Stakeholders and the Profit Maximizing Firm

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Austrian Student Scholars Conference

February 2020

In free enterprise economies, corporations are profit seeking entities which place the interest of the shareholders above all else. Shareholders, acting as the principle, contract corporate executives to act as agents to use the resources of the firm to achieve shareholder's ends. For the eleemosynary institution, these ends are charitable, and the profits of the shareholders may simply be psychological. For the typical business, however, the chief end is to generate income, profits are purely monetary.

In today's society, this system is under heavy scrutiny. The crux of the argument is that only the shareholders benefit from such a system, other stakeholders, however, bear the full burden of all negative externalities generated. This criticism has given rise to alternative decision-making models, designed to help the corporate manager behave in a more ethical and socially responsible manner. Is it true, that stakeholders fully bear all costs generated by firms myopically pursuing shareholder value? What are the social benefits of such a firm's existence, if any, and how can the rights, privileges and interests of other stakeholders be protected if the firm is solely to care for the will of the shareholders?

Within four sections this paper will discuss the issues at hand. Firstly, the nature of the firm, the nuts and bolts at least, will be described. Real world examples of the firm will not be given. The firm will be examined as it operates in the unhampered market economy. This theoretical framework, although mentally taxing, will avail us key apodictic takeaways which will aid our analysis. Secondly, criticism of the firm's current structure will be addressed. Thirdly, this paper will demonstrate the impossibility of alternative decision-making models. Finally, this paper will run the gamut of all recognizable stakeholders, demonstrating that, although the firm only cares about shareholders, other groups benefit from the shareholder's self-

interested behavior. Crucially, it will be shown that even creditors, whose interests would appear to be utterly antithetical to the interests of the shareholders, are indeed aligned.

I. The Firm As Is

To understand business, one must first understand exchange theory, after all, exchange is the fundamental activity around which the business depends. Fortunately, fertile ground has been tilled and sewed here within economic literature. Plato, in his *Republic*, centers his discussion of the city state and how it develops around the phenomenon of exchange. Roughly 14 to 17 centuries later, the Christian Scholastics wrote extensively on exchange theory. Their primary concern was fairness of exchange between buyers and sellers. What exactly makes up a “just price” for a particular good was of immense interest to them. Later, the 17th century French political economist, Pierre de Boisguilbert, built his entire economic analysis from a description of two-party exchange. From such simple exchange he would then analyze villages, cities and nations as a whole.

Two party exchange is one of the most fundamental phenomenon of economics. When two individuals exchange, we can know that they do so because each party prefers the other’s good more than the good in possession. We know this *a priori*, that is, we know this without any empirical evidence. We do not need to consult empirical data to test this. It is, as mentioned earlier, a key apodictic takeaway needed for our later conclusions. As economic activity increases, individuals may find it in their best interest to form an entity so as to engage in trade jointly, to divide their labor. This division of labor is a natural phenomenon that arises due to three factors. 1) men are physically unequal in their ability to produce 2) there is diversity of productive factors given geographical location in the world and 3) some tasks physically require

the labor inputs of multiple men simultaneously.[1] Dividing labor allows man to increase trade and increase the profitability of such trade. We may call this cooperative enterprise a joint venture, business firm or corporation if we like. Such nomenclature would appear all the more fitting if the venture were to last for some time and develop into a larger endeavor with the contribution of many men. The formation of a business firm also allows individuals (working as a "single" business unit that is) to overcome certain costs which, on an individual level would otherwise make operations not worthwhile. These costs may include transaction, search, information and bargaining costs. [2] Regardless of the reason, it is this newfound entity which we call a business. As businesses grow, many different groups become key to its operations, although the activities of one group can certainly blend over into the activities of at another. The owners of the firm are the ones who create the institution in the first place and who put resources (equity) into the enterprise to get it going. For this reason, such persons are called equity holders, or shareholders. The two terms are equivalent. These shareholders may perform most of the necessary labor or they may hire employees to organize day to day activities. If shareholders hire employees to manage the company, these managerial employees are set in such a position of power by the mandate of the shareholder. In other worlds, the shareholders are the principles, and the employees act as agents for the principles. Yet neither the shareholders nor the operational managers are the most important "group" in the firm's existence. The most important group in the operations of a business are the customers who purchase goods and services from the firm. For, if shareholders never believed a customer to exist in the first place, why would he produce at all? Indeed, it is "production which opens a demand for products"[3]. In other words,

