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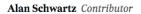
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— Opinion

Why Milton Friedman was right and wrong

The Friedman doctrine was right and wrong about the responsibility of business. For democratic capitalism to live up to its name, voters, not corporate interest, must set the rules of the game.





Fifty years ago to the day, Milton Friedman set forth the famous <u>"Friedman doctrine"</u>. In biting prose, he rejected the idea that business has "responsibilities for providing employment, eliminating discrimination and avoiding pollution", and argued that the "one and only social responsibility of business" is to maximise its profits.

The past decade has brought a Cambrian explosion in species of "socially responsible" capitalism: sustainable investing (environmental, social and governance), impact investing, inclusive capitalism, conscious capitalism and stakeholder capitalism, to name a few. What does the doctrine mean for this throng of would-be reformers?



To solve climate change, economists estimate that \$US10 trillion (\$13.7 trillion) in profits would need to be forgone by 2030. It would be optimistic to believe that businesses and investors will sacrifice 1 per cent of this figure.

Many of them are inclined to <u>dismiss Friedman out of hand</u>. This is understandable. We are at the tail end of an era powerfully shaped by Friedman, Friedrich Hayek and other free market enthusiasts, and the environment, society and democracy are in a shambles. But serious reformers should not be so hasty. The Friedman doctrine offers them two precious gifts.

The first is insight into what it takes to change society. Right or wrong, it is the clarity and coherence of Friedman's vision of the economic system that gave it such lasting influence over economists, businesspeople and policymakers. Today's advocates of socially responsible capitalism, by



contrast, offer an anarchy of buzzwords, hype and improbable promises. Most conspicuously, they do not explain how their piecemeal strategies – most of which lean heavily on the weak reed of voluntary action – will coalesce into a system that is potent enough to address the challenges we face.

The second is a matter of substance. I do not aim to defend Friedman's body of work in general. For example, his faith in consumer rationality led him to favour the elimination of licensing for doctors. Is there a single reputable economist who supports this today? But the logic of the Friedman doctrine is, for the most part, impeccable. Reformers cannot go around it; they must find a way through.

In particular we have in mind Friedman's division of labour between business and government. The role of the voting majority is, through its elected government, to set the rules of the economic game. The role of business is to maximise profits within those rules. Friedman identifies three problems that arise when business begins to replace government as the pursuer of social goals.

The first problem is of knowledge. The corporate executive is "an expert in running his company – in producing a product or selling it or financing it". However, "nothing about his selection makes him an expert on inflation" or an expert in satisfying public preferences on any other social or environmental issue. Should the preferences of unaccountable executives, rather than of voters, determine how much tax is paid, which schools and hospitals to fund, or how to deal with pollution?



Milton Friedman addresses the National Press Club in Canberra in 1975

The second problem is of incentives. "Socially 1975.

responsible" business relies on voluntary action. With Friedman, we share Adam Smith's scepticism about how much we can expect from "those who affected to trade for the public good". To solve climate change, economists estimate that \$USI0 trillion (\$13.7 trillion) in profits would need to be forgone by 2030. It would be optimistic to believe that businesses and investors will sacrifice 1 per cent of this figure.

The third problem is of redundancy. The very purpose of the division of labour is that voters have the power to ensure that profit-seeking is socially responsible. If the rules of the game are right and externalities such as carbon emissions are properly costed, then all investment is socially responsible. In such a case, as Hayek put it, "by pursuing profit we are as altruistic as we can possibly be".

Of course, businesses can do good where the rules fall short. But socially responsible capitalism will remain a bit player. Rule-making and profit-seeking are the two core mechanisms of our system – it is called "democratic capitalism" for that reason. If we cannot get these mechanisms working then no amount of volunteering at the edges can fix them.

Where, then, has this system - and Friedman's doctrine - gone wrong?

The market society only works if voters can set the right rules. However, because profits can be increased by weakening competition, evading taxes

or suppressing climate regulation, Friedman recognised that business would seek to bend and capture the rules of the game. He went so far as to declare business one of the "two great enemies" of the market society.

This puts Friedman in a diabolical bind: the sole responsibility of managers is to maximise profits, and a key means of maximising profits is bending rules in their favour. It follows, then, that distorting the regulatory structure is one of the key responsibilities of business. In short, the 'Friedman doctrine' means that business has a "social responsibility" to erode democracy.

Friedman argues it is up to voters to keep business in check. But what if voters are unable to suppress the enemies of the free enterprise system? What if business, through lobbying, campaign finance and distortion of the media, displaces voters as the most important influence on regulation?

On this, Friedman is silent. His model falls short.

Friedman is right that business cannot assume the mantle of government. But he is wrong when he says that it has "one and one only social responsibility". Business has two social responsibilities: first, to maximise profits, and, second, to leave the rules of the game to the voter.

Without misinformation campaigns and corporate influence, we would have had tobacco regulation decades earlier and carbon pricing would already be widespread. Because rule-setting and profit-seeking are the two core mechanisms of democratic capitalism, we must restore the power of the informed voter.

The mark of the socially responsible executive is not that they make voluntary investments as a meagre substitute for good government. It is that they follow, and enforce among their peers, a new norm: businesses should be rule-takers and not rule-makers. Only then can democratic capitalism live up to its name.

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