Friedman's Feedback Loop

by

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Fifty years ago, with Economics in the grip of reductionism, Milton Friedman wrote his famous article arguing 'the social responsibility of business is to increase its profits'.

Placing Friedman's statement under the modern lens of systems dynamics reveals that he initiated a feedback loop – 'Friedman's Feedback Loop' – which propels the runaway corporatism that continues to destabilize our society and environment.

A systems perspective suggests the debate on 'corporate purpose' is off target. Instead, it is the relationship between corporations and governments – the 'in-betweenness' – that requires mending.

In a famous article written 50 years ago this week, Milton Friedman argued 'the social responsibility of business is to increase its profits'.[1] The statement remains a lightning rod for the debate on 'corporate purpose' – whether public corporations should be managed just for the benefit of shareholders or for a broader set of stakeholders, including employees, suppliers and the community.

We continue to go back and forth. In 2019, to much fanfare, 181 CEOs of the US Business Roundtable publicly committed to manage corporations for stakeholders – reversing their 1997 statement that upheld shareholder primacy![2] Not so fast, countered Harvard Law Professors Lucian Bebchuk and Roberto Tallarita, who argued that stakeholderism can backfire in insulating corporate leaders from external accountability and compromising economic performance… to the detriment of broader stakeholders![3]

An Essay of its Time

Friedman's essay was necessarily of its time. In 1970, Friedman was one of the leading economists of his day. However, and not really his fault, he presided over a discipline profoundly shaped by a reductionism that was then the deep guiding force of social sciences, but which has since revealed limitations.

Economics was not alone in being so waylaid but was arguably most affected. The extraordinary explanatory power of reductionism in the hard sciences over the preceding centuries had drawn all fields with scientific pretensions in the direction of physics and its methods. Social scientists were

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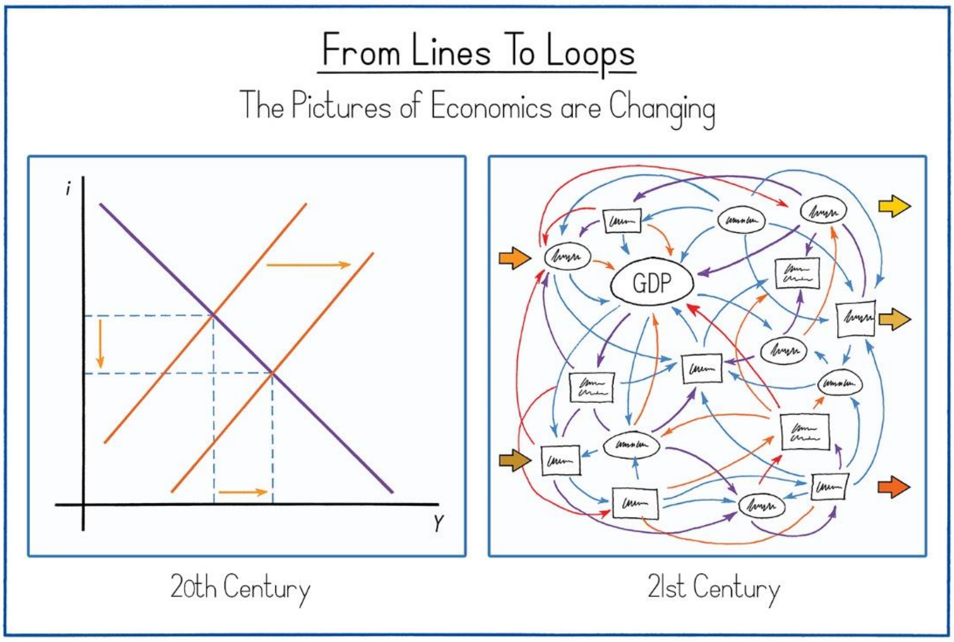
eager for their own simple, universalizable laws and for the prestige which might follow such discoveries.

But, fifty years on, general laws in the social sciences remain elusive, and another development from the 1970s clarifies why. Even as Friedman was penning his op-ed, a new science – ‘complexity science’ – was emerging. Complexity science – and its associated ‘systems thinking’ – began to announce itself with the formation of the Santa Fe Institute in 1984. In its foundations, complexity science rejects some of the simplistic premises of reductionism that, while sufficient to unravel the mysteries of classical physics and chemistry, falter in explaining the behaviour of living systems, which are, well, more complex. The gathering momentum of systems thinking since the 1970s, aided by computational advances, crystallizes a sense that we have reached diminishing returns to reductionism as a perspective to comprehend the world.