[1] Ludwig Von Mises (1949) "Human Action"
[2] Ronald Coase (1937) "The Nature of the Firm", *Economia*. Wiley Library Online (1937)
[3] Jean Baptists Say "Treatise on Political economy" 1803 Ch. XV pp133

man does not produce for the sake of production. Outside of his desire to consumer the fruits of his own labor, man produces in order to make a sale, in order to acquire a medium of exchange in order to use that medium of exchange to buy still other sorts of product for his own ends and means. The customer, therefore is the most important "group" in a business. On the other end of the value chain, suppliers are yet another important "group". These men provide factors of production for the firm, key inputs necessary for production. Other "groups" include competitors, who compete for profits, and lenders, who give financing to the firm in exchange for future interest payments and principle. The larger the firm becomes, the more its internal operations will be specialized into these different groups (managers, shareholders, regular emloyees) and the more it interacts with society as a whole.

The firm's "desires" are rooted in the original desires of the owners of the firm. Just as the individuals exchanging unilaterally as outlined before, the united desire of the owners of the firm is to generate profit. The firm trades less preferred goods for more preferred goods, which often comes in the form of money, that is, the medium of exchange. A business may sell a product to an end customer who himself consumes the good (known as B2C), or to another business (B2B) who in turn sells the product off to another entity.

In summation, A business is an organization which converts factors of production into a product paid for and consumed by customers. Businesses incur costs by purchasing these factors (including both producer goods and labor) and generate revenues by selling products to customers, weather altered or unaltered. If revenues outweigh costs, the owners of the firm profit and are satisfied. The intent of the shareholders is the same as it was under the simple two-person exchange framework, to acquire other goods in exchange for goods currently possessed, that is to make a profit.

II. A Critique of the Firm and Alternative Decision-Making Models.

The perceived problem with the firm is its profit seeking. If the firm is to only profit for the sake of one particular group, indeed a minority group, the shareholders, how is everybody else going to benefit? It would seem that in such a system, only the few benefit and all other "groups" bear the burden of all negative externalities generated. To put it in terms of popular critiques of today, businesses do not bear their fair share of the responsibilities in society. They are economic machines operating in the interest of the minority. They do not serve the general welfare, they only serve the equity holders.

There have been many famous critiques of the firm's profit seeking. Today perhaps the most politically threatening and recognizable of these critique is Elizabeth Warren, whose complaint is centered around the perceived injustice that businesses receive the legal rights of individuals but do not contribute to the general welfare of society. Legally, businesses in the U.S. are regocnized as legal "persons" because, as outlined above, he existence of business flow from the joint cooperation of individual persons. The sNew England Senator, and other ideological allies, are most vexed by this. They point to a 2010 Supreme Court ruling, *Citizens United Versus the Federal Election Committee*, in which the high court affirmed the right of businesses and unions to spend political money on campaigns, as one of many instances of abuse of this legal recognition of personhood.In that ruling,the high court ruled that such political lobbying expenditures fall under the protection of the 1st Amendment as free speech.. It was here that the political left began to ratchet up their criticism of this legal recognition. In a 2012 speech to the Democratic National Convention, Senator Warren laid out her case by remarking that "*Corporations are not people. People have hearts. They have kids. They get jobs. They get sick.*

They cry. They dance. They live. They love. And they die". [4] Some years later in an August 2018 op-ed in the Wall Street Journal, claimed that "*American Organizations exist only because the American people grant them charters. These charters confer valuable privileges-such as limited liability for their owners-that enable businesses to turn a profit.*" [5] What do Americans get in return, she asks? In short, nothing reciprocal, only negative externalities.

