PROFIT MAXIMIZATION: A MISTAKEN PREMISE

by

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The conventional wisdom in microeconomics is that firms maximize profits. The analytics have been developed to establish certainty as to the specific output level that accomplishes this objective and the unique market price that assures that the profit-maximizing output is sold. The analytics are reinforced by diagrams that are simple, straightforward, and convincing, and are found in virtually every principles textbook.

Those unfamiliar with the diagrammatics regarding the typical profit-maximizing firm operating in a perfectly competitive market environment, where the price is determined by supply and demand conditions in the market and the firm achieves profit maximization at the output level uniquely identified with this condition: marginal cost = marginal revenue, are referred to Appendix A. In the short run, such a firm may earn profits but in the long run competition forces the firm to operate at maximum efficiency by cutting its price and reducing its profits to what is barely required to assure that it will continue to operate. Others more familiar with the micro-economics involved need not bother with Appendix A.

The Profit Maximization Principle

The mainstream demonstration of the profit maximization principle is essentially mechanical in which the economic agent is represented as fundamentally *passive* in nature, taking price as given and then locating the point of profit maximization. Any departure from the profit-maximizing solution is self-correcting because the loss of profits associated with that departure prompts the firm to *return* to the level of output uniquely identified with maximum profits. Any other behavior is unthinkable. Notice, however, the circular rather than linear thinking embedded in this "*return* to … maximum profits."

Add to these analytics the assertion made most powerfully by Nobel laureate Milton Friedman (p. 133) and widely embraced today by mainstream economists that the only purpose for which the firm exists is to earn profits for its owners, and the analytical concept of profit maximization that at best is a premise becomes the one and only purpose of the firm. No proof is necessary because its validity is self-evident. In other words, the property rights of the owners deriving from the monies they invest and put at risk are foundational to the operations of the firm and those rights rule.

In Friedman's world workers have rights regarding wages, hours, and working conditions, which are affirmed in the employment contract, but no property rights.[1] There is no room in this theory of the firm for the entrepreneurial person who wants to do more than make a profit, who wants to make a difference in the workplace or the marketplace.

This mainstream account of the operations of the typical firm is not without its critics, some of whom argue that firms can and do pursue other objectives such as maximizing sales, revenues, market share, employment. In one instance a firm may lower its price below the cost of production -- may deliberately take losses -- in order to destroy the competition. In another it may operate at an output level greater than the one that yields

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[1] For more on property rights and personal rights, see Ellerman (pp. 13-39). Notice that employee stock ownership plans award profits to workers by providing access to property rights. Profit-sharing plans on the other hand award profits to workers by affirming their personal rights.

maximum profits in order to placate an aggressive union that threatens to strike if management cuts the workforce to what is necessary for profit maximization. This account has been directly challenged by Anderson and Escher (pp. 5, 38, 86-87, 92-98) who asserted that the purpose of the firm is to maximize shareholder value. They see the firm as an instrument not for extracting value but for creating it (p. 236).

Thus, the firm may have its own good reasons for eschewing profit-maximization. Further, there is no way for the average shareholder to know when the firm is not maximizing profits. What she does know with some certainty is whether or not the firm is making any profits, whether or not it is paying any dividends.

Confusion Surrounding the Profit Maximization Principle

The confusion originates in construing a premise as an objective. The syllogism underlying profit maximization premise-taken-as-an-objective fails.

- **The firm exists for one purpose only: to produce profits for its owners.**
- **The owners are best served by maximum profits.**
- **It follows that the firm *necessarily* operates in a way to maximize profits.**

The third statement in that syllogism, however, does not follow from the first two. Taking the first two statements as givens, the third statement ought to read:

- **It follows that the firm *should* operate in a way to maximize profits.**

Thus, properly constructed, this syllogism ends not with a positive statement of fact but with a normative assertion of opinion.

Even the would-be profit maximizing firm may fall short because of numerous operational unknowns: the reliability of its suppliers to deliver on time, the dependability of its workers to report to work and meet production schedules, the loyalty of its consumers to continue to buy its products/services, the ability of its competitors to innovate and bring superior products/services to market, the willingness of its bankers to extend credit as needed, the propensity of government to regulate it in the public interest.

