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The Origin Of 'The World's Dumbest Idea': Milton Friedman

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i.forbesimg.com/stevedenning/files/2013/07/MiltonFriedman3.jpg) No popular idea ever has a single origin. But the idea that the sole purpose of a firm is to make money for its shareholders got going in a major way with an [article by Milton Friedman in the New York Times](#) (<http://www.colorado.edu/studentgroups/libertarians/issues/friedman-soc-resp-business.html>) on September 13, 1970.

As the leader of the Chicago school of economics, and the winner of Nobel Prize in Economics in 1976, Friedman has been [described by The Economist](#) (<http://www.economist.com/node/8313925>) as “the most influential economist of the second half of the 20th century...possibly of all of it”. The impact of the NYT article contributed to [George Will calling him](#) (http://www.boston.com/news/globe/city_region/breaking_news/2006/11/nobel_lauriet_e.htm) “the most consequential public intellectual of the 20th century.”

Friedman’s article was ferocious. Any business executives who pursued a goal other than making money were, he said, “unwitting puppets of the intellectual forces that have been undermining the basis of a free society these past decades.” They were guilty of “analytical looseness and lack of rigor.” They had even turned themselves into “unelected government officials” who were illegally taxing employers and customers.

How did the Nobel-prize winner arrive at these conclusions? It’s curious that a paper which accuses others of “analytical looseness and lack of rigor” assumes its conclusion before it begins. “In a free-enterprise, private-property system,” the article states flatly at the outset as an obvious truth requiring no justification or proof, “a corporate executive is an employee of the owners of the business,” namely the shareholders.

Come again?

If anyone familiar with even the rudiments of the law were to be asked whether a corporate executive is an employee of the shareholders, the answer would be: clearly not. The executive is an employee of the corporation.

An organization is a mere legal fiction

But in the magical world conjured up in this article, an organization is a mere “legal fiction”, which the article simply ignores in order to prove the pre-determined conclusion. The executive “has direct responsibility to his employers.” i.e. the shareholders. “That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom.”

What’s interesting is that while the article jettisons one legal reality—the corporation—as a mere legal fiction, it rests its entire argument on another legal reality—the law of agency—as the foundation for the conclusions. The article thus picks and chooses which parts of legal reality are mere “legal fictions” to be ignored and which parts are “rock-solid foundations” for public policy. The choice depends on the predetermined conclusion that is sought to be proved.

A corporate executive who devotes any money for any general social interest would, the article argues, “be spending someone else’s money... Insofar as his actions in accord with his ‘social responsibility’ reduce returns to stockholders, he is spending their money.”

How did the corporation’s money somehow become the shareholder’s money? Simple. That is the article’s starting assumption. By assuming away the existence of the corporation as a mere “legal fiction”, hey presto! the corporation’s money magically becomes the stockholders’ money.

But the conceptual sleight of hand doesn’t stop there. The article goes on: “Insofar as his actions raise the price to customers, he is spending the customers’ money.” One moment ago, the organization’s money was the stockholder’s money. But suddenly in this phantasmagorical world, the organization’s money has become the customer’s money. With another wave of Professor Friedman’s conceptual wand, the customers have acquired a notional “right” to a product at a certain price and any money over and above that price has magically become “theirs”.

But even then the intellectual fantasy isn’t finished. The article continued: “Insofar as [the executives’] actions lower the wages of some employees, he is spending their money.” Now suddenly, the organization’s money has become, not the stockholder’s money or the customers’ money, but the employees’ money.

Is the money the stockholders’, the customers’ or the employees’? Apparently, it can be any of those possibilities, depending on which argument the article is trying to make. In Professor Friedman’s wondrous world, the money is anyone’s except that of the real legal owner of the money: the organization.

One might think that intellectual nonsense of this sort would have been quickly spotted and denounced as absurd. And perhaps if the article had been written by someone other than the leader of the Chicago school of economics and a

front-runner for the Nobel Prize in Economics that was to come in 1976, that would have been the article's fate. But instead this wild fantasy obtained widespread support as the new gospel of business.

People just wanted to believe...

