scarce

resources that have value and dignity. For example, the religious values of a community could be included in opportunity cost based decision-making. In contrast, the proposed concepts of active moral agency and ethical capital ask first for the economic "power" of persons and issues involved in decision-making and they stay firmly within an economic framework before ethical concerns are taken on board.

However, Friedman and behavioural ethics researchers alike may criticize the argument regarding the creation of ethical capital and active moral agency as illusory. As mentioned above, Friedman and many behavioural researchers on business ethics, e.g. Chryssides and Kaler (1993, p. 231), Stone (1995, p. 145) or Hoffman (2002, pp. 718–19), similarly argued that ultimately good must not be done for reasons of profit. This reflects a value judgment regarding the type of ethical concepts applied to ethical reasoning – a judgment one does not necessarily have to agree with. The kind of ethics Friedman based his evaluations on reflects a motive ethics. Only on grounds of a motive ethics, such as Kantian duty ethics, Aristotelian virtue ethics or a religious ethics, would one carefully scrutinize *inputs* to a decision, such as motives, in order to assess a decision's ethical status. If the profit motive is an input to a decision and if other ethically desirable goals, such as virtuous ones, are instrumentally treated in relation to the profit motive, then a motive ethics would step back from assessing behaviour as ethical. Friedman (1970/1993, p. 253) was outspoken in this respect. He called the labelling of profit-maximising actions that were done under the heading of corporate social responsibility as "hypocritical" and "fraud" (similarly Levitt, 1958). This reflects the stance of a motive ethics.

On the other hand, there are competing ethical doctrines to motive ethics. Strong competitors are utilitarianism and consequentialism. They share the view that *outcomes* of decision-making behaviour are assessed in order to make a judgment about the ethical status of a decision. According to the utilitarian or consequentialist approach, the profit motive can

still be an input to a decision while outcomes, such as green consumer behaviour and the related corporate green behaviour, could be viewed as socially responsible, ethical behaviour. Likewise, self-interest and profitable behaviour can be viewed as ethical if a larger group (ideally society at large) benefits. In this way, the Friedman thesis is comprehensively revised, by taking on board the concept of ethical capital and by grounding the ethical assessment of business behaviour in a consequentialist, utilitarian manner.

The question whether and why business behaviour should be philosophically and ethically grounded in a motive ethics rather than an outcome ethics cannot be finally resolved. To some extent it reflects an arbitrary decision, but for the purpose of this paper it is sufficient to note that the application of an outcome ethics opens up the way for a fundamental revision of the Friedman theorem. As indicated above, the significant point I make in this respect is that active moral agency of the firm is conceptualised in a *motive-independent* way. This is important in so far as the application of a motive ethics (e.g. virtue ethics or duty ethics) would not necessarily allow for the conceptualisation of the corporate behaviour of firms like Ecover, Fair Trade organizations, or The Bodyshop as ethical because the profit motive of the firm is aligned with ethical thinking. As stressed, from the point of view of virtue ethics or duty ethics, motives for ethical behaviour have to be rather pure. If this is not the case, for example the self-interested profit motive is present, corporate behaviour cannot necessarily be assessed as ethical. From a consequentialist point of view it does not matter whether self-interested motives drive business behaviour – as long as additional outcomes are achieved that surpass the profit maximization of the firm (e.g. better environmental protection, increased welfare of farmers in developing countries, a better consideration of animal rights, etc.).

On a bolder note and in the utilitarian tradition of Bentham and Mill, one could argue that the Smithsonian concept of the market economy is fundamentally and intrinsically

outcome orientated. Regarding its philosophical and ethical underpinnings, it may reflect an utilitarian, consequentialist approach to business ethics rather than a behavioural ethics approach that focuses on inputs to a decision. From here some important implications emerge regarding the very nature of *business* ethics, especially the ethical decision-making behaviour of top managers. The aforesaid indicates in this respect a preference for utilitarianism and consequentialism (but the same question of preference is left open for investors, employees or consumers).

III. Implications of an Economic Revision of the Friedman Theorem for Stakeholder Management

A key element of Friedman's discussion of corporate social responsibility was his agency argument. He proposed that managers were the agents of shareholders and that a fiduciary relationship existed between them (Friedman, 1970/1993, p. 250; 1989, p. 14). According to this view, the key responsibility of managers was to maximise the firm's profits. This view of the firm can be integrated, in line with the economic revision of the Friedman theorem outlined above, with an instrumental, strategic approach to stakeholder management. This lives up to calls that Friedman's simple agency model should be replaced with a stakeholder model of the firm (Birsch, 1990, p. 34: similarly Smith, 1990, p. 63).