Warren and her leftie friends point to the disparity between rich and poor as a consequence of self-interested corporate behavior. Indeed the claim of growing economic disparity between rich and poor is more cacophonous than ever. One statistic which is quite popular to toss around today is the growing disparity between corporate employee salaries and corporate executive salaries. In the 1950's the average CEO made roughly 20 times what the average worker made, but today that multiple is roughly 361 times the average worker. [6] This disparity, surely, is due to the increasingly greedy and self-interest behavior of shareholders.

In response, Warren has proposed a bill to transform businesses from profit-seeking, shareholder serving organizations, into philanthropic institutions. Her proposed bill would require all companies that generate over $1 billion in annual revenue to actually apply for a charter of citizenship. The bill would also limit the ease with which corporations could make political contributions, and it would force businesses to share voting rights with workers. [7] Warren's proposal, however, isn't just wrongheaded on theoretical grounds. It breaks a long-established legal president of the business as well.

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[4] Elizabeth Warren (2018) "Companies Shouldn't Be Accountable Only to Shareholders; my new bill would require corporations to answer to employees and other stakeholders as well". Wall Street Journal
[5] ibid.
[6] Diana Hambree (2018) "CEO Pay Skyrockets to 361 Times That of the Average Worker". Forbs Magazine
[7] Yglesias (Vox, 2018)

The legal history of the personhood of the firm goes back much further than the 2010 supreme court ruling. It is not a recent innovation of the greedy capitalists, as some seem to think. As late as the 18th century, the influential British legal commentator William Blackstone distinguished corporations as "*artificial persons*". What's more, he even claims that such persons are created "*for the advantage of the people*". [8] In the early years of this county's founding, Supreme Court justice and Pennsylvania founding father James Wilson put it more strongly. "*These societies also are deemed to be moral persons: but not in a state of natural liberty: their actions are cognizable by the superior power of the state, and are regulated by its laws. To these societies the name of corporations is generally appropriated."* [9] Finally, it was in the Dictionary Act of 1981 that the United States which formalized the use of the word "corporation". [10]

Just as the idea of a corporation as a legal person is not a new idea, neither is the criticism of those on who scorn the profit-seeking institution. It was in response to those "*unadulterated socialists…who are unwitting puppets of the intellectual forces*" that Milton Friedman wrote his 1970 New York Times article, "The Social Responsibility of a Business is to Increase its Profits". [11] Although Friedman did well to point out the principle agent relationship of managers and employees, the lefts critiques only seemed to intensify in the years following. Some of the most influential anti-profit literature was published well after 1970. In the 1980s and 90's two very similar lines of thought began to develop which dominate college business schools today, even in supposedly conservative institutions like Grove City College The first is Corporate

[8] William Blackstone "Commentaries" Vol. II (New York, Augustus M. Kelly Publishers, 1969), p467.
[9] James Wilson, *Lectures on Law* Vol. I (Indianapolis, Liberty Fund, 2007), p636.
[10] GovInfo "Dictionary Act of 1871" Section 1
[11] Milton Friedman. *The Social Responsibility of a Business is to Increase its Profits* (New York Times, 1970)

Social Responsibility and the second is Stakeholder theory. Both of these ideas are academia's attempts to incorporate the aforementioned critiques into the inner workings of the firm.

Corporate Social Responsibility was first defined by Keith Davis in 1973 as "*The firm's consideration of and response to, issues beyond the narrow economic, technical and legal requirements of the firm*." [12] Most famously, it can be condensed down to the tripartite platitude "*people, planet, profit*" as coined by Jon Elkington in his 1994 article "Towards the Sustainable Corporation." Whatever the exact definition is, the general idea is that the corporation is to care for all groups, not just the shareholders.

