How to Market the Market: The Trouble with Profit Maximization

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Few statements have undermined the case for the markets more than Milton Friedman's statement that "the social responsibility of business is to increase its profits." With that statement, Milton Friedman did more harm to advancing the cause of markets than all the socialist rants against the market combined.¹ The problem is not that the argument is totally wrong. Interpreted in the appropriate context, it can be justified. But, as a way of marketing the market, it is awful. It is like selling hamburger by calling it pink slime. What's even worse is that some individuals use Friedman's statement to justify sleazy actions that even Milton Friedman would have condemned.

To understand why an emphasis on maximizing profits is a poor way to market the market, let's go back to an earlier defender of the market, Adam Smith. Smith wrote the *Wealth of Nations* as a follow-up to his *Theory of Moral Sentiments*. In that book, Smith argued that people were not totally selfish, but were instead self-interested, by which he meant that they had multiple dimensions that included a social and caring dimension as well as a selfish dimension. Part of the human struggle involved reconciling these different dimensions. Businesspeople for Smith were no different than others; they blend self-interest and compassion. This vision of people was so important to Smith that he begins *The Theory of Moral Sentiments* with the following:

How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortunes of others, and render their happiness necessary to him, though he derives nothing from it, except the pleasure of seeing it. Of this kind is pity or compassion, the emotion we feel for the misery of others, when we either see it, or are made to conceive it in a very lively manner. That we often derive sorrow from the sorrows of others, is a matter of fact too obvious to require any instances to prove it; for this sentiment, like all the other original passions of human nature, is by no means confined to the virtuous or the humane, though they perhaps may feel it with the most exquisite sensibility. The greatest ruffian, the most hardened violator of the laws of society, is not altogether without it.

Smith's view of human nature is one that almost all economists accept. Humans embody a blend of motives; they are selfish, but they are also social beings who care about others. The question Smith addressed in the *Wealth of Nations* involved how best to blend those characteristics? Smith's answer is a "tough love" answer: If you care

about people, in many instances society should rely more on bottom-up organizations such as markets *that balance one person's selfishness with another's*, rather than on eleemosynary institutions and government that don't have that offsetting balance. The reason was to economize on love and social responsibility, the scarcest and most valuable resource. Smith advocated directing people's primary social responsibility toward creating and protecting a competitive ecostructure that pits selfishness against selfishness. Yes, markets may rely upon selfish motives, but in the right institutional competitive context, competing selfishness can cancel itself out — invisibly transforming self-interest into the social good. Sufficiently competitive markets provide a way of controlling the selfish aspect of people with other people's selfishness.

The *Wealth of Nations* is not an ode to markets; it is an argument that the practical problems with alternative ways of achieving social goals often make the market the least worst alternative. Smith's justification for markets in no way glorifies greed, and it certainly doesn't rely on a firm's only social responsibility being to maximize profit. Smith's self-interest was a balanced self-interest, not a sociopathic self-interest. If you look for the term "maximizing profit" in Smith, or in any of the standard textbooks on economics up until the 1930s, such as John Stuart Mill's *Principles of Economics* or Alfred Marshall's *Principles of Economics*, you won't find it. Nor will you find any argument that it is the social responsibility of firms to increase their profits. Economists recognized that firms had to, over the long run, "make a profit" in order to stay in business. But "making a sufficient profit to be sustainable" is fundamentally different from "maximizing profit."

It was only in the 1930s that it became fashionable for economists to start formally modeling firms as if they maximized profits. The reason why the assumption became part of the basic economic model was that it made the model more tractable since the assumption that firms maximize profit paralleled the assumption that individuals maximize utility. Assuming that firms maximize profit allowed economists to use the same math to analyze supply that they used to analyze demand, and to put supply and demand together in a combined model that captured aspects of the workings of the economy.

The supply/demand model allowed economists to show, analytically, one way in which, assuming perfect competition, the invisible hand might work to the advantage of society. This supply/demand justification was not their only, and certainly not their primary, justification for markets. Economists such as Alfred Marshall recognized that the supply/demand model was a model that relied on too many assumptions to justify real-world markets. Instead, their primary argument for the market was a "least worst alternative" argument. In the real world, policies implemented by government, or by individuals with a supposed eleemosynary goal, would, far too often, be subterfuges, providing sneaky ways to benefit specific interests, not to benefit the general public. Smith writes:

The proposal of any new law or regulation of commerce which comes from this order ought always to be listened to with great precaution, and ought never to be adopted till after having been long and carefully examined, not only with the most scrupulous, but with the most suspicious attention. It comes from an order of men whose interest is never exactly the same with that of the public, who have generally an interest to deceive and even to oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it.

