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Is Economic Familiarity a Necessary Prerequisite for Understanding Milton Friedman's View of Shareholder Primacy? Reflections on a Classroom Exercise

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Abstract. This article provides an overview of a classroom exercise based on Milton Friedman's infamous declaration that "the social responsibility of business is to increase its profits." Despite their familiarity with both the phrase and Milton Friedman as an economist, a notable proportion of surveyed students adopted a "straw-man" understanding of Friedman's intended meaning. To correct this, students were tested on their knowledge of three key concepts—methodological individualism, principal-agent problems, and economic calculation—and then assigned supplementary readings. The result was an increase in their agreement with the Friedman quote. The exercise also demonstrated that not all profit is the same, and provided students with materials to help them understand the differences among economic, sustainable, and wealth-creating profit. Instructors can use these resources to ensure that their own classroom discussions are based on sound economic foundations.

Keywords: corporate social responsibility, methodological individualism, principal agent problems, stakeholder theory.

1. Introduction

In their seminal textbook on business ethics, Crane *et al.* (2019) open their discussion of corporate social responsibility (CSR) with a critique of Milton Friedman's claim, made in a 1970 *New York Magazine* article, that "the social responsibility of business is to increase its profits." This statement is often used in the classroom, where students are asked to consider Friedman's view as a prelude to a richer and, supposedly, deeper treatment of CSR. Indeed, as Carson (1993, p. 3) states, "[a]lmost everyone who writes on the topic writes at least partly in reaction to Friedman."

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The phrase "the social responsibility of business is to increase its profits" is merely the title of an opinion editorial, which, in turn, summarizes a section from his 1962 book, *Capitalism and Freedom*.[1] What has become known as "shareholder primacy" or the "Friedman doctrine"—the idea that businesses should neglect ethical issues and focus on profit-seeking behavior—may, in fact, be a "straw man" (Muldoon *et al.* 2023).[2] This article investigates whether students possess a superficial understanding of Friedman's point and pays proper attention to understanding the economic concepts that underpin it. It provides two additional readings that can be used in conjunction with Friedman (1970) to expose students to several economic concepts that Friedman, as an economist, perhaps took for granted and to clarify how economists conceptualize profit.

The first supplementary reading, called "Concepts", provides short definitions of methodological individualism, the principal-agent problem, and the economic calculation debate, and discusses how these concepts relate to corporate decision-making. It also defines three types of profit: economic, sustainable, and wealth-creating. The second supplementary reading, called "Cases", contains three short case studies, and asks students to try to determine the company and the associated type of profit.

Over the years, an extensive literature has focused on rejecting or defending Friedman's statement. Seminal critiques include Liechty (1985), who acknowledges that Friedman treats economic considerations as primary, rather than sole, but still intends to "refute" Friedman's position. Mulligan (1986) argues that Friedman's argument rests on the premise that executives who engage in socially responsible actions impose costs on others, which is the equivalent of taxation without representation. He proposes an alternative paradigm in which socially responsible executives build consensus with shareholders. In response, Shaw (1988) claims that this perspective glosses over the difficulty of finding common purpose among all shareholders, and distinguishes between problems that require collective-action solutions and those solvable through private enterprise. Nunan (1988) argues that executives are not necessarily breaking their fiduciary duty to shareholders if they pursue socially responsible behavior provided that those shareholders have voluntarily entered into permissible contracts. Cosans (2009) highlights that Friedman's concept of business ethics is grounded in the nature of business and the imposition of negative externalities

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1. Newspapers often attempt to sensationalize a story and gain attention through the artistic use of a catchy title. For this reason, a journalist who has the ability to suggest, demand, or veto headlines that they believe trivialize and misrepresent their articles holds significant power. In my opinion, the article's headline was not necessarily a bad one, and I am not aware of whether Friedman suggested or approved it. However, using the headline of an opinion piece as an adequate summary of the arguments expressed within it is a notoriously unreliable approach. As Elrick and Thies (2018, p. 298) argue, "[t]he headline is certainly provocative; but, out of context, potentially a misrepresentation."
2. A "straw man" is a false representation of an idea, often deployed because they are easy to criticise.

without compensation. And, Ferrero, Hoffman, and McNulty (2014) recognize that Friedman's argument rests on a specific type of organization—a corporation that provides limited liability protection for shareholders. They argue that this undermines his position by revealing the socially interdependent nature of business relations, which should not preclude consideration of how stakeholders are affected by negative externalities.

