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Stakeholder Theory and "The Corporate Objective Revisited"

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Stakeholder theory begins with the assumption that values are necessarily and explicitly a part of doing business. It asks managers to articulate the shared sense of the value they create, and what brings its core stakeholders together. It also pushes managers to be clear about how they want to do business, specifically what kinds of relationships they want and need to create with their stakeholders to deliver on their purpose. This paper offers a response to Sundaram and Inkpen's article "The Corporate Objective Revisited" by clarifying misconceptions about stakeholder theory and concluding that truth and freedom are best served by seeing business and ethics as connected.

Key words: stakeholder theory; corporate objectives; separation thesis; value creation; stakeholder relationships

Stakeholder theory is managerial in that it reflects and directs how managers operate rather than primarily addressing management theorists and economists. The focus of stakeholder theory is articulated in two core questions (Freeman 1994). First, it asks, what is the purpose of the firm? This encourages managers to articulate the shared sense of the value they create, and what brings its core stakeholders together. This propels the firm forward and allows it to generate outstanding performance, determined both in terms of its purpose and marketplace financial metrics. Second, stakeholder theory asks, what responsibility does management have to stakeholders? This pushes managers to articulate how they want to do business—specifically, what kinds of relationships they want and need to create with their stakeholders to deliver on their purpose. Today's economic realities underscore the fundamental reality we suggest is at the core of stakeholder theory: Economic value is created by people who voluntarily come together and cooperate to improve everyone's circumstance. Managers must develop relationships, inspire their stakeholders, and create communities where everyone strives to give their best to deliver the value the firm promises. Certainly shareholders are an important constituent and profits are a critical feature of this activity, but concern for profits is the result rather than the driver in the process of value creation.

Many firms have developed and run their businesses in terms highly consistent with stakeholder theory. Firms such as J&J, eBay, Google, Lincoln Electric, AES, and the companies featured in *Built to Last* and *Good to Great* (Collins 2001, Collins and Porras 1994) provide compelling examples of how managers understand the core insights of stakeholder theory and use them to create outstanding businesses. Whereas all these firms value their shareholders and profitability, none of them make profitability the fundamental driver of what they do. These firms also see the import of values and relationships with stakeholders as a critical part of their ongoing success. They have found compelling answers to the two core questions posed by stakeholder theory, which underscore the moral presuppositions of managing—they are about purpose and human relationships.

Stakeholder theory begins with the assumption that values are necessarily and explicitly a part of doing business, and rejects the separation thesis (Freeman 1994). The separation thesis begins by assuming that ethics and economics can be neatly and sharply separated. In this context, the challenge of doing business ethics or improving the moral performance of business becomes a Sisyphean task because business ethics is, by definition, an oxymoron. Many proponents of a shareholder, single-objective view of the firm distinguish the economic from the ethical consequences and values. The resulting theory is a narrow view that cannot possibly do justice to the panoply of human activity that is value creation and trade, i.e., business.

In our view, Sundaram and Inkpen (2004) exhibit their commitment to such a narrow interpretation of the shareholder ideology in their paper "The Corporate Objective Revisited." They begin, "Governing the corporation requires purposeful activity. All purposeful activity, in turn, requires goals." They conclude that the goal of "maximizing shareholder value" is the only appropriate goal for managers in the modern corporation.

More subtly, according to McCloskey (1998), the "maximizing shareholder value" view is put forward as a "scientific" theory that is modeled and verified appropriately by ideologists called "economists." Unfortunately, in an attempt to be accepted by their "scientific brethren," several management theorists have adopted

the fashion of accepting the economic view of business activity as the most useful one available and have fallen into the trap of the separation thesis. "Maximizing shareholder value" is not a value-neutral theory and contains vast ideological content. At its worst, it involves using the prima facie rights claims of one group—shareholders—to excuse violating the rights of others. Shareholder rights are far from absolute, regardless of how much economists talk about the corporation as being the private property of the shareholders. The rights of shareholders are prima facie at best, and cannot be used to justify limiting the freedom of others without their consent.