Profit maximization for producers is the second half of the principle of the maximization of personal net advantage that is known in mainstream economics as utility maximization for consumers. This general principle, as Waters points out so insightfully (pp. 87-88), removes all active and spontaneous human action in economic affairs for the purpose of transforming economics into a more nearly exact science. This maximization principle, along with the utility calculus, Waters traces to utilitarianism that in turn derives from rationalism (p. 82).

Guided by feelings of pleasure and pain, economic agents make decisions passively and automatically. Walras and Jevons supplied the necessary techniques of quantification to operationalize this principle and advance economics as a modern science (p. 88). Waters does not mince words condemning this development.

> **… to mistake what [the maximization principle]could only be an assumption, to be used as a tool of analysis, for an actual phenomenon is *unpardonably bad scholarship* (Waters, p.89; emphasis added).**

Reconstructing Economic Science to Address the Confusion Surrounding Profit Maximization

To reconstruct economic science, according to Waters (pp. 90-91ff.), it is necessary to uproot the mainstream's representation of the economic agent as a passive, automatic, and thoroughly predictable utility-maximizing machine. In its place he offers an economic agent who in everyday economic affairs is an active, often creative, complex and therefore not always predictable human being. We call this economic agent the *person of action*. It is more than a little ironic that mainstream economists deny the economic agent the very individuality that they find so appealing in the individualism that serves as the philosophical foundation for their way of thinking about economic affairs.

Like the products/services of the typical firm operating in a perfectly competitive market environment, the *homo economicus* of mainstream thinking is always and everywhere the same. In sharp contrast, the *person of action* of personalist thinking is always and everywhere one of a kind.

Our guiding premise therefore is this: profits are a *necessary condition* for the survival of the firm over the long term. This premise truly is self-evident and requires no drawn-out proof because the real-world evidence is overwhelming. Though it may survive for a while by drawing down cash reserves, selling some of its assets, and bringing in new senior managers, in the end the firm must earn profit or see its share price plunge toward zero as unhappy shareholders divest their holdings.

In a strict accounting sense there is only one way to make profits: by selling a product/service at a price greater than the unit cost of production. However, this is a truism, not an operating principle. Our operating principle is that the firm is *most likely* to earn profits and survive by conducting its affairs in an upright manner. This principle is expressed in the following syllogism.

- **The firm's survival depends on motivating managers, suppliers, and employees to do their best and retaining the best among them.**
- **The best way to motivate and retain these parties along with the firm's customers is to treat all of them in an upright manner.**
- **Thus, treating everyone in an upright manner is the best strategy for the firm to operate profitably and surviving.**

However, the best strategy which focuses on the human beings involved does not provide an *ironclad guarantee* that the firm will operate profitably and survive. Firms fail even when they are operated in a totally upright manner if they are not smart enough or nimble enough to stay ahead of their competition. Vision -- seeing opportunities and possibilities where others see nothing beyond the way things are at the moment -- along with a willingness to gamble with the new and different are key ingredients to success in business. Virtue alone, in other words, is insufficient to secure the future of the firm.

Evidence Confirming Flaws in the Mainstream's Profit Maximization Principle

Two sets of evidence are offered to confirm our argument that the maximization principle of mainstream economics is flawed. Maximizing profits is not a satisfactory operating principle because many companies set aside some of their profits for a higher good. Maximizing personal net advantage is not a satisfactory behavioral principle because many human beings have been destroyed in the pursuit of that end. The evidence we offer in both instances is strictly anecdotal but compelling, we submit, because it (a) reflects real-world experiences that contradict the conventional wisdom of mainstream economics and (b) clearly represents a much larger set of similar experiences that could be cited but would not contribute additional weight to our argument.

***Maximizing personal net advantage is not a satisfactory behavioral principle.* There are for sure many cases of persons engaged at the highest levels of business affairs who have destroyed themselves in the pursuit of maximum personal net advantage. They include Andrew Fastow (Enron), Bernie Madoff (Bernard L. Madoff Investment Securities), Michael Milkin (Drexel, Burnham, Lambert), Dennis Kozlowski (Tyco), Bernie Ebbers (Worldcom), Jeffrey Nacchio (Qwest), James McDermott, Jr. (KBW), Sam Waksal (ImClone), Sam Israel (Bayou Group), Lou Pearlman (Trans Continental Airlines), not to mention many others already convicted or under indictment.[2]**

In each case, a person or group of persons failed to conduct business in an upright manner. Instead of settling for the expected and perfectly justifiable economic gains that come from routine business transactions, they deliberately took for their own or recklessly destroyed the expected gains of their counterparties. By failing to conduct their business in an upright manner we mean that minimally they did not render to their counterparties that which was owed. They failed the most basic test of justice in economic affairs. They took what belonged to others.