Stakeholder Theory is the means by which executive managers are to figure out whose interests are supposed to be satisfied, if not the shareholder's alone. The theory says that for any business to be successful, it has to create value for all groups, for all of its "stakes". These groups include suppliers, employees, customers etc. The theory is most famously associated with University of Virginia professor Edward Freeman who asserts that the interests of all these "stakes" have to go together and it is, and ought to be, the duty of the socially responsible firm to make all the interests of these various groups align. [13] The Premise of professor Freeman is that the interests of these groups are naturally in conflict with each other, and it takes an intentional business manager to consider the interests of all stakeholders, not just the myopic pursuit of the bottom line, to make a successful firm

[12] Jeremy Moon *Corporate Social Responsibility: a very short introduction* (Oxford, Oxford University Press, 2014), p4.
[13] R. Edward Freeman *What is Stakeholder Theory?* (Corproateethics, 2009)

III. The Impossibility of Stakeholder Theory

To the economist, what the stakeholder theorists appears to be advocating for today is not so unlike that of British philosopher and economist Jeremy Bentham. Bentham was a utilitarian and took an artificial view on the topic of economic harmonies. Unlike Adam Smith, who took a natural view, Bentham believed that entities acting in self-interest creates disharmony in society. Accordingly, he was a big legislative champion for regulation and welfarism. Bentham popularized the classic utilitarian term "*the greatest good for the greatest number*". [14] Parliament was to consider the general welfare when making a law, not the welfare of any one particular group. Bentham advocated the use of felicific calculus as a means of measuring the utilities when considering an action. This is of greatly relevance for the topic now at hand. The very same challenges that faced Bentham's philosophy in 18th century Britain, face the "socially responsible" corporate executive today. How is a corporate executive to balance all of the interests of all the stakeholders, and then peruse the "policy" which best suits the most important of them? How is a corporate executive to even determine *who* the most important and *who* the least important stakeholders are in the first place? There are two primary problems with stakeholder theory. The first is the position of power problem and the second is the knowledge problem.

Firstly, the executives are good at managing a company to generate profits, but they have not been placed in such a powerful position for philanthropic reasons. It is beyond their skill set for them to determine what is best for the "general welfare". In his famous 1970 New York Times article, Milton Friedman does an excellent job pointing out that corporate executives have

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[14] Ekelund & Hebert *History of Economics Theory and Method* 6th edition. (Long Grove Illinois, Waveland Press, 3024), p137.

been contracted as agents by the shareholders. To abuse this position of power, Milton points out, would be to literally take the resources of the shareholders and use them for unauthorized activities, in other words to commit theft. Actually, some modern stakeholder theorists agree with at least part of Milton's claim. In a recent 2016 article, Robin Byerly, who himself is stakeholder theoristwrites, that the corporate executive has some sort of social duty, but it is more than clear that he has a fiduciary duty to do his job as an employee of the shareholders.[15] In his 1970 article, Friedman also points out that if corporate executives start behaving more and more like politicians, putting the general welfare above profit, their position of power will disappear. Executives will no longer be able to perform the business functions which were the impetus for their placement in the first place. In the words of Friedman, if businessmen are *"civil servants rather than employees of their stockholders than in a democracy they will, sooner or later, be chosen by the public techniques of election and appointment. And long before this occurs, their decision-making power will have been taken from them."*[16]

The second impossibility of stakeholder theory is the knowledge problem. Even if he were morally and practically free to do so, it would be impossible for an executive to weigh all the utilities or valuations of each stakeholder, and balance his decision making. The job of a"socially responsible" executive manager is beginning to appear more like economic calculation in the socialist economy than the straightforward profit mandate of capitalism. If executives are supposed to weigh interests of all multifaceted stakeholders, they will face the same challenges as addressed by famous 20th century Austrian Economist Ludwig Von Mises in his Economic Calculation Debate. Mises points out that prices reflect information, and in a system where there

[15] Robin Byerly *A New Institutionalism Approach to Stakeholder Theory.* as found in A Stakeholder Approach to corporate Social Responsibility (Burlington, MPG Books, 2012), p333.
[16] Milton Friedman *Capitalism and Freedom* (Chicago, Chicago University Press, 1962), p135.

