Response to How to Market the Markets: The Trouble with Profit Maximization

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Professor Colander uses Milton Friedman as his foil, arguing that Friedman's contention that the 'social responsibility of business is to increase its profits' has contributed more to undermining the case for free markets than any other. He then proceeds to use Adam Smith, the patron saint of free markets, albeit a morally conflicted one, to make the case that human beings are not just motivated by economic interests but also by social and caring interests, a point that I don't think Friedman would have contested. The rest of the article is a discourse on the limitations of profit maximization as a business objective, though the alternative is not clearly specified. Rather than follow Professor Colander into the labyrinth that he has created, let me make the case that his opinion piece misses the mark at every level, starting with getting the objective of a business wrong, then confusing objectives with constraints and concluding without a clear contrast between privately-owned businesses and publicly traded companies.

1. *The objective function* I do not consider myself an economist, but I do teach and practice corporate finance and valuation, fields of applied economics that are firmly grounded in the pragmatic tradeoffs that have to be made to run a business. I have no interest in theory for the sake of theory, and no qualms about making assumptions that would make conventional economists blanch to get to results. The *objective in running a business is to maximize its value, not its profits*. The difference is subtle but has significant consequences. The value of a business is a present value of its profits (cash flows, but I am willing to gloss over that difference) over its lifetime. The power of "maximizing value" as an objective is that many of the concerns that most people have about overreach in private enterprise are contained in that objective. If I, as a business person, take advantage of my customers to increase my near-term profits, those customers will not return, reducing future profits and value today. If my employees are poorly paid or feel ill-treated or abused, they will leave and while my profits in the next year or two may rise, my value will decrease. In short, the notion that increasing value is incompatible with taking care of your customers and employees is misplaced. (There is a narrower version of this objective, where publicly traded companies try to maximize stock prices and I agree that the objective can be flawed, to the extent that markets don't always measure value.)
2. *Constraints versus objectives* There are well-meaning people who argue that the correct objective of a firm should be to maximize stakeholder wealth, with stockholders, labor, customers, and society all sharing in good fortune. These assumptions suffer from a fundamental problem. Not only do these fuzzy and broad objectives become a way in which managers avoid accountability, blaming other stakeholder groups when confronted with failures to deliver by any one group, it is

impossible to run any entity with multiple objectives. Milton Friedman, not surprisingly, recognizes this well. What Professor Colander points to as qualifiers and wiggling by Friedman represent a recognition that businesses operate within the legal, environmental, and tax framework imposed on them by society. If you feel that a company is increasing its profits by taking advantage of poorly written tax laws, the response is to fix the tax laws, not lecture the company about its moral obligations to pay more in taxes. I am open to a debate about what these society-imposed constraints should be, whether they be on taxes, the environment, or in labor/customer relationships, and I would want businesses to operate under whatever those constraints are, but moralizing about what they should be doing is feel-good talk that accomplishes nothing.

3. *Separate private businesses from public corporations* By lumping all businesses together, Professor Colander is missing an important distinction between a business that you own and run and a publicly traded company. When you own and run a business, I agree that the end game is to maximize your utility, not profits not even value. Thus, if you choose to give away some of your products or services for free to those who cannot afford them, pay more than your fair share of taxes or pass on half of your profits to charity, those are your choices to make and you make them because they increase your utility. With a publicly traded company, with thousands of shareholders, this becomes a tougher call. As the manager of the company, you are an employee, not an owner, and you should not be substituting your personal preferences for those of your shareholders, letting your moral impulses drive your decisions. Note that if you are a shareholder, you are still free to take your payoff from owning shares and doing with them whatever gives you utility, whether that be spending it on conspicuous consumption or giving it to the homeless.
4. *Recognize that businesses have never been loved* The sense that you get out of Professor Colander's piece is that until Milton Friedman came along and pushed for profit maximization, not only were businesses run with altruistic instincts but were loved by the rest of the world. I must be reading a different history but I cannot think of a time period in history when businesses were loved. They clearly were not in the days of Adam Smith, when economics was viewed as the Gospel of Mammon, and religions were quick to brand wealth seekers as sinful, while offering them salvation in return for a slice of the profit. They were not loved in the early part of the industrial revolution, or Karl Marx would not have found fertile ground for his writings. Andrew Carnegie and John Rockefeller may be viewed in sepia tones today, but they were more feared than loved during their lives. In much of the world, people have seen firsthand what the alternatives to profit maximizing businesses have delivered (or failed to) and while they may not love businesses, they hold successful businesses and business people in far higher esteem than they do politicians, economists, or professors.

I think that it is supreme irony that the piece takes issue with Milton Friedman for undermining the case for business when his most lasting legacy on the front is "Free to Choose," the ten-part television series on free markets that he did with his wife, Rose, that was not only unabashed in its defense of business pursuit profits but sold a generation of young people (including me) on the merits of free enterprise. Early in his article, Professor Colander talks about how arguing that businesses should focus on profitability is like "selling hamburger by calling it pink slime." Implicit in that statement is the presumption that talking about private businesses making profits makes people feel queasy, a presumption which may be justified in the rarefied air of some parts of Vermont but it is not true in the rest of the world!