We wish to offer three main critiques of "The Corporate Objective Revisited" (Sundaram and Inkpen 2004). First, Sundaram and Inkpen have grossly mischaracterized stakeholder theory. Second, there are good reasons for rejecting their arguments for the primacy of shareholder value maximization. Indeed, if stakeholder theory is understood in a fairly commonsense way, then many of the opposite conclusions could be drawn. Finally, we suggest that if the underlying ideological issue is one of either economic or political freedom, then Sundaram and Inkpen would do better to become pragmatists and join the big tent of stakeholder theorists. We take each point in turn.

The Mischaracterization of Stakeholder Theory

One of the most glaring errors of their paper is that Sundaram and Inkpen decide to lump all views that are not the shareholder maximization thesis as stakeholder views. They claim that stakeholder views have dominated significant periods of time over the past 150 years (Sundaram and Inkpen 2004). They lump all the following diverse activities together as part of a stakeholder approach to corporate governance: corporate chartering, unions, acting in the interests of consumers, paying attention to the natural environment and, we would suppose, Nader's proposal for federal chartering, stakeholder statutes (some of which are obvious excuses for managerial self-dealing), proposals for independent directors with a sense of public good, and criticisms of globalization.

Although stakeholder theory can be many things to many people, it does not follow that we should cast it as "everything nonshareholder oriented." First, it is important to remember (as Sundaram and Inkpen have forgotten) that shareholders are stakeholders. Dividing the world into "shareholder concerns" and "stakeholder concerns" is roughly the logical equivalent of contrasting "apples" with "fruit." Shareholders are stakeholders, and it does not get us anywhere to try to contrast the two, unless we have an ideological agenda that is served by doing so.

Second, Sundaram and Inkpen write a great deal about the difficulty of resolving conflicts among stakeholders and figuring out how to treat different groups (Sundaram and Inkpen 2004). Not only is this concern overblown, it is not unique to the stakeholder view. Advocates of the shareholder view also have to deal with this criticism, even if they have a different and more simplistic theory to use. On what terms are we going to get stakeholders to sign on and give their best for the firm? Ironically, we would argue that stakeholder theory gives managers more resources and a greater capability to deal with this challenge, because they can offer not only financial reward, but language and action to show that they value relationships with other groups and work to advance their interests over time. In an era when firms are relying on committed value-chain partners (e.g., employees and a whole range of suppliers in the supply chain) to create outstanding performance and customer service, stakeholder theory seems to provide managers with more resources to find success.

Third, Sundaram and Inkpen (2004) blow the problem of "whose values count" out of proportion and make it seem an impossible task. Again, there are many companies that have addressed this challenge, and that use their answers to the values questions posed by stakeholder theory to run successful businesses over a long time (e.g., Merck, J&J, 3M, and Motorola). If we see this as a pragmatic exercise of firms with their stakeholders to find ways to cooperate with each other the task is a lot easier and admits a variety of answers—something that fits a pluralistic culture that values freedom and voluntary cooperation. If we see it as a philosophical problem that has only one answer, an answer which has to conform to the rigors of Kant's categorical imperative, then life gets much harder. Stakeholder theory pushes managers to embrace the pragmatic and pluralistic approach and recommends we avoid the philosophical and single-theory approach.

Fourth, and finally, stakeholder theory does a better job of explaining and directing managerial behavior in markets. Stakeholder theory claims that whatever the ultimate aim of the corporation or other form of business activity, managers and entrepreneurs must take into account the legitimate interests of those groups and individuals who can affect (or be affected by) their activities (Donaldson and Preston 1995, Freeman 1994). It is quite natural to suggest that the very idea of value creation and trade is intimately connected to the idea of creating value for stakeholders. Business is about putting together a deal so that suppliers, customers, employees, communities, managers, and shareholders all win continuously over time. In short, at some level, stakeholder interests have to be joint—they must be traveling in the same direction—or else there will be exit, and a new collaboration formed (Venkataraman 2002). The best deal for all is if managers try to create as much value for stakeholders as possible. There are, of course, conflicts among stakeholder interests but these conflicts must be resolved

so that stakeholders do not exit the deal—or worse—use the political process to appropriate value for themselves or regulate the value created for others.

All of this seems to us to be managerial common sense, dressed up in its Sunday finery for publication. Stakeholder theory is inherently managerial, as Donaldson and Preston (1995) argue and as countless executives have testified (for a recent example, see George 2003). As we argue elsewhere in this journal, stakeholder theory finds its justification in a pragmatist approach to management theory (Wicks and Freeman 1998).