are no prices, the cost and success of resource allocation cannot be determined. In fact, even if we assume that a socialist politburo is virtuously incentivized in the first place, successful resource allocation is impossible. In the words of Mises, "*All economic change, therefore, would involve operations the value of which could neither be predicted beforehand nor ascertained after they had taken place. Everything would be a leap in the dark. Socialism is the renunciation of rational economy*"[17]

Mises's ideas are not those of some far-off "crank", they are precisely the same concerns of socialists and stakeholder theorists alike. Oskar Lange, the famed communist economist who dueled Mises in the calculation debate if the 1930's once remarked of Mises that his contributions in exposing the flaw of economic calculation in the socialist economy were so great that "*Both as an expression of recognition for the great service rendered by him and as a memento of the prime importance of sound economic accounting, a statue of Professor Mises ought to occupy an honorable place in the great hall of the Ministry of Socialization or of the Central Planning Board of the socialist state*".[18]

Stakeholder theorists as well are just as honest. In the words of the very founder of stakeholder theory, the task of effectively balancing such utilities is so herculean that "*Management in today's corporation is akin to that of King Solomon*".[19] How can managers overcome such a knowledge problem? The typical response from such proponents is to begin by ranking each "group" in order of importance. Only then can stakeholder theory remain relevant. According to stakeholder theorist Robin Byerly, "*For stakeholder theory to have significance for the firm, of necessity, it typically involves prioritization of relevant stakeholder groups that*

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[17] Ludwig Von Mises *Socialism* (Northampton, John Dickens and Co., 1936), p122.
[18]Oskar Lange *On the Economic Theory of Socialism* (Review of Economic Studies, 2936), p53.
[19] Evan and Friedman *Stakeholder Theory for the Modern Corporation* (1988), p103.

are most closely linked and of the most important to the organization, and fashioning a genuine engagement with those parties." Perhaps after such a careful analysis, the stockholders themselves would come to mind as the group "*most important to the organization*", thereby yielding the entirety of stakeholder literature as wasted ink. It appears stakeholder theory is more than an impossibility; it is an absolute waste of hot air.

IV. Close Stakeholders as Net Beneficiaries

If demonstrating that stakeholder theory is impractical and impossible were not enough, it would be of great benefit to show that, actually, the claims of stakeholder theorists are unwarranted in the first place. Although the business functionally serves only the profit seeking interests (monetary or otherwise) of the shareholders alone, the interests of all other groups are actually aligned. Importantly, shareholders are the *chief* beneficiaries of profit, not the *sole* beneficiaries. Before it is demonstrated that all groups benefit by the activities of the profit seeking firm, some clarification on the nature of the shareholder is necessary. There are three preliminary observations to be made, the first two of which tie closely together.

Firstly, shareholders are not guaranteed profits. In fact, by definition of what it means to take equity ownership in an enterprise, shareholders assume all future profits and all future losses. Such a distinction has been noted as least as far back with 18th century economist Richard Centillion who observes that, whereas laborer's earn fixed wages, the "wages" of undertakers (entrepreneur's) are uncertain or "unfixed".[20] Richard Cantillon was highly influential in his work on the entrepreneur. He actually gives us the world for entrepreneur (he calls them 'undertakers') and it is Cantillon who notes the second distinction of importance to this paper;

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[20] Richard Cantillon Essay on the Nature of Commerce in General (New Brunswick, Transaction Publishers, 2003), p23.

entrepreneurs are risk takers. Looking back at our abstract analysis in part I. of this paper, it was the shareholder, the entrepreneur, who first put his own money down in order to get the business rolling. The shareholder put equity into the business in order to profit, but profit he might not. Thirdly, it is critical to understand that the "groups" identified by stakeholder theorists are not as rigid as depicted. In the unhampered market economy, individuals in one group can freely participate in the activities of another. Anyone can be a shareholder. Actually, in our current economic environment, more and more regular Americans are themselves becoming shareholders. The democratization of equity has been a fairly steady phenomenon since the beginning of the 20th century. In the 1920's, for example, roughly 10% of Americans owned stock. Today that proportion of the population is nearing 53%, thanks in larger part to 401(k) accounts.[21]

With those three preliminary observations out of the way, it is now time to run the gamut of all "near' stakeholders in order to demonstrate that they too benefit from profit seeking. The stakeholders covered here will be suppliers, customers, workers,managers and finally the bondholders, whose interests would appear to be completely antithetical to those of the shareholders.