The success of the article was not because the arguments were sound or powerful, but rather because people desperately *wanted* to believe. At the time, private sector firms were starting to feel the first pressures of global competition and executives were looking around for ways to increase their returns. The idea of focusing totally on making money, and forgetting about any concerns for employees, customers or society seemed like a promising avenue worth exploring, regardless of the argumentation.

In fact, the argument was so attractive that, six years later, it was dressed up in fancy mathematics to become one of the most famous and widely cited academic business articles of all time. In 1976, Finance professor Michael Jensen and Dean William Meckling of the Simon School of Business at the University of Rochester published their paper in the *Journal of Financial Economics* entitled "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure."

Underneath impenetrable jargon and abstruse mathematics is the reality that whole intellectual edifice of the famous article rests on the same false assumption as Professor Friedman's article, namely, that an organization is a legal fiction which doesn't exist and that the organization's money is owned by the stockholders.

Even better for executives, the article proposed that, to ensure that the firms would focus solely on making money for the shareholders, firms should turn the executives into major shareholders, by affording them generous compensation in the form of stock. In this way, the alleged tendency of executives to feather their own nests would be mobilized in the interests of the shareholders.

The money took over...

Sadly, as often happens with bad ideas that make some people a lot of money, shareholder value caught on and became the conventional wisdom. Not surprisingly, executives were only too happy to accept the generous stock compensation being offered. In due course, they even came to view it as an entitlement, independent of performance (<http://www.forbes.com/sites/stevedenning/2012/02/22/hbr-blows-the-lid-off-c-suite-over-compensation/>).

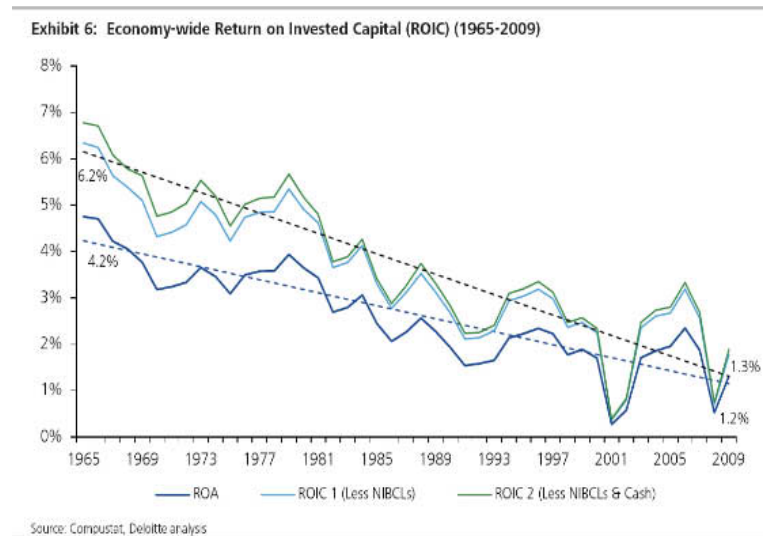
Politics also lent support. Ronald Reagan was elected in the US in 1980 with his message that government is "the problem". In the UK, Margaret Thatcher became Prime Minister in 1979. These leaders preached "economic freedom" and urged a focus on making money as "the solution". As the Michael Douglas character in the 1987 movie, *Wall Street*, pithily summarized the philosophy, greed was now good.

Moreover an apparent exemplar of the shareholder value theory emerged: Jack Welch. During his tenure as CEO of General Electric from 1981 to 2001, Jack Welch came to be seen—rightly or wrongly—as the outstanding implementer of the theory, as a result of his capacity to grow shareholder value and hit his

numbers almost exactly. When Jack Welch retired, the company had gone from a market value of \$14 billion to \$484 billion at the time of his retirement, making it, according to the stock market, the most valuable and largest company in the world. In 1999 he was named “Manager of the Century” by Fortune magazine.

The disastrous consequences...

So for a time, it looked as though the magic of shareholder value was working. But once the financial tricks that were used to support it were uncovered, the underlying reality became apparent. The decline that Friedman and other sensed in 1970 turned out to be real and persistent. The rate of return on assets and on invested capital of US firms declined from 1965 to 2009 by three-quarters, as shown by the [Shift Index](http://www.forbes.com/sites/stevedenning/2012/01/25/shift-index-2011-the-most-important-business-study-ever/) (<http://www.forbes.com/sites/stevedenning/2012/01/25/shift-index-2011-the-most-important-business-study-ever/>), a study of 20,000 US firms.