The Primacy of Creating Value for Stakeholders

The main rhetorical thrust of Sundaram and Inkpen comes in a five-point argument for the primacy of shareholder value maximization. They suggest:

> (1) The goal of maximizing shareholder value is pro-stakeholder. (2) Maximizing shareholder value creates the appropriate incentives for managers to assume entrepreneurial risks. (3) Having more than one objective function will make governing difficult, if not impossible. (4) It is easier to make shareholders out of stakeholders than vice versa. (5) In the event of a breach of contract or trust, stakeholders, compared with shareholders, have protection (or can seek remedies) through contracts and the legal system.

Given that Sundaram and Inkpen have lumped so many different views into stakeholder theory, it does not make sense to take the time and space to address every argument they put forth against it. There is, in fact, a large literature on stakeholder theory that clarifies what stakeholder theory is and why it does not fall victim to the arguments that Sundaram and Inkpen use (Phillips et al. 2003). Instead, we wish to suggest the following as alternative arguments for the view that we should understand capitalism as creating value for stakeholders:

(1) The goal of creating value for stakeholders is decidedly pro-shareholder.

(2) Creating value for stakeholders creates the appropriate incentives for managers to assume entrepreneurial risks.

(3) Having one objective function will make governance and management difficult, if not impossible.

(4) It is easier to make stakeholders out of shareholders than vice versa.

(5) In the event of a breach of contract or trust, shareholders, compared with stakeholders, have protection (or can seek remedies) through mechanisms such as the market for shares.

We shall briefly take each argument in turn.

(1) *Stakeholder Theory Is Decidedly Pro-Shareholder.* Shareholders are stakeholders, at least according to every piece of literature with which we are familiar, or that we have written. Creating value for stakeholders creates value for shareholders. How else could managers create shareholder value other than by creating products and services that customers are willing to buy, offering jobs that employees are willing to fill, building relationships with suppliers that companies are eager to have, and being good citizens in the community? Creating value for stakeholders is important, if for no other reason than to avoid the folly of regulation and government expropriation. Of course, understood this way, Sundaram and Inkpen's claim that shareholder theory is pro-stakeholder is also correct. Here is the main point: There is no need to posit these theories as oppositional. Jones et al. (2002) and many others have made this point for years.

(2) *Stakeholder Theory Gives Us the Correct Way to Think About Entrepreneurial Risks.* Venkataraman (2002) suggests that taking a stakeholder approach enables us to develop a more robust theory of entrepreneurship, one in which the role of entrepreneurial risk is better understood. Sundaram and Inkpen's view is that taking such an approach would lead to risk avoidance behavior by managers, because, according to them, "constituencies except the residual cash flow claimants have incentives to dissuade managers from taking excessive entrepreneurial risks." Leaving aside the question of excessive risks and whether avoiding excessive risks is a good or bad thing, this argument again shows that Sundaram and Inkpen's view of stakeholder theory is one of allocating benefits to other stakeholders at the expense of shareholders. Of course, it is in each stakeholder's interest for management to take risks that can lead to increasing the size of the pie for everyone. Indeed, in the real world, as opposed to the world of economics journals, managers often work with stakeholder groups, such as customers and suppliers, to jointly test new products and services. Often, customers and suppliers will accept some of the risk inherent in developing new ideas, products, and programs. The recent wave of corporate alliances and the emergence of issues such as supply-chain management are evidence that stakeholders can see their interests as joint, not just opposed. (For a nice review of this literature, see Inkpen 2001.) By focusing on the allocation aspect of stakeholder theory, Sundaram and Inkpen miss the idea of seeing entrepreneurial risk in its richer context of joint stakeholder relationships.