Despite their use of the profit-maximizing model of the firm (or its "maximizing shareholder value" derivative) economists recognized that the profit maximization model

was not a good description of what firms actually did, and that it was not a good description of what they felt firms should do. Through the 1960s, there was an active debate about whether the “profit maximization” assumption was a useful way of modeling firms. Alternatives such as sales maximization, profit satisficing, and increasing market share were all proposed as alternative descriptors of firm behavior. The primary justification for modeling firms as profit maximizers in the 1950s was that even though it clearly was not a good description of what firms actually do, it was still useful to analyze them *as if* they did that.

In the neoclassical debate about how best to model firms, there was never a scientific belief that firms *should* maximize profit. That would have been a normative argument that neoclassical economists avoided — they did positive economics. Determining what real-world firms *should* do went far beyond what could be said on the basis of economic theory. What neoclassical economists could say was that, within a model of a perfectly competitive economy, in which individuals are perfectly rational (with rationality appropriately defined to fit the model) and maximize non-interdependent utility functions (along with a bunch of other assumptions), then, *if* firms maximize profits, the resulting outcomes in the model will have certain desirable characteristics.

Of course, a good neoclassical economist would also point out that in a competitive general equilibrium of the model any excess profits (such as captured by the model) beyond the minimum required to keep the firm in business were actually not “profits” but instead rents to specialized resources, or returns to the organizer’s efforts and risk. In the neoclassical model, all above-normal profits (profits that were not actually rents) would be competed away, so that any above-normal profits accruing to a single firm would be both small and temporary. Moreover, in the aggregate, any temporary profits of successful firms would be largely offset by temporary losses of unsuccessful firms. In a stable equilibrium, net “above-normal” profits for society were close to zero. If significant aggregate profits remained, then the competitive assumptions of the model weren’t appropriate, which meant that the model could not be applied. That was the beauty of the competitive market — the desire for profits drove the economy to benefit the public; competition drove the profits to zero, so the cost to society was zero. Narrowly defined profit maximization in appropriately competitive markets could be justified; broadly defined profit maximization, which is the way profits are usually defined in the real world, not only could not be justified by the model, but could be shown to work against the public interest.

THE CONTEXT OF FRIEDMAN’S ARGUMENT

Milton Friedman, of course, understood all these arguments, and his argument in favor of profit maximization is best interpreted as a rhetorical argument to be understood in context. By that I mean that his argument for profit maximization was not a general argument supporting profit (or its shareholder value derivative) maximization as a normative imperative for firms. Rather it was a more narrowly directed argument against the then dominant lay view that corporation executives had a social responsibility to do good separately from conducting their business in a socially responsible manner. Friedman opposed this view, and Smith, Mill, and Marshall would have likely opposed it as well.

The reason they would have opposed calls for “social responsibility” is Smith’s warning that I outlined above; such calls are very likely subterfuges designed to “deceive and even to oppress the public.” Social responsibility is a highly ambiguous concept ripe for misuse. Whose concept of social responsibility should firms follow? Government’s?

Executive's? Owner's? Worker's? Consumer's? A government, or executive-imposed, social responsibility goal would likely undermine the offsetting selfishness aspect of markets. For example, social responsibility was often interpreted as paying existing workers higher wages and benefits, rather than as holding wages and benefits down. That helps the workers with jobs at the firm, but it hurts both other workers who would like to work for that firm at the existing wage, and consumers who would end up paying higher prices for the firm's goods. Such a "higher wage" interpretation of "social responsibility" can be seen as a way of discouraging the competition that was necessary for the "offsetting selfishness" role of competitive markets to work. Market competition forces firms to take that social responsibility to other workers and consumers into account, and to balance it with their social responsibility to existing workers. This does not mean that corporations should not be socially responsible. It just means that social responsibility is a much more nuanced concept than supporters of corporate social responsibility often portray it. Friedman wanted to point that out.