<http://www.forbesimg.com/stevedenning/files/2013/07/Shift-Index-ROA13.jpg>

The shareholder value theory thus failed even on its own narrow terms: making money. The proponents of shareholder value and stock-based executive compensation hoped that their theories would focus executives on improving the real performance of their companies and thus increasing shareholder value over time. Yet, precisely the opposite occurred. In the period of shareholder capitalism since 1976, executive compensation has exploded while corporate performance declined.

Maximizing shareholder value thus turned out to be the disease of which it purported to be the cure. As Roger Martin in his book, *Fixing the Game*, noted, “between 1960 and 1980, CEO compensation per dollar of net income earned for the 365 biggest publicly traded American companies fell by 33 percent. CEOs earned more for their shareholders for steadily less and less relative compensation. By contrast, in the decade from 1980 to 1990, CEO compensation per dollar of net earnings produced *doubled*. From 1990 to 2000 it quadrupled.”

Even Jack Welch sees the light...

Moreover in the years since Jack Welch retired from GE in 2001, GE's stock price has not fared so well: in the decade following Welch's departure, GE lost around 60 percent of the market capitalization that Welch "created". It turned out that the fabulous returns of GE during the Welch era were obtained in part by the risky financial leverage of GE Capital, which would have collapsed in 2008 if it had not been for a government bailout.

In due course, Jack Welch himself came to be one of the strongest critics of shareholder value. On March 12, 2009, he gave an interview with Francesco Guerrera of the Financial Times and said, "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. Managers and investors should not set share price increases as their overarching goal... Short-term profits should be allied with an increase in the long-term value of a company."

From shareholder value to hardball...

The supposed management dynamic of maximizing shareholder value was to make money, by whatever means are available. Self-interest reigned supreme. The logic was continued in the perversely enlightening book, *Hardball* (2004), by George Stalk, Jr. and Rob Lachenauer. Firms should pursue shareholder value to "win" in the marketplace. These firms should be "willing to hurt their rivals". They should be "ruthless" and "mean". Exponents of the approach "enjoy watching their competitors squirm". In an effort to win, they go up to the very edge of illegality or if they go over the line, get off with civil penalties that appear large in absolute terms but meager in relation to the illicit gains that are made.

In such a world, it is therefore hardly surprising, says Roger Martin in his book, *Fixing the Game*, that the corporate world is plagued by continuing scandals, such as the accounting scandals in 2001-2002 with Enron, WorldCom, Tyco International, Global Crossing, and Adelphia, the options backdating scandals of 2005-2006, and the subprime meltdown of 2007-2008. Banks and others have been gaming the system, both with practices that were shady but not strictly illegal and then with practices that were criminal. They include widespread insider trading, price fixing of LIBOR, abuses in foreclosure, money laundering for drug dealers and terrorists, assisting tax evasion and misleading clients with worthless securities.

Martin writes: "It isn't just about the money for shareholders, or even the dubious CEO behavior that our theories encourage. It's much bigger than that. Our theories of shareholder value maximization and stock-based compensation have the ability to destroy our economy and rot out the core of American capitalism. These theories underpin regulatory fixes instituted after each market bubble and crash. Because the fixes begin from the wrong premise, they will be ineffectual; until we change the theories, future crashes are inevitable."

Peter Drucker got it right...

Not everyone agreed with the shareholder value theory, even in the early years. In 1973, Peter Drucker made a sustained argument against shareholder value in his classic book, *Management*. In his view, "There is only one valid definition of business purpose: to create a customer. . . . It is the customer who determines

what a business is. It is the customer alone whose willingness to pay for a good or for a service converts economic resources into wealth, things into goods. . . . The customer is the foundation of a business and keeps it in existence.”