(3) *Having One Objective Function Makes Governance and Management Difficult.* It is hard to imagine how anyone can look at the recent wave of business scandals, all of which are oriented toward ever-increasing shareholder value at the expense of other stakeholders, and argue that this philosophy is a good idea. The problem with focusing on a single objective is that the world is complex, and managers and directors are boundedly rational (at least we can meet economists on their own assumptions). By employing pseudoscientific measurements and quantifying away

uncertainty in a naïvely Bayesian fashion, proponents of techniques such as economic value added and other consulting ploys have convinced many companies and managers that the effects of a particular project can be seen in the short-term movement of a company's common stock. There is too much complexity and uncertainty. Managers need to use judgment more than ever. It is not always clear how the new plant in Indonesia is going to affect our operations in Paris, and how hiring a new human resources director in Omaha can affect Friday's stock price. If we see stakeholder interests as fundamentally joint, it will be the managers' job to guide these relationships in the right direction. If these relationships are managed well, shareholders will reap the profits. It has long been known in philosophy, at least since John Stuart Mill and probably since Aristotle, that if you want to maximize a particular thing, such as utility, you should perhaps not try to do it consciously. As Hayek and others have suggested, in a complex world order emerges.

In reducing this complexity, the shareholder view is more susceptible to moral myopia. According to Sundaram and Inkpen (2004), having a single function for the firm makes life easier for managers precisely because it cuts through the morass of claims and potential responsibilities placed at the feet of managers. They claim management has only one responsibility: Make money for the shareholders. Although this is convenient for managers it distorts reality (i.e., both legally and morally) and fosters a worldview where managers do not see themselves as moral agents responsible to a wide array of groups for their actions. If making money for shareholders is my primary duty and I do not have responsibilities to other groups, it might be considerably easier for me to rationalize questionable practices that place harm at the feet of nonshareholder stakeholders (such as workers or suppliers, to whom I allegedly have no moral responsibilities) in the name of increased profitability.

This view also downplays the language of morality and moral complexity. Business is about making money for shareholders. There is no clear moral grounding for such a claim, nor is there a discussion about how managers deal with the other moral and legal challenges they face in the day-to-day activities of the firm. There is already considerable evidence that managers have a difficult time seeing the moral dimensions of business—preferring instead the financial and amoral view of business (Bird and Waters 1984, Freeman 1994, Werhane 1998). Offering managers more proof that business is only about profits for shareholders (and that morality is either irrelevant or places only a few broad constraints on managerial action) will more likely foster the kind of tunnel vision, rationalizations (e.g., "everyone else is doing it"), and self-dealing we see in ethics disasters such as those that took place at Enron, WorldCom, and HealthSouth.

We recognize that the shareholder view does not condone the activities of managers at these firms. Indeed, the shareholder view finds these actions deplorable. However, the issue is which worldview enables managers to rationalize risky, unethical, and ultimately illegal behavior. Our claim is that a view that places morality largely out of the conversation, and that reduces managerial responsibility to making money, is more likely to foster unethical behavior. At the very least, Sundaram and Inkpen's view does not seem to offer us much help in seeing ethics as connected to the day-to-day activities of managers, and as providing them with resources to better manage the challenges of the day.

(4) *It Is Easier to Make Stakeholders Out of Shareholders.* This one is easy. Shareholders are already stakeholders. Q.E.D.

(5) *Stakeholders Have Remedies that Shareholders Do Not Have.* This issue is tricky. Oliver Williamson has tried to make the point that nonshareholder stakeholders have contractual remedies that shareholders do not have, so that shareholders bear greater asset specificity (the cost of redeploying assets). This argument has been rebutted by the idea that the market for shares acts as an instantly costless redeployment process (Freeman and Evan 1990). Shareholders who sell enough stock to move the price of the stock cannot instantly redeploy costlessly, of course, but this is a function of the size of the holdings. It is possible that large suppliers, large customers, and large shareholders have more in common than would appear at first glance. Freeman and Evan distinguish between safeguards—where the parties to the contract pay the costs of the safeguards—and contracts—where the costs of safeguards can be imposed on others. They suggest that the claim that stakeholders can more costlessly redeploy is really the claim that there are mechanisms in society so that parties external to the contract pay the costs. Witness the so called protections of labor: the Fair Labor Practices Act, the National Labor Relations Board, and so on. If this is correct, shareholders appear to be in the same boat as other stakeholders. The whole point of the recent Sarbanes-Oxley Act, the furor over the Securities and Exchange Commission, and the issue of transparency and validity of financial reporting was to protect shareholders. Sundaram and Inkpen miss the point by focusing on the derivative suits by shareholders as the only means of shareholder protection. Surely, we want value creation and trade to be self-sustaining whereby parties to the contracts pay the costs of safeguarding those contracts rather than imposing those costs externally on others. The only way this can be conceptualized is by taking a stakeholder approach.