Once their unjust and illegal practices were exposed, the zero-sum activities that they had misrepresented to their counterparties as positive-sum in nature degenerated into negative-sum activities, and tore their business organizations apart. In some instances, those negative-sum activities actually destroyed their organizations.

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[2] **CNBC's *American Greed* that documents persons engaged in scams and schemes to defraud launched its first episode in 2007. It is in its fourteenth season of programming (https://www.cnbc.com/2021/01/11/season-14-of-cnbcs-american-greed-premieres-monday-january-18-at-10pm-et/pt.html).**

Fastow, Madoff, Kozlowski, and the others do not fit the mold of *homo economicus* -- a passive, automatic, and thoroughly predictable utility-maximizing machine. Each one is different. Each one is a *person of action* -- an active, often creative, complex and not always predictable human being -- whose behavior in business affairs is driven not by the prospect of the economic gain that is rightfully theirs but by the opportunities for seizing the gain that rightfully belongs to others. They crossed the line from upright behavior to criminal conduct.

They can be represented as pursuing the maximization principle of personal net advantage only if one sees no limits to that principle, only if one is unwilling to acknowledge the difference in business behavior that at minimum is based on the virtue of justice from conduct that is grounded in the vice of greed. Only if one is unwilling to accept that even though they might be tempted to cross that line for many human beings engaged in business affairs there is a higher good than maximizing personal net advantage. A sense of justice and perhaps a fear of public exposure keep them from crossing that line. And a realization that at times it is necessary to limit personal net advantage in order to serve that good.

***Maximizing profits is not a satisfactory operating principle*. Notwithstanding the documented evidence of egregious wrongdoing on the part of the aforementioned persons, our own experience persuades us that many companies can and do operate in an upright manner. Over an 11-year period we visited more than 50 firms in Louisiana in order to evaluate their efforts to improve quality and productivity and their success in bringing new ideas to the workplace and marketplace. Those firms covered a wide spectrum of successful activity in health care, shipbuilding, crude oil, light manufacturing, construction, lumber, and heavy manufacturing. [3]**

During those visits we observed several successful strategies that firms employ to operate in an upright manner, to meet their obligations under the principle of justice. Those strategies include gain-sharing, employee stock ownership, quality circles, vendor partnership, and company code of ethics.[4] The first three -- gain-sharing, employee stock ownership, and quality circles -- encourage employees to do their best that is reinforced by some additional gain beyond the wages they are paid. Vendor partnership encourages suppliers to do their best through a formal commitment between the firm and a vendor that is grounded in mutual trust, cooperation, and coordination. The company code of ethics challenges the firm to do its best to meet its obligations to its owners, suppliers, managers, employees, and customers.[5] In the end, all of these strategies have one thing in common: they attempt to improve the firm's profitability and survivability by setting higher standards for human behavior.

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[3] See O'Boyle 2002 for more on these visits.

[4] The producer cooperative and co-determination are two other strategies that can encourage upright behavior, but we observed neither one during our visits.

[5] See O'Boyle 1998 for more on the duty of the firm in selling to the poor.

A company is not a machine, it is a human organization that sets its objectives according to its own values. The following evidence demonstrates that companies often pursue objectives more highly valued than maximum profits, that the upright company is not a hopeless and unattainable ideal of personalist economics, that companies can succeed and survive without rigidly following the profit maximization principle.

Consider the following companies:

Vanguard Funds (https://investor.vanguard.com/mutual-funds/profile/VFTAX) offers its FTSE Social Index Fund Admiral Shares to investors interested in supporting human rights and the environment.

Located in California's Livermore Valley, Concannon Vineyard has been helping the needy since 1883. At present their acting-alone philanthropy focuses on providing financial assistance to regional food banks and to Stanford Health Care – ValleyCare Breast Cancer Women in Need Fund. (https://www.concannonvineyard.com/our-story/community-philanthropy/)

Life Is Good, the company that uses the "life is good" theme on its products, has established a foundation dedicated to helping kids overcome poverty, violence, and illness. (https://content.lifeisgood.com/kidsfoundation/).