A careful read of Friedman's article shows how he added qualifications that gave him wiggle room for his argument that firms should maximize profits. He writes: "there is one and only one social responsibility of business — to use its resources and engage in activities designed to increase its profits *so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.*" (My italicizing)

Notice that his qualifications limit the argument to firms that are in an open competitive market, and to firms that do not engage in deception or fraud. These qualifications modify much of what people object to when they object to large sustained profits made by firms. An economy that has "open and free competition" would not have large and sustained profits — and "no deception and fraud" would make it so that firms are fulfilling actual desires of consumers, not taking the often easier path to "profits" by misleading people for the firm's not the consumers' benefit. So all Friedman is actually saying is that a version of society's definition of social responsibility is already built into the "rules of the game" and that calls for additional social responsibility are often attempts to escape those rules. That is a reasonable argument that is debatable, but defensible.

THE CONTRACTUAL FAIRNESS ARGUMENT FOR PROFIT MAXIMIZATION

The above argument should make clear that Friedman's justification for firms maximizing profit is a highly limited one; it implicitly accepts that the rules of the game are acceptable, that property rights are ideal, and that sufficient competition exists. Accepting these assumptions allows him to frame what is probably best called a "contractual fairness" argument for corporations maximizing profit. Within this limited context, it is an argument that many people would accept. The argument goes as follows: A corporation is an organization set up by individuals under the laws of the land. If the rules are fair, it follows that the corporation, as extensions of individuals, should reflect the organizers' desires; if it didn't, they very likely would not have created the organization. Imposing social responsibilities on corporations that do not reflect the will of the organizers of the firm, whether done by government or management, undermines the contractual foundations under which the corporations were established and, if done widely, could undermine the workings of a market economy. Many people, including me, would agree with this limited argument.

Friedman is explicit that this is his argument. He writes:

In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. 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.

Notice the significant wiggle words here. Friedman writes that the corporation should conform to the basic rules of the society, including those embodied in “ethical custom” and “basic rules of the game.” These qualifications allow a large degree of social responsibility on the part of the firm and certainly do not preclude firms from being as socially responsible as their owners want them to be. But Friedman makes an even stronger qualification to his argument. He writes:

Of course, in some cases his employers may have a different objective. A group of persons might establish a corporation for an eleemosynary purpose—for example, a hospital or a school. The manager of such a corporation will not have money profit as his objective but the rendering of certain services.

This qualification provides an alternative way to justify *any* level of corporate social responsibility as long as it reflects the views of the owners. This means that, even accepting all of Friedman’s premises, if the organizers of corporations do not want to just maximize pecuniary profit (and as I stated above, economists’ view of individuals is that they do not), then corporations should not just maximize pecuniary profits. Friedman presents this as an exception and assumes that most owners would only be interested in pecuniary profits, but he in no way makes any argument that society would not be better if owners cared about social responsibility and saw that the firms they owned operated in what they consider a socially responsible manner.

CONCLUSION

The above discussion should help clarify what Friedman meant (or at least should have meant) when he argued that the social responsibility of business is to increase its profits. It is a highly limited statement that does not say that firms should not be socially responsible in many different types of ways. It simply says that the social responsibility debate is much more nuanced than advocates, or opponents, often make it out to be.

My problem is not so much with the statement, but with the effect of the statement. It is a statement that, almost by design, is meant to be misinterpreted, and to get people to dislike markets. It is a statement that has allowed firms to attempt to justify all types of unsavory behavior by appeal to economic theory, when economic theory justifies no such actions. It has even allowed such justifications to become built into the institutional and legal structure, without any of the qualifications that accompany economist’s justification of profit and markets.

By turning profit maximization and greed into something that is to be glorified, not something that is to be, at best, accepted, and tamed by competitive forces, Friedman turned corporations and the market into institutions that people dislike, rather than beneficial institutions that play an important role in keeping society focused on a nuanced social responsibility that incorporates the many different interpretations of the term.

Friedman's characterization of greed and markets has allowed our society to lose sight of Smith's insight that the competitive market is an institution that destroys selfishness by pitting it against other's selfishness, and in the process eliminates profit for both, and spreads the gains of the pursuit of selfishness to society. For those of us who believe that appropriately constrained markets are a very useful way to organize society, Friedman's statement is an albatross around our necks as we justify markets. That, in my view, is a lousy way to market the market.

Notes

- 1 Why did Milton Friedman make such an outlandish statement? The best reason I can figure out is that over-the-top rhetoric is a good way to make waves and achieve fame for the person who makes the argument. Strong, seemingly outlandish statements that get associated with a person give that person brand recognition. It certainly worked for Milton Friedman — it advanced him, and made him stand out as the go-to supporter of the market for journalists. It enabled them to avoid dealing with the much more nuanced classical liberal justification for markets.