Instrumental or strategic stakeholder management defines stakeholders as those groups who are vital to the survival and success of the firm (Freeman and Reed, 1983; Freeman, 1984; Freeman, 1997, p. 69). As Goodpaster (1991, pp. 57–9) outlined, strategic, instrumental stakeholder analysis views stakeholders outside the stockholder group as economic factors that can potentially affect the overarching goal of optimising stockholder

interests. Other stakeholders are subordinated to the concerns of stockholders; they are instrumental economic factors. The revised Friedman theorem can link to this narrow, specific conceptualisation of stakeholders. Friedman's approach to business ethics would then no longer be classified in the terms of Weiss (1994, pp. 76–7) as "productivist," being merely focused on stockholders and self-interest, but as "progressivist," that is self-interested stakeholder management conducted in economic terms.

Another idea of Friedman on the conceptualisation of the firm neatly connects to an instrumental approach to stakeholder management. Friedman (1953, p. 22) linked the survival considerations to profitability of the firm: "Given natural selection, acceptance of the [maximisation-of-returns] hypothesis can be based largely on the judgment that it summarizes appropriately the conditions for survival." As indicated above, here Friedman made some rudimentary steps to include, besides stockholders, groups of consumers and employees in the consideration of survival issues.

On the basis of an instrumental approach to stakeholder management, the idea of ethical capital opens up stakeholder management in an instrumental way that goes beyond stakeholder management that is merely concerned with legal compliance. This qualifies and clarifies the view of Goodpaster (1991, p. 59) that instrumental stakeholder management is limited to fiduciary responsibility supplemented by legal compliance. In particular, active intended moral agency in relation to the creation of ethical capital surpasses moral minimum standards required by law.

Goodpaster (1991, p. 60), however, went on to question generally the ethical status of strategic, instrumental stakeholder management. He argued that it lacked moral concern for stakeholders other than stockholders and he condemned it as "business without ethics." On different grounds this view can be contested. Already with regard to "level one" and "level two" moral agency, discussed above as *unintended passive moral agency* and *intended*

passive moral agency, ethical claims can be made for instrumental stakeholder management. But this is all the more true for "level three" moral agency. With the creation of ethical capital, instrumental stakeholder management is infused with ethical concern. Goodpaster (1991, p. 69) is also mistaken when he suggests that Friedman's rejection of corporate social responsibility implied that stakeholders lacked a morally significant relationship with the firm. A morally significant relationship exists with regard to levels one, two and three of moral agency as outlined above. Friedman's position, once revised in economic terms, allows for the integration of moral judgment, predominantly in a utilitarian, consequentialist tradition, with corporate strategy and the pursuit of competitive advantage and profit maximisation.

To a degree, Goodpaster's assessment of instrumental stakeholder management as "business without ethics" reflects the same "mistake" made by Friedman when he characterized profit-orientated business ethics as hypocritical. The kind of ethics both Goodpaster and Friedman seemed to have in mind was a motive ethics, such as a religious ethics. Goodpaster (1991, p. 67) was quite specific here when he finally argued, in a Kantian tradition, for categorical duties regarding stakeholders. Other writers on business ethics who follow a Kantian approach to stakeholder management come to a similar assessment (e.g. Evan and Freeman, 1995; see also Donaldson and Preston, 1995, p. 73).

The suggested instrumental stakeholder approach that is based on the concept of ethical capital is complementary to Freeman and Evan's (1990) economic stakeholder interpretation of corporate governance. Freeman and Evan developed their argument around the notions of endogenous and exogenous contractual safeguards. Exogenous safeguards protect nonowner stakeholders from moral hazards and opportunistic behaviour when it comes to interactions with the firm. Such safeguards are imposed through the coercive power of the state and basically reflect legal regulation. Thus, exogenous safeguards can be related

to “level two” moral agency, to ethical standards that are codified in laws. In contrast, endogenous safeguards are developed by contracting partners. Whereas Freeman and Evan’s assessment focused on safeguards to stakeholder relations, my analysis deals with the substance and contents of ethical contracting, namely the exchange of ethical capital. If ethical capital shows features of high asset specificity, which is likely to be the case, Freeman and Evan’s (1990, p. 354) argumentation for endogenous contractual safeguards applies.