Since 1998, Hyundai's Hope on Wheels program (https://hyundaihopeonwheels.org/), along with its dealers, has contributed more than $172 million for pediatric cancer research.

Merck's Patient Assistance Program (https://www.merckhelps.com/) pledges that "no one should go without medicines or vaccines they need."

The Patient Assistance Program sponsored by Astrazeneca supplied persons in need around the world with more than $801 million of medicines in 2019. (https://www.astrazeneca.com/sustainability/access-to-healthcare/affordability.html).[6]

Newman's Own (https://www.newmansown.com/food/)[7] produces a variety of food products and over the last 35 years has donated 100 percent of its profits totaling more than $550 million to good causes that focus on encouraging philanthropy, promoting children's quality of life, empowering people to overcome adversity and uphold human rights, and provide access to fresh food and nutrition education.

Goodshop (http://www.goodsearch.com/goodshop.aspx) is an online service that offers shoppers coupons that lower the price of purchases from popular companies such as HP, Vistaprint, Shutterfly, and Puritan's Pride, and at the same time financially supports more than 118,000 nonprofits and schools (https://www.goodshop.com/causes).

[6] **See Astrazeneca's *Sustainability Report*.**

[7] **It may be necessary to Google Newman's Own to gain access to this website.**

Even the much-criticized mega-giant retailer Wal-Mart has pledged $2 billion to fight hunger. (http://money.cnn.com/2010/05/12/news/companies/Walmart_donation/).

For the last 30+years Anheuser-Busch and its Foundation have donated more than $600 million to various charitable organizations and causes. (https://www.anheuser-busch.com/community/other-initiatives.html).

Perhaps most significant of all is Chief Executives for Corporate Purpose (https://cecp.co/) which was established in 1998-1999 largely at the behest of Paul Newman to encourage a greater corporate response to needs in their communities. Today CECP has more than 200 corporate members.

Even the would-be profit maximizing firm may fall short because of numerous operational unknowns such as bottlenecks in the supply chain, labor management disputes, and global liquidity issues that shut down access to credit from the usual sources.

Given these unknowns, the typical firm is capable of only an informed guess as to what and how much to produce and what price to charge. It can make adjustments in the expectation of improving profits but those adjustments always are made subject to the same unknowns. In the midst of all these uncertainties, one operating principle is clear and necessary. It must earn a profit to survive.

Toms Shoes is one example of a company that failed for that very reason. It was launched in 2006 on the basis of a business model that promised to donate one pair of its canvas shoes to the needy for every pair sold. For several years Tom Shoes operated profitably and by 2013-2014 had donated 10 million pairs to the needy. However, the company collapsed due to falling sales revenues and in 2019 was taken over by its creditors. See (https://www.businessinsider.com/rise-and-fall-of-toms-shoes-blake-mycoskie-bain-capital-2020-3)

Flaws in the Principle of Maximum Net Personal Advantage

Maximizing personal net advantage is flawed most fundamentally because conventional economics eschews any personal sense of justice on the part of economic agents on grounds that injecting justice in economic affairs transforms economics into a normative, value-laden discipline analytically beset with uncertainty. Instead, the invisible hand of the market is employed that sets no such limits and is entirely consistent with its representation of *homo economicus* as a passive, automatic, and predictable utility-maximizing machine. Accordingly, economics is a positive, value-free discipline analytically freed of uncertainty.

The several examples we have supplied regarding business executives who stole the economic gains that rightfully belonged to their counterparties demonstrate forcefully that the invisible hand does not prevent an active, often creative, complex and unpredictable economic agent – the *person of action* – from behaving in a criminal manner. The several other examples provide evidence to the effect that some business executives are *persons of action* who behave in an upright manner. The *person of action* in other words is not an

automaton. Some ruthlessly pursue maximum personal advantage. Others march to a different drummer.

A human being is a living, breathing, existential actuality who is more or less free to choose between goodness and wickedness. She accumulates what we prefer to call personalist capital and develops as a person by acting in an upright manner in everyday affairs. On the other hand, a human being suffers a loss of personalist capital and regresses as a person by acting in a wicked manner in everyday affairs. Like it or not, ill-gotten gain is the price we pay for freedom in business affairs.