A. Suppliers – a firm cannot operate without factors of production. Whereas a stakeholder theorist would advocate that managers consider the interests of the suppliers before making decisions, the reality is that by seeking profit, the manager already serves the suppliers. The very operations of the suppliers are only successful to the extent that a

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[21] FDIC.gov Historical Timeline (2014)

business can take those factor products and sell them as revenues. Remember the outline above, firms earn profits by generating greater revenues than costs. For revenues to be generated, factor products are necessary to be purchased in the first place, whether those factor products be tangible or intangible

B. Customers – When two persons exchange a product, we know, a priori, that the exchange is mutually beneficial. The buyer of a product prefers the other good more than the good (or money) already in the buyer's possession. That is not to say that there is not entrepreneurial error. An individual may be doing something that, in the long run, he comes to regret. But as far as can be known in the present, the exchange is a good one. No one is better equipped to judge the efficacy of the exchange than the two exchanging entities themselves. When a customer purchases a good from a company, no one is holding a gun to that customers head. The exchange is voluntary, and the biggest bearers of risk in the exchange are the two parties, therefore it is these two persons who are most incentivized to make a good decision.

A common adage that is often heard in the business world is that the customer is always right. You hear it not for the sake of flattery, but because for a business to disregard the customer is akin to shooting itself in the foot. The Customer is key, and it is in the manager's interest (it is in the manger's profit seeking interest) to figure out what exactly it is that the customer wants, perhaps even before the customer himself knows! Highly influential management author and consultant, Peter Drucker, hit the nail on the head when he says that…

> *"If we want to know what a business is we have to start with its purpose. And its purpose must lie outside of the business itself. In fact, it must lie in society since a business enterprise is an organ of society. There is only one valid definition of a business purpose; to create a customer. Markets are not created by God, nature or economic forces but by businessmen. The want they satisfy may have been felt by the customer before he was offered the means of satisfying it. It may indeed, like the want of food in a famine, have dominated the customer's life and filled his waking moments. But it was a theoretical want before; only when the action of a businessmen makes it effective demand is there a customer, a market… It is the customer who determines what a business is. For it is the customer, and he alone, who through willing to pay for a good or service, converts economic resources into wealth, things into goods…The customer is the foundation of a business and keeps it in existence"*[22]

In short, the customer is already of the highest concern to the executive manager because by trying to turn a profit, the executive manager must create and satisfy his customers. He must do one of the most challenging tasks a man can do; he must convince other human beings to voluntarily purchases goods in return for money. A difficult task indeed.

C. Workers and Managers – It is this group that stakeholder theorists have most in mind when advocating for a "wholistic" management framework. Indeed, to many moderns,

[22] Peter Drucker *The Practice of Management* (New York, Harper and Brother Publishing, 1954), p37.

the tasks and interests of the labor and capitalist (or shareholders) seem often to conflict with each other. This is no doubt a reflection of the pervasiveness of Marxist mentality on modern thought, even 130 years after Marx's death and three decades after the Soviet Union's. Are the interests of the (as Cantillon puts it) fixed and unfixed wage classes aligned or antithetical? The former is clearly the case.