At its core, systems thinking encourages us to see the world in loops, not lines. All complex systems contain ‘positive’ or reinforcing loops, which exacerbate situations – think of stock market bubbles or vicious spirals – and ‘negative’ or dampening loops, which balance a system – think of a thermostat preventing a house from getting too hot or too cold or your body’s innate ability to do the same. At any time, the overall dynamic of a system depends on whether the reinforcing loops or the dampening loops have the upper hand. In the former, runaway situations develop. In the latter, a system exhibits balance. Economics is starting to grasp this – ‘complexity economics’, no less – but back in 1970, this all lay in the future.



Friedman’s Feedback Loop

If one now submits Friedman’s op-ed to a systems perspective that was in its infancy when he wrote, it becomes a more interesting document. While the article’s clearest argument is that companies should refrain from pursuing unprofitable social or environmental goals, what is insufficiently recognized is that it simultaneously licenses companies to obstruct any costly social or environmental policy.

In a political system where corporations can influence policymaking – via lobbying, financial support for candidates, or other means – Friedman's contention justifies corporations investing to shape policies in their interest. For, if the expected return on expenditures committed to influencing regulations is greater than a company's weighted average cost of capital, and if lobbying against regulations is permitted under what Friedman terms the 'rules of the game', then the notion that companies have a social responsibility to maximize profits *equates to firms having a social responsibility to resist any regulation that appears costly*. Not all companies may choose to act this way, but the key is that companies have a profit incentive to do so and so enough companies will. And, over a long enough period, this will affect the behaviour of the whole system.

In complexity terms, Friedman's op-ed sanctions the development of a positive feedback loop from corporations to the policymaking arena, in which a portion of corporate profits are invested into shaping laws and rules to enable higher future profits, which in turn creates more funds to reinvest into shaping future laws and so on. One might call it Friedman's Feedback Loop.

If reinforcing feedback loops are not counterbalanced by dampening feedback loops, runaway dynamics ensue. Human society is a complex adaptive system in which countless loops of differing magnitudes and speeds are running all at once, some cancelling each other out, some amplifying each other further. However, Friedman's Feedback Loop stands out as a particularly strong dynamic. It has propelled a succession of regulatory and legal changes that has steadily bolstered corporate influence over politics and so shifted a more balanced earlier form of capitalism towards today's runaway corporatism.

As this feedback loop has persisted, Friedman's statement has become increasingly tautological – what is profitable increasingly defines what is socially responsible. The meaning of 'social responsibility' collapses from something that citizens and governments might define in the public interest into anything that increases corporate profits. In turn, the domain of viable socially responsible initiatives is restricted to only those actions that might be profitable, which is the constraint now binding the ESG (environmental, social and governance) and impact investing communities. They seek to remedy the social and environmental problems left behind by the profit-driven market system, but, perversely, find they can only implement investments or projects that are profitable! They are caught in the Loop.

Complete or Incomplete Markets?

In all of this, what ultimately determines the soundness of Friedman's contention is the context. None of this would be a problem in a world of 'complete markets', which was another deep, physics-inspired, assumption underpinning mid-20th Century economics. In a hypothetical world of 'complete markets', all human preferences would be marketized and Friedman's argument would be valid. Social values and market values would entirely align.

Complete markets would effectively launder self-interest – whether individual or corporate – of any of its negative connotations identified through the ages. In a system of complete markets, everyone could follow their self-interest with abandon and markets would 'add back up' the results of everyone's pursuit of self-interest to arrive at the best of all possible worlds. Greed would not just be 'good', but the impulse necessary to make the system work. In this utopia, the best contribution business could make would, indeed, be to maximize profit.

Of course, 20th Century economists recognized that markets were not really complete, *but, critically, they believed them complete enough that we should proceed as if they were*. And so, we diligently set about making our contemporary world in the image of 20th Century economic theory. Economic growth became the end; shareholder value maximization (SVM) became the means.

Alas, we are awakening to the fact we live in a world of 'very incomplete markets'. Ecological economists estimate that the value of 'services' provided free by the Earth's ecosystem is roughly twice the value of global GDP. Unpaid housework may be half again the value of GDP. Large chunks of what is valued by humans lie outside the market's grasp.

In the real world of very incomplete markets, Friedman's innocent-seeming contention becomes existentially disingenuous. Friedman's Feedback Loop becomes the conduit by which corporations shape the bounded market domain to *include* what is profitable – your personal data, perhaps? – and *exclude* what is costly – such as a price on carbon emissions. Shorn of the laundering magic of complete markets, self-interest starts to look like, well, plain old selfishness. Complete market theory, which was a powerful influence over 20th Century economics, starts to look like an elaborate justification for greed. And so, as Friedman's Feedback Loop has gathered momentum, a 'trickle-down' economy has slowly but surely reversed into a 'flood-up' economy and policy initiatives to protect the environment have been pushed ever further away. In a world of very incomplete markets, the social and ecological fabric simply cannot withstand the increasingly muscular maximization of such narrowly constituted profit.