We have no difficulty differentiating a Mother Teresa from an Adolph Hitler, admiring the one and despising the other. We should not be surprised, however, that a person who for years has lived in a truly upright manner may be seduced by the opportunity for ill-gotten gain. Or that a person who gives every appearance of goodness at heart may be driven by wickedness. Scruton (p. 37) points out that Enron, for example, was adept at publicly supporting "diversity, equal opportunities, care for the environment" that he characterizes with hindsight as Enron wrapping itself in a "veil of political correctness."

We would re-write the maxim that "every person has her price" to correspond to the sentiment expressed in the Golden Rule as follows. "In the end, every person must concede the gain that rightfully belongs to a counterparty if she is to expect a counterparty to concede the gain that rightfully is her own."

Because companies are human organizations we can say with confidence that they are neither all upright nor all wicked. Rather they function somewhere along a spectrum between those two extremes, moving from time to time in one direction or the other depending most fundamentally on how the company's principals define its primary objectives and what means they are willing to employ in pursuing those ends.

Maximizing Personalist Capital: Replacement for Maximizing Net Personal Advantage

In this article, we explored the role of virtue and vice in business affairs along with profit maximization as the governing principle in the typical business enterprise. Our intent has been to demonstrate that a firm can operate in an upright manner and earn profits at the same time. Indeed, in the long run, it cannot operate in an upright manner in the absence of profits. Such a firm understands that operating in that manner means that it must restrict itself to the gains (profits) that are justifiably its own. Included in its net worth is the asset goodwill that originates by operating in an upright manner, in respecting and accepting the gains that rightfully belong to others that it engages in everyday affairs.

We acknowledge that a firm can choose to operate in a wicked manner and also earn profits. In the long run, however, by not respecting the gains that rightfully belong to others, by instead seizing those gains for its own, the firm engages in practices that in the end are self-destructive because when in the end they are publicly exposed it is illwill not goodwill that attends those practices. Sufficient illwill can destroy the firm by reducing its

net worth to zero wiping out the holdings of its owners and leading to its total collapse. Consider the sudden demise of the prestigious accounting firm Arthur Anderson when the public learned that it had been "cooking the books" for Enron.

To replace the maximization of profits as the fundamental operating principle of the firm, personalist economics offers the maximization of personalist capital. To explain, a person who acts virtuously in business affairs -- is diligent, trustworthy, fair-minded, honest, hard-working – adds to her personalist capital and becomes an even more honorable person and a more effective and more valued economic agent. At the same time, however, a person who acts viciously in business affairs -- is shiftless, corrupt, unjust, dishonest, lazy -- depletes her personalist capital and becomes an even more contemptible person and a less effective and less valued economic agent. See Appendix B.

Further, the company becomes an upright firm when the persons working there act accordingly. And because persons who act in an upright manner are more effective as economic agents, the firm is more effective, including more profitable though profitability cannot be guaranteed for all times and places. Thus, the firm ought to maximize personalist capital and will thereby become more effective as a profit-making enterprise. The key to operationalizing itself as an upright firm is in selecting, training, nurturing, motivating, and retaining employees who routinely conduct themselves in an upright manner, who are better persons and more effective employees because for the most part they put virtue into action.[8]

The upright company that maximizes personalist capital does not have to outperform the profit-maximizing firm. It simply needs to earn enough profits to satisfy its owners. However, there is nothing intrinsic in maximizing personalist capital that keeps the upright company from outperforming the profit-maximizing firm by producing a better product at a better price with better service after the sale. It is possible, in other words, to do good, to do well, and to outperform the competition all at the same time.

Beyond assuring a level playing field by aggressively punishing unfair business practices, government need not afford the upright company special protection to assure its survival in a tough competitive environment. The discipline of the market in general will determine which firms succeed and which ones fail. The firm that maximizes profits has no lock on street smarts. Neither does the firm that maximizes personalist capital.

There is support for the personalist-capital argument to be found in the very origins of economics in that Smith's *Moral Sentiments,* though overshadowed by his *Wealth of Nations,* speaks often of the importance of the virtues of generosity, benevolence, and sympathy. Further, there is recognition in mainstream economics of the significance of three other virtues in economic affairs: thrift, industriousness, and diligence. This article argues that (a) it is not only possible and feasible but also rational and profitable for the firm to maximize personalist capital and (b) there is a corresponding need to re-construct

[8] In this regard, a company code of ethics can be helpful provided it is more than just a wall hanging. Rather, it is a living document that guides the entire workforce, most especially senior management, toward goodness in everyday affairs.

the theory of the firm to incorporate uprightness and wickedness as the real drivers of economic affairs.