Already we have recognized that the firm allows for individuals to improve their ability to profit via cooperation more so than they could unilaterally. Workers therefore become necessary components of the profit equation. But workers, like customers, have to be contracted voluntarily. The exchange of labor for wage is akin to that between business and customer. The business must somehow convince the worker to sell his labor, a difficult task. Entrepreneurs recognize that it is the human element of their operations is the most important aspect for delivering value to the final customer. Unhappy and inefficient employees with not make for a happy and efficient workplace. It is in the profit interests of the shareholders therefore, although minimizing costs, to maintain a content employee base. Robin Byerly belies that maintaining happy employees is necessary to prevent loss of talent to competing firms. "*An institutional employer that recognizes, not just the moral values of its human assets, but perhaps more significantly the benefits achieved by major competitors in recruiting and retaining employees and building strong supportive cultures, may smartly mimic those competitors by offering a more supportive work environment and benefit package."*[23]

[23] Byerly p336

Even so, it cannot be forgotten that the barriers between the two groups is far more blurred than theoreticians posit. The differences between shareholders and employees is not a caste demarcation. Recent scholarly work has been accomplished within this realm of business economics which applies nicely to the discussion of stakeholder theory at hand. The scholarship takes the idea that "with great power comes great responsibility" and applies it to the role of upper level management. Building upon already established entrepreneurial theory, economist Nicolai Foss and Peter Klein make the distinction between *original* judgement and *derived* judgement. Whereas *original* judgment is the discretion of the overall strategy of the firm and is determined by the owners of the firm, derived judgment is the delegated discretion of more trivial tasks. *Derived* judgment is that judgement for the corporate manager, not the shareholders to undertake. Moving down the "chain of command" in a firm from top to bottom, the significance of *derived* judgement is diminished until one arrives and the task of a common laborer whose tasks are clearly delineated and less skilled. Whereas the mere janitor works designated shifts and has few risks in his role, upper level management bears much uncertainty. The monetary reward for upper level management's efforts can vary greatly, depending on the success of their administration. Foss and Klein call these executive managers "proxy-entrepreneurs".[24]

Clearly it can be seen that the lines between owners and employees is quite blurred. Stakeholder theorists like Edward Freeman are confused when they say that the interests of shareholders, managers and employees are not aligned and that it is the job of

[24] Foss and Klein *Organizing Entrepreneurial Judgment: A New Approach to the Firm* (New York, Cambridge University Press, 2012), p191.

corporate big wigs to get them aligned. The fact of the matter is that, by mere profit seeking, everybody within the firm is already playing ball for the same team.

D. Creditors – A point all too lost on common people is the distinction between debt (or credit) and equity; between stocks and bonds. This distinction is of the highest importance for this paper. The premise of the stakeholder theorists, and of political pundits like Elizabeth Warren alike, is that via the profit seeking activities of firm owners, all other groups lose. If our leftie friends were correct, this would be nowhere more evident than in the relationship between debt holders and equity holders.

What is debt and equity? Equity, as discussed aboveis capital, whether it be goodwill or tangible, that individuals put into a business. On a balance sheet, equity is the difference between assets and liabilities. In terms of the economist, equity is the slice of the corporate pie that gives the holder of that slice the right to assume all future profits and losses. An equity ownership is what makes an individual an entrepreneur. From the perspective of the business, equity **is not** an obligation. It is simply a promise that, if there are any profits, those profits will be returned to the equity holder. From the perspective of the business, debt **is** an obligation. Through debt, a business acquires capital (in the form of money) today in exchange for the promise of future interest payments, and an eventual return of the principle. From the perspective of the lender (the creditor), exchanging cash for debt is also an entrepreneurial activity. The creditor hopes to get his principle back and some interest in order to make the exchange worthwhile. The reason for the exchange between creditors and debtors is simply time preference, the

preference for present money over future money. If one were to listen to Elizabeth Warren and Edward Freeman, wouldn't it seem that creditors would get the short end of the stick every time? Clearly, however, this is not the case. The interests of the shareholders and the debt holders are aligned for several reasons. Asymmetry of information and the potential moral hazard of debt are primarily mitigated through three financial activities. These activities will show that the although seaming antithetical, the interests of even the shareholders and bondholders are aligned. Finally, an examination of bankruptcy will reveal that in circumstances of business failure, it is the shareholders who are last in line to collect a check, if at all.

