This is the eighth of a series examining the moral dimensions of economic "externalities", the spillover or incidental side effects in market activity.

The series is available in expanded form, with an introductory chapter and updated essays, as an e-book to facilitate reading and annotating: https://nmichaelbrennen.com/shop/.

Standard business school theory teaches the centrality of maximizing shareholder value. A recent Forbes article summarizes two textbooks in which that theory is the core of the curriculum; while decades ago that idea worked, it no longer does. As recounted in the article, in 2009 Jack Welch, the storied CEO of General Electric, stated this in a *Financial Times* interview: "On the face of it, shareholder value is the dumbest idea in the world. Shareholder value is a result, not a strategy… your main constituencies are your employees, your customers and your products."

This shift in thinking reflects an idea that emerged over 30 years ago: stakeholder theory. In the Preface to his book on the topic, Edward Freeman defined a stakeholder as "any group or individual who can affect, or is affected by, the achievement of a corporation's purpose" (145.) As Jack Welch expressed, employees and customers are among those whom a business must consider as having a stake in its operation, not just shareholders; the smallest proprietorship to the largest multi-national corporation are thus within the scope of stakeholder theory. Employees find work or not, and customers have the products they want or not, as businesses prosper or fail; stakeholder theory wants to account for their interests as well.

While Freeman did not particularly discuss externalities per se, the concept is all through stakeholder theory, in that anyone that can be influenced by a company's production, or anyone that can influence a company's production in any number of way, should be considered within a corporation's planning. For example, considering corporate social responsibility, Freeman cited a 1975 work by W. Dill that noted that management had long seen seen the "views and initiative of stakeholders as externalities to the strategic planning process … as data to help management shape decisions. … The move today is from stakeholder influence toward stakeholder participation" (1001.) Freeman further noted that failing to take stakeholders into account is "asking for more regulation of 'externalities,' more social critics and ultimately less productive work" (1509.)

Stakeholder theory opens corporate thinking from a narrow, self-interested view of one's productive activities to include those who can be affected by and who can affect those activities. Though Freeman did not mention Ronald Coase, it seems to me that stakeholder theory is implicitly founded on Coase's 1960 argument that social costs are mutual; stakeholder theory in turn seeks to engage the interested parties in negotiation – or at least seriously consider stakeholders' views – in order to find a balance of interests. Freeman's proposal is for "effective management" that integrates the ideas of social responsibility and business issues, rather than seeing them as two opposing directions (1956.)

Freeman noted that values and ethics of various sorts are now recognized, both at the organizational and personal level: "value judgments are a primary ingredient of a successful strategy" (1943;) he noted aesthetic, social, religious, and moral values (2063.) Dissonance between an organization and its various stakeholders may mean that successful transactions rarely occur (2089.) Freeman analyzed five types of stakeholder corporate strategy listed below that "can be seen as achieving 'fit' among stakeholders, values, and social issues. (Exhibit 4.6, loc. 2156;) others are also possible. These are not simply another call for corporate social responsibility; rather, it is finding coherence between an organization's values and its stakeholders (2262,) even dissolving the conflicts between them (116.)

1. Specific stakeholder strategy: Maximize benefits to one or a small set of stakeholders
2. Stockholder strategy: Maximize benefits to stockholders or "financial stakeholders"
3. Utilitarian strategy: Maximize either the benefits or the average welfare level of all stakeholders, or to society
4. Rawlsian strategy: Seek to raise the level of the worst-off stakeholder
5. Social Harmony strategy: Seek to create social harmony or gain consensus from society

Apart from Hausman's work as a philosopher, the role of values play a significant difference between Freeman's management work and the economic works previously considered in this series. Coase and Demsetz ignore values, leaving it to the parties to transactions to find a balance between their individual values and their willingness to translate them into money amounts. Freeman acknowledged the novelty of the idea of trying to synthesize the impersonal, rational mode of corporate thinking with the values-laden interests of stakeholders (1952.)

An organization operating within stakeholder theory may be much more integrated with its stakeholders than anything that seems possible in welfare economics. In Pigovian welfare economics, the State is the mediator that seeks to internalize the externalized costs through taxes or bounties. In stakeholder theory, organizations directly engage Coasean transaction costs: the costs of identifying stakeholders, determining their impact, establishing communication and/or dialogue, and eventually finding common ground could well be high. Yet, in the process of engaging stakeholders, costs that might otherwise be externalized are in fact internalized or avoided through negotiations. If this is correct, stakeholder theory seems to accomplish the Coasean goals of negotiating settlements between parties, despite high transaction costs and in a more complete manner than Coase, because engaging stakeholders includes the dimension of values. Where such transaction costs could well seem excessive for standard rational economic efficiency arguments toward maximizing stockholder value, for Freeman such transaction costs are integral to the survival of a business, summarized in the following statement.

> The "reason for being" for most organizations is that they serve some need in their external environment. When an organization loses its sense of purpose and mission, when it focuses itself internally on the needs of its managers, it is in danger of becoming irrelevant. Someone else (if competition is possible) will serve the environmental need better. The more we can begin to think in terms of how to better serve stakeholders, the more likely we will be able to survive and prosper over time. (1755)

In conclusion, as I see it, stakeholder theory is a strong movement toward recognizing Daniel

Hausman's view that we should try to come to "a view of market processes that sees voluntary exchange among individuals as an integral part of a series of complex social linkages" (§6.) It also may be able to accomplish the Coasean goal of internalizing or avoiding many external costs.

Coase, Ronald. "The Problem of Social Cost." *Journal of Law and Economics*, Vol 3 (Oct., 1960), pp. 1-44. JSTOR: http://www.jstor.org/stable/724810

Freeman, R. Edward. (1984.) *Strategic Management: A Stakeholder Approach*. Kindle e-book edition. Cambridge: Cambridge University Press. All references are to the Kindle location.

Hausman, Daniel. "When Jack and Jill Make a Deal." *Social Philosophy and Policy* 9 (1992): pp. 95-113. Unpaginated HTML text available at http://philosophy.wisc.edu/hausman/papers/jack-and-jill.htm