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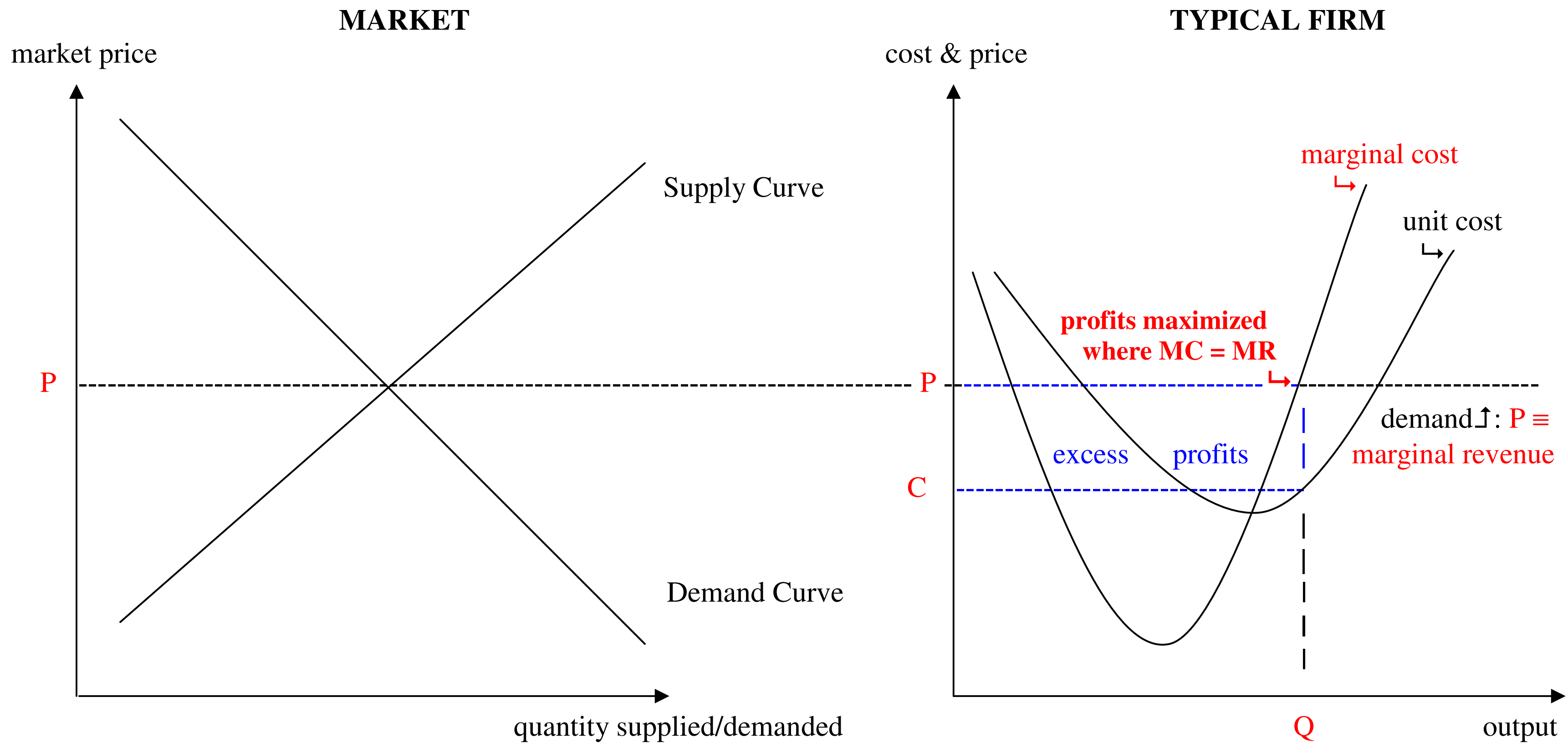