In contrast to an instrumental, strategic approach to stakeholder management, an idealistic approach conceptualises the idea of the stakeholder much wider than economic, survival issues. The stakeholder is then defined as any group or individual who can affect or is affected by the corporation (Freeman and Reed, 1983; Freeman, 1997, p. 69) or as “groups and individuals who benefit from or are harmed by, and whose rights are violated or respected by, corporate actions” (Evan and Freeman, 1995, p. 149; similarly Chryssides and Kaler, 1993, p. 235). The key practical problem of this approach is that it lacks a procedure for conflict resolution among stakeholders. There is little chance to reconcile idealistic stakeholder management with Friedman’s approach to corporate social responsibility, not even in its revised version. In contrast, instrumental stakeholder management prioritises conflict resolution in relation to the maintenance of survival and profit maximisation. Those stakeholders who have the greatest impact on the firm, by withdrawing their support from the firm, are given primary attention. Interests of other stakeholders are subordinated.

IV. Conclusions

The analysis of Friedman’s theorem on business ethics made clear that moral agency is exhibited by the firm in various ways. In its original formulation that the only social

responsibility of the firm was to increase its profits while obeying laws and ethical customs, the Friedman theorem had already set out an agenda for business ethics. The pursuit of profit-making behaviour in competitive market processes reflects passive, unintended moral agency ("level one" moral agency) in so far that many groups or "stakeholders" benefit from this behaviour, not only stockholders but also employees or customers. Regarding the latter, the provision of employment and the production of a desirable product or service, and more abstractly, the rise of welfare in a society over time can be viewed as ethical goals. Staying within laws and ethical customs, such as the avoidance of deception, reflects the obeying of moral minimum standards. This has been discussed by the paper as passive, intended moral agency of the firm ("level two" moral agency). The original version of the Friedman theorem covered "level one" and "level two" moral agency – but only these two levels.

The paper suggested that the Friedman theorem can be revised in economic terms to include active moral agency ("level three" moral agency). Such a revision has been developed around the idea of ethical capital that is created by the firm by anticipating or reacting to the demands of consumers, shareholders or employees who are willing to pay for costly business ethics of the firm. Then, one can show Friedman from an economic point of view, that it is feasible for a firm to be *both* profitable and ethical *in the market process*. Voluntary intent of ethical conduct in the market process distinguishes active moral agency ("level three" moral agency) from passive unintended and intended moral agency ("level one" and "level two" moral agency). The compatibility of profitability and business ethics that goes through the market is implied for "level three" moral agency. This revision of the Friedman theorem does not reject the theorem but qualifies it in economic terms. Business ethics is thus grounded in a view of the firm that can be reconciled with Friedman's position.

This paper projects an economic revision of the Friedman theorem to an instrumental approach to stakeholder management. It appears that the revised Friedman theorem can be

easily reconciled with an instrumental approach to stakeholder management but less so with an idealistic one. It is especially the creation of ethical capital that opens up a new route to moral responsibility that can be taken on by the managers of the firm. A firm can actively create ethical capital by nourishing a market segment of ethically high-minded stakeholders who are willing to pay, for example, for the costs of a product that is produced to higher standards than required by law. On the other hand, a firm may be "pushed" by ethically minded stakeholders who are economically resourceful to take on moral responsibilities beyond the moral minimum that is laid down in laws. As outlined, in these latter respects, Friedman's suggestions on business ethics are revised in economic terms.

A critical question regarding active moral agency and its conceptual link to instrumental stakeholder management is whether, because of the instrumental, profit-oriented treatment of ethics, such an approach reflects "business without ethics," as Goodpaster (1991, p. 60) put it and as Friedman similarly stated. This criticism reflects a value judgement on ethics, namely that a motive ethics like virtue ethics or duty ethics are superior to an outcome ethics like consequentialism. In this respect, Friedman like behavioural business ethics researchers did not see that profitable business behaviour that satisfied the ethical demands of stakeholders in the market process could be conceptualised as moral agency of the firm by grounding it in an outcome ethics. As this paper has demonstrated, consequentialism shows a way out of this normative grounding dilemma for a model of moral agency of the firm.

Finally, we can return to the opening quote of this article in which Friedman (1953, p. 41) claims that much criticism of economic theory is irrelevant but also that existing economic theory does not deserve any high degree of confidence. Regarding Friedman's irrelevance claim, the paper has discounted various behavioural criticisms of Friedman's views on business ethics, positioning his thinking with regard to "level one" and "level two" moral agency. In another respect, following Friedman's suggestion that existing economic

theory does not deserve any high degree of confidence, the paper has critiqued Friedman's own position on business ethics and economics. The paper has shown in economic terms that Friedman's scepticism regarding the compatibility of profitability and business ethics behaviour of a firm that goes right through the market process is unjustified. The concepts of active moral agency of the firm and ethical capital have been advanced in this respect.

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