In struggling to make sense of all this, we want to make sure that the reader does not search for ways to frame or resolve this debate that miss the core question at the heart of our differences with Sundaram and

Inkpen. There are several ways one might try to make sense of the difference between these two approaches. For instance, one might be inclined to see the disagreement as being about levels of analysis—that stakeholder theory gives performance metrics that work for managers at the operating level, whereas shareholder theory gives performance metrics that work for financial markets (Meyers and Gupta 1994). Both have their place and use, but they only work well within their domain. Second, one could argue that it is a conflict between an ideal (shareholder) and a real-world (stakeholder) theory. The former might do a great job of capturing the ideal workings of the market from the macro view, well above the rumblings of the trading-room floor, whereas the latter speaks to managers from the vantage point of their day-to-day activities. Finally, there might also be grounds for seeing an issue of scale involved—that stakeholder theory makes more sense in entrepreneurial firms and that shareholder theory is a better fit in larger and more established companies. All of these readings provide a way to give each side its due.

In our view, although each of these issues is interesting and might provide useful insights, each also deflects attention from the fundamental issue—how we understand business and value creation writ large. If we want to reject the separation thesis and see a moral dimension to business activity, then stakeholder theory provides the requisite framework. The shareholder theory, particularly as propagated by economists, continues to perpetuate the idea of business as an amoral economic activity that radically constricts what is possible for human beings. The core question is whether we embrace the separation thesis and whether we want to be a part of organizations that take it as a given. It is critical that we see firms and markets as integral vehicles for working with others to improve everyone's stake. To do this, we must see the separation thesis as optional.

Of course, we could articulate the shareholder theory in a way that does not commit it to the separation thesis. Briefly, it would go something like this: Corporate property is the private property of shareholders. Moral rules that apply to private property apply to corporate property. No one, or their agent, may use his or her property to harm others (at least without their permission). Freedom to make agreements about how we and our agents use our property is an important principle. So it follows that business works because shareholders or their agents use their property to create value for which others freely trade. It is important, if this is to be done effectively, that managers (agents of shareholders) understand the needs of other affected parties and how those parties are indeed affected by trading with the agents of shareholders. In practice, these parties are usually customers, suppliers, employees, and communities. Ergo, something like a stakeholder view would emerge from a more-carefully worked out, fully moral version of shareholder theory.

Once we have rejected the separation thesis, the issue is not whether a theory has moral content, but rather what kind of moral content it has (Freeman 1994). As we have argued in this paper, stakeholder theory better equips managers to articulate and foster the shared purpose of their firm. Unlike the narrow view of shareholder theory that ascribes one objective function to all corporations, stakeholder theory admits a wide range of answers. In this view, there is not just one stakeholder theory, but many possible normative cores (i.e., particular answers to the two questions) that make up the genre of stakeholder theory (Freeman 1994, Jones and Wicks 1999). A careful look at firms such as 3M, Merck, and Johnson & Johnson shows that there is a wide range of answers that firms have given to the questions posed by stakeholder theory. On this account, even shareholder theory is, in fact, a version of stakeholder theory—one whose moral presuppositions include a respect for property rights, voluntary cooperation, and individual initiative to improve everyone's circumstances. These presuppositions provide a good starting point, but not a complete vision of value creation.

The Real Issue: Economic and Political Freedom

There is much at stake in this debate. The shareholder ideologists want us to believe that economic freedom, and therefore political freedom, are threatened by stakeholder theory. Nothing could be further from the truth. The whole idea of seeing business as the creation of value for stakeholders and the trading of that value with free consenting adults is to think about a society where each has freedom compatible with a like liberty for all (Rawls 1971). Value creation and trade have to go together. One is no good without the other. Hence, the very idea of economic and political freedom being separable is questionable (Freeman and Phillips 2002).

Management theory needs to get back to management—to the understanding of how value gets created and traded—in all of its gory particularistic detail. Talking about how all value must get created, or the one and only best way to organize value creation, or the one and only stakeholder group whose prima facie rights must always win, are all intellectual moves that serve neither truth nor freedom.

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