Plenty of attention has also been paid to defending Friedman. James and Rassekh (2000) recognize that Friedman's view of self-interest does not imply narrow selfishness and, like Adam Smith, retains scope for ethical judgment. Carson (2003) reflects on how stakeholder theory, which states that corporations should be run for the benefit of a larger range of affected interests than just shareholders, might be updated in light of accounting scandals such as Enron. He states that Friedman's shareholder theory "*clearly* prohibits the actions of these executives" (Carson 2003, p. 391) but shows that incentive alignment is critical for improving corporate behavior. Elrick and Thies (2018) point out that Friedman qualified his argument by including the ethical constraint of honest dealing and that this is often ignored by critics. A range of insightful reflections can also be found outside the academic literature.[3]

Several attempts have been made to introduce Friedman's article into a classroom setting. Dunn and Burton (2006) identify 10 statements contained within the piece that can serve as discussion points. Each statement contains a suggested critique, demonstrating that the purpose of the activity is not so much, as claimed, "to ensure that students have a nuanced view of the arguments for and against its stance" (Dunn & Burton 2006, p. 8) but to, in fact, challenge Friedman. In contrast, this article takes a broadly supportive approach to utilizing Friedman's article and, at least, establishes whether students have read and properly understood it. Indeed, perhaps the reason why his claim is often viewed as provocative by those interested in the ethics of capitalism is because they lack training in basic economic principles.

This article serves as a teaching note that can be used as a supplement to the Friedman piece. In so doing, it constitutes a useful resource for any instructor discussing Friedman in a classroom setting.[4]

2. The Study

The study was conducted as part of a Business Economics course delivered in London in January 2024. The module was a third-year elective within a Bachelor in Management program at a well ranked business school. The program is highly

3. A classic defense of Friedman's position is found in *The Economist* (2009). Recent examples of sophisticated non-academic publications include Strain (2020) and Dumitriu (2021).
4. All resources mentioned in this article can be found on the following webpage: https://anthonyjevans.com/friedman/

international with a wide mixture of nationalities and backgrounds. All of the 68 enrolled students had previously completed an introductory course on microeconomics, and presumably had some degree of competence and interest in economics. In order to prevent students from preparing for the exercise, no information was provided before the topic was introduced in class. Moreover, as the Friedman reading is typically used in a business-ethics context rather than an economics class, all students began the study with the same level of anticipation and preparation. Although the context for this iteration of the study was a Microeconomics course, it is intended to be just as useful when teaching Business Ethics.

The sequence of intervention was as follows:

1. Students took quiz 1 under exam conditions. This provided insights into their existing knowledge of the article's content.

2. Students were then asked to read the Friedman article before the next session.

3. Students took quiz 2, which tested their comprehension of the Friedman article.[5]

4. Students received the "Concepts" and "Cases" handouts.[6] They were given 20 minutes to read the handouts.

5. Students took quiz 3, which includes a reflection on the exercise as a whole.

The "Concepts" reading defines methodological individualism, the principal-agent problem, and the economic calculation problem, and relates them to Friedman's argument. The discussion of the economic calculation problem distinguishes among three types of profit: economic (which includes the opportunity costs of production); sustainable (which focuses on an appropriate time horizon); and wealth-creating (as opposed to rent-seeking).[7] The aim of this reading is not to issue caveats about Friedman's point, but to ensure that the term "profit" is understood as economists use it. If companies pursue opportunities that cover their visible costs of production but neglect alternative courses of action that would deliver higher returns, this is not "profit" in an economic sense. If companies trade off their future profitability for short-term success, then their profit is not sustainable. And if companies earn money by utilizing political favor rather than creating value for consumers, then their profit does not enhance social welfare.

The "Cases" reading builds on this by providing short histories of Kodak, Enron, and AT&T. Kodak earned "profits" from its traditional imaging services

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5. This quiz can be used as a stand-alone exercise. It is available here: https://forms.gle/dAFXKvr9KRs181ae9
6. The "Concepts" reading is available in Appendix A and the "Cases" reading can be found in Appendix B.
7. Friedman's article is not explicitly about these concepts, but they are relevant for understanding how economists conceptualise "profit". For a Business Ethics audience, it is especially important to cover them.