Similarly in 1979, Quaker Oats president Kenneth Mason, writing in *Business Week* (<http://www.greenbiz.com/news/2006/11/24/milton-friedman-and-social-responsibility-business>), declared Friedman’s profits-are-everything philosophy “a dreary and demeaning view of the role of business and business leaders in our society... Making a profit is no more the purpose of a corporation than getting enough to eat is the purpose of life. Getting enough to eat is a requirement of life; life’s purpose, one would hope, is somewhat broader and more challenging. Likewise with business and profit.”

The primacy of the customer...

Peter Drucker’s argument about the primacy of the customer didn’t have much effect until globalization and the Internet changed everything. Customers suddenly had real choices, access to instant reliable information and the ability to communicate with each other. Power in the marketplace shifted from seller to buyer. Customers started insisting on “better, cheaper, quicker and smaller,” along with “more convenient, reliable and personalized.” Continuous, even transformational, innovation became requirements for survival.

A whole set of organizations responded by doing things differently and focusing on delighting customers profitably, rather than a sole focus on shareholder value. These firms include Whole Foods [WFM], Apple [AAPL], Salesforce [CRM], Amazon [AMZN], Toyota [TM], Haier Group, Li & Fung and Zara along with thousands of lesser-known firms. The transition is happening not just in high tech, but also in manufacturing, books, music, household appliances, automobiles, groceries and clothing. This different way of managing turned out to be hugely profitable.

The common elements of what all these organizations are doing has now emerged. It’s not merely the application of new technology or a set of fixes or adjustments to hierarchical bureaucracy. It involves basic change in the way people think, talk and act in the workplace. It involves deep changes in attitudes, values, habits and beliefs.

The new management paradigm is capable of achieving both continuous innovation and transformation, along with disciplined execution, while also delighting those for whom the work is done and inspiring those doing the work. Organizations implementing it are moving the production frontier of what is possible.

The replacement for shareholder value is thus now identifiable. A set of books have appeared that spell out the elements of this canon of radically different management.



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i.forbesimg.com/stevedenning/files/2013/07/Books-2013-Old-And-New13.jpg)

In effect, shareholder value is obsolete. What we are seeing is a paradigm shift in management, in the strict sense laid down by Thomas Kuhn: a different mental model of how the world works.

See: [When Will 'The Dumbest Idea In The World' Die?](http://www.forbes.com/sites/stevedenning/2013/07/05/the-overunder-on-when-the-worlds-dumbest-idea-will-die/)
(<http://www.forbes.com/sites/stevedenning/2013/07/05/the-overunder-on-when-the-worlds-dumbest-idea-will-die/>)

And read also:

[The dumbest idea in the world: maximizing shareholder value](http://www.forbes.com/sites/stevedenning/2011/11/28/maximizing-shareholder-value-the-dumbest-idea-in-the-world/)
(<http://www.forbes.com/sites/stevedenning/2011/11/28/maximizing-shareholder-value-the-dumbest-idea-in-the-world/>)

[Can shareholder value be saved?](http://www.forbes.com/sites/stevedenning/2012/11/27/can-the-shareholder-value-theory-be-mended/)
(www.forbes.com/sites/stevedenning/2012/11/27/can-the-shareholder-value-theory-be-mended/)

[The management revolution that's already happening](http://www.forbes.com/sites/stevedenning/2013/05/30/the-management-revolution-thats-already-happening/)
(<http://www.forbes.com/sites/stevedenning/2013/05/30/the-management-revolution-thats-already-happening/>)

[Don't Diss the Paradigm Shift: It's Happening](http://www.forbes.com/sites/stevedenning/2012/10/31/dont-diss-the-paradigm-shift-in-management/)
(<http://www.forbes.com/sites/stevedenning/2012/10/31/dont-diss-the-paradigm-shift-in-management/>)

[How America lost the capacity to compete](http://www.forbes.com/sites/stevedenning/2013/05/01/leadership-in-the-three-speed-economy/)
(<http://www.forbes.com/sites/stevedenning/2013/05/01/leadership-in-the-three-speed-economy/>)

[The five surprises of radical management](http://blogs.forbes.com/stevedenning/2011/07/08/the-five-big-surprises-of-radical-management/)
(<http://blogs.forbes.com/stevedenning/2011/07/08/the-five-big-surprises-of-radical-management/>)

Steve Denning's most recent book is: [The Leader's Guide to Radical Management](#)

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