Fixing The 'In-Betweenness'

So, how to resolve? In emphasizing the loops in a system, complexity thinking shifts attention away from entities and towards the *relations* between entities – to the 'in-betweenness' of a system. The persistence of unmet stakeholder needs is not so much rooted *in* corporations or *in* government, but in the *relationship between* corporations and government (and, indeed, between all human institutions).

Hence, the debate on corporate purpose is slightly off-target. Stakeholder advocates might do better to aim at the 'in-betweenness'. In practice, this would be to press for greater separation of Commerce and State and the severance of Friedman's Feedback Loop.

Of course, some will argue that this impinges upon corporate freedoms, but separation between spheres of human activity is commonplace: students are not free to mark their own exams, football players not free to call the offside line, politicians (ideally) not free to count the ballots. What makes all these activities work satisfactorily is a clearly defined *functional relationship* between parties that generates a healthy and sustainable outcome for the overall system. In other words, redefining *the relationship between the corporation and the government* might allow us to 'break the cycle' that propels our economic system to its increasingly unfair and environmentally damaging outcomes.

I recognize this is an unlikely moment to place one's hopes in a more liberated public sector. Even some of the more dependable governments of recent times are today in disarray. But we should not be surprised by this. An inevitable consequence of Friedman's Feedback Loop is the development of a complementary reinforcing loop: a 'Government-is-the-Problem' Loop. In self-fulfilling fashion, this loop has inexorably eroded the capability and competence of government and its ability to attract and retain the best talent. And so, at least regarding environmental and social issues, the free market has secured the government it wanted, which is to say one that does the market's bidding and not much else.

Our collective capacity to manage public goods problems has been eroded, as COVID-19 has brutally exposed. Unfortunately, the grander timing could not be worse: 20th Century Economics guided us to diminish public sector capacity, just as we identified, in the global ecological crisis, the greatest public goods problem of all time.

Friedman wrote in the grip of a reductionism that had slowly crept up from hard sciences to natural sciences to social sciences ultimately, with his help, to shape our socio-economic form. *We reduced ourselves*. Today, natural sciences and many social sciences are retreating from the blinkered perspective of reductionism. Economics and finance remain the last bastions of reductionism but consequentially so, as these are the disciplines that continue to most shape our attitude to the world. We urgently need to *unlearn* 20th Century economics and finance foundations.

Back Round to the Roundtable

Which brings us back to the Business Roundtable statement of 2019, because highly conspicuous by its absence was any mention of the role government or public policy might play in meeting a broad set of stakeholder issues. It was a statement more notable for what it did not say than for what it did say.

If the 181 CEOs are sincere about addressing a wide swath of environmental and social issues that continue to beset modern society, a helpful next step might be to publish a similarly succinct statement describing what they believe is an appropriate relationship between corporations and government for a 21st Century marked by global public goods challenges. Such a statement might commit to releasing government from corporate influence to begin to restore society’s capacity to address social and environmental problems with public policies that are a better match for the scale and nature of those problems than piecemeal corporate initiatives ever will be.

I have no doubt that 181 CEOs could make a real contribution on this issue. The key question, which is the question that frankly underlies this whole 50-year debate, is whether business leaders can find the courage to renounce the bogus justifications for the pursuit of corporate self-interest at any cost in order to help rebalance our social and ecological systems.

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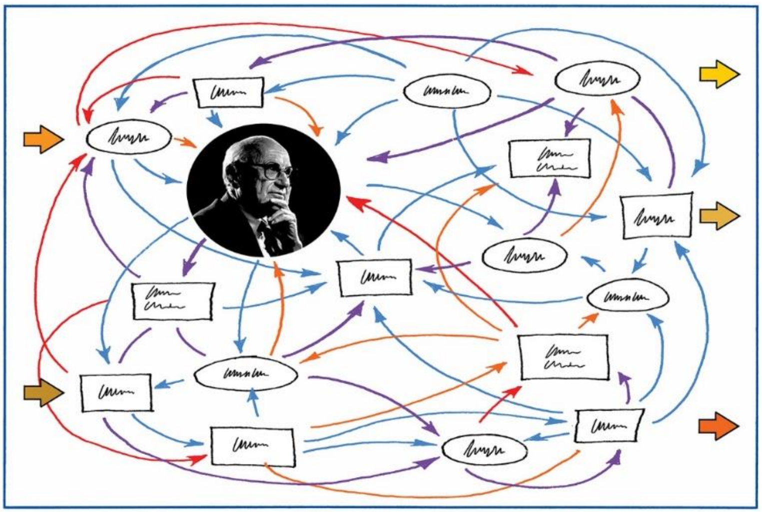

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