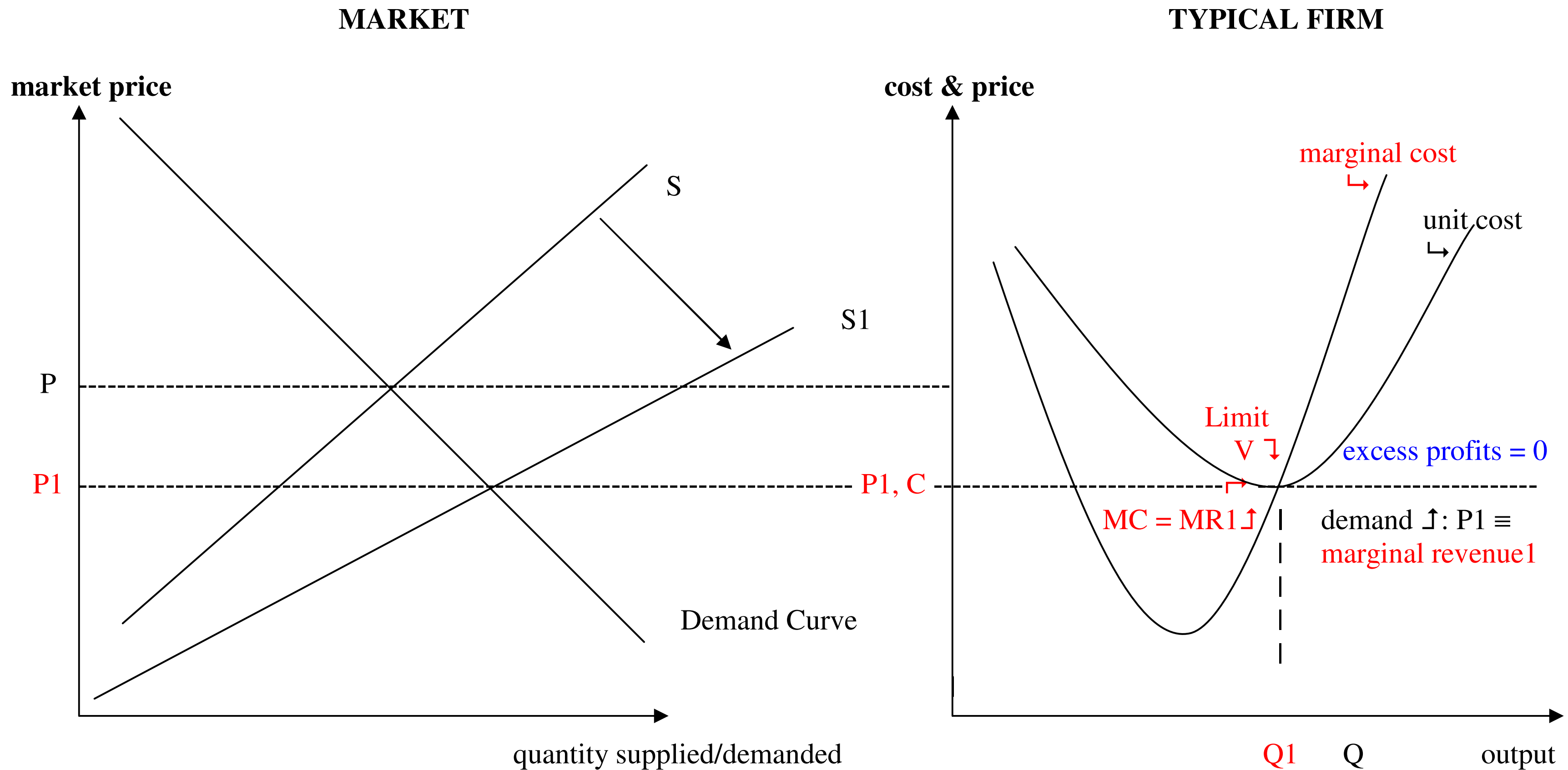
APPENDIX A