The first of these three activities are covenants. Influential New York University Stern School of Business professor, Aswath Damodaran, describes covenants as "*the most effective way for bondholders and lenders to protect themselves*".[25] These covenants are basically restrictions on the activities of the business. A banker lends to the firm, but with conditions. Lenders may limit the firm's investment activities. For example, a lender to a bank may lend profligately, but only on the condition that the bank not underwrite mortgages to sub 550 FICO borrowers. Lenders may also restrict dividends to a certain payout ratio. Lenders may even restrict additional leverage, such as setting maximum total debt to consolidated net worth ratios. The short of it is that, when lenders lend, strings get attached. The second activity that lenders can do, and often do, to protect themselves is to simply take a complementary equity stake in the firm. As Damodaran points out, this can be done at the outset of the loan, or by lending convertible bonds

[25] Aswath Damodaran *Applied Corporate Finance* 4th edition (Danvers, John Wiley and Sons, 2015), p41.

which transition from debt to equity.[26] The last financial activity which mitigates asymmetry and aligns the interests of the share and bond holders is a financial innovation known as puttable bonds. These securities give the holder the right to return the bond to the issuing company and receive the face value of the bond should some breach of contract occur. All of these example powerfully serve to show that, via profit seeking, the interest of both shareholders and debtholders, although seemingly antithetical, are indeed both united.

It is not in the interest of the debt holders for a business to suddenly become "socially responsible" and risk ruin. However, there is another group which actually would like to avoid a corporate bankruptcy even more than the debt holders. Those are the shareholders. Indeed, bankruptcies demonstrate the fundamental ignorance of our leftie friends when they criticize the owners of the means of production. That is because in a bankruptcy, the creditors are first in line to receive the proceeds from liquidated assets. The shareholders only get the left-over scraps! The reason for this goes back to the beginning. Shareholders are not guaranteed returns, they assume both future profits **and** losses. Shareholders, as entrepreneurs, are the greater bearers of risk in the investment world. It isn't always profits and daisies for the Bourgeoisie.

V. Conclusion

This paper has covered much ground. In section one, the facts of the case were outlined. The theory of exchange was summarized, and the basic mechanics of profit and loss were shown. Furthermore, it was demonstrated that the firm is a natural phenomenon arising from the

[26] Ibid p42

cooperative interest of multiple individuals seeking to profit. In section two, criticism of the profit seeking firm were outlined and an alternative decision-making model explained. The personhood of the corporation was discussed along with the legal history of such recognition. Warren's criticism were complemented with those of the "stakeholder" theorists like Edward Freeman, Robin Byerly and others who also denounce profit as the ultimate guide for corporate behavior. In section three, the impossibility of stakeholder theory is outlined. The problem is twofold. The first is the position of power problem. If executives begin acting like politicians, their position will be relegated to politicians. The second problem is the knowledge problem, an issue that stakeholder theorists themselves are still wrestling with. Finally, in section four, each major group is examined to see if indeed their interests are antithetical or aligned with those of the shareholders. Interestingly, Foss and Klein's work on 'proxy-entrepreneurs" is applied to demonstrate that these "groups" are not so rigidly defined as they appear and that employees too are incentivized by corporate profit. Damningly, it is demonstrated that even creditors would like the business to be as profitable as possible.

Are businesses, by only perusing profits, incentivized to harm all other groups or are the incentives of all groups aligned thanks to the desire forprofit? The conclusion is that the incentives of stakeholders are already naturally aligned via self-interest and profit seeking. Furthermore, for the business run by non-majority shareholders, any deviation from such a profit seeking behavior (e.g. stakeholder theory) is both meaningless and impossible.

Unfortunately, this work is not truly complete without a discussion of "remote" stakeholders as well. Given limiting factors, it was impossible to include such a lengthy dialogue. With future time and resources, a discussion of the alignment of harmonies would be fruitful. The use of 19th century Frederic Bastiat's "Economic Harmonies" would likely prove of

great value in understanding how the unhampered market economy fosters *uniform* alignment of interest, although perhaps not mutually beneficial action. In the meantime, this paper demonstrates sufficiently enough that, thanks in full to the very nature of profit seeking, all stakeholder's interest are indeed naturally aligned.

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