SHORT-RUN PERFECT COMPETITION



A perfectly competitive market is one in which (a) the product is homogenous, (b) there are so many buyers and sellers that no single buyer or seller has control over the price or, simply, price P is determined in the market, and (c) there are low barriers to competition and therefore it is easy for a new firm to penetrate this market. The typical firm in such a market is able to sell as much or as little at the market price without influencing that price. P ≡ MR because each additional unit sold adds to the firm's total revenue an amount equal to the product's market price. The short run is that time period from the present into the future during that the firm faces no new competition. This time period is longer for firms producing complex products or services and utilizing capital-intensive and roundabout production processes. With price P, the firm maximizes short-run profits by producing Q. Excess profits = [(P - C) x Q].

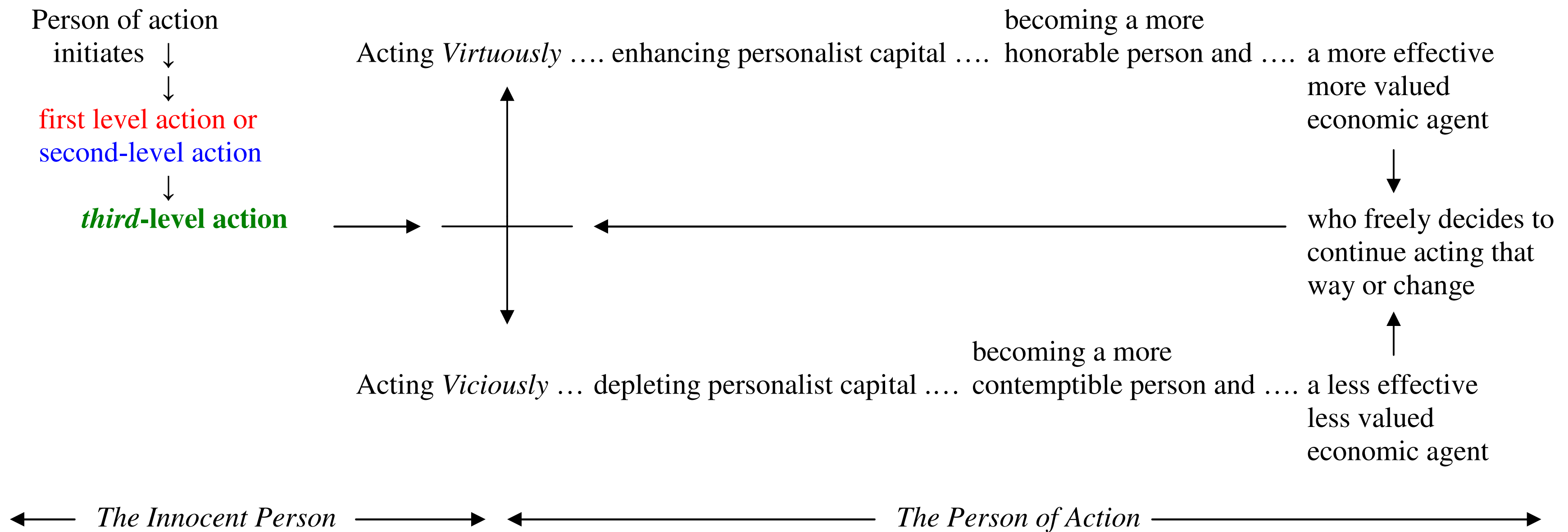
LONG-RUN PERFECT COMPETITION



In the long run new firms will enter a perfectly competitive market expecting to earn the same excess profits that the typical firm has been achieving in the short run. Their entry shifts the supply curve from S to S1 dropping the market price from P to P1. New firms continue to enter the market until P1 = unit cost at Limit V. Following the profit maximization principle, the firm reduces output from Q to Q1 thereby conforming to the principle of supply: the lower the price (P→P1), the smaller the quantity supplied (Q→Q1). At Q1 where output is uniquely associated with MC = MR1, the firm operates at maximum efficiency (Limit V). If it operates at any output other than Q1, it loses money because at every output other Q1 unit cost > P1. The activating principle of competition forces the firm to minimize waste or be driven out of business. Though excess profits = 0, the normal profits of the efficient firm, which are included in the cost of production, enable the owners to continue operations.

APPENDIX B

ACTING VIRTUOUSLY OR VICIOUSLY AND PERSONALIST CAPITAL: DEVELOPMENT OF THE PERSON OF ACTION



With justice, caring, and Christian charity, acting virtuously means *justly, generously, lovingly.*

In contrast, acting viciously means *unjustly, miserly, hatefully.*

First-level action refers to reflexive or instinctive action that humans have in common with animals.
Second-level action is purposeful or intentional.
***Third*-level** action produces a change (good or bad) in the person who engages in that action.