

What is the Best Way to Argue Against the Profit- Maximization Principle?

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A COMMENT ON Waheed Hussain (2012), “Corporations, Profit Maximization and the Personal Sphere,” *Econ & Phil* 28(3): 311–331.

ABSTRACT

This brief paper engages with Hussain’s critique of what he refers to as the “efficiency argument for profit maximization.” Here I argue that Hussain’s strategy of seeing the corporation as an extension of the private sphere is not a very effective way of challenging the profit-maximization norm.

WAHEED HUSSAIN HAS recently intervened in the normative discussion on the goals toward which corporations ought to be oriented. Hussain argues that we cannot conceive such orientations solely in terms of social optima, but must balance these goals with our liberal commitments to what he calls respect for ‘personal space’. He frames this as a critique of Jensen’s (2002) efficiency argument for maximizing profit (EAMP), claiming that this normative standard prescribes one particular good for corporations – the good of maximizing profit – at the expense of other aims. The problem with the EAMP is seen most starkly when considering non-profit and hybrid corporations, which explicitly seek goods other than profit. Therefore, even if

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Jensen is right that a profit-maximization norm produces a social optimum in terms of welfare, Hussain says we need to balance this social optimization with our private freedom to associate with others to pursue our aims. Because the corporation is an extension of ‘personal space’ we should not apply blanket principles to it that stipulate one good over others.

I should say at the outset that I agree with the spirit of Hussain’s argument, which I take to be resisting ‘profit’ as the sole criterion by which corporate behavior should be judged while also being skeptical of stakeholder theory as a viable alternative. Still, I would like to pose two objections to his approach. First, I believe Hussain mischaracterizes Jensen’s argument, which is not so strongly at odds with concerns about the personal sphere and individuals’ ability to choose particular corporate aims. Secondly, I argue that we ought not to see the corporation as an extension of the personal sphere as Hussain suggests. Instead I contend that recognizing the firm as a social and political institution presents the best way to understand the diverse purposes and responsibilities corporations have.

The first point to note is that Hussain claims Jensen sees maximization of profit and maximization of value as the same, despite Jensen’s insistence on emphasizing the latter. Hussain argues that, for Jensen, the long-run market value of a corporation is essentially equivalent to the “long-run market value of the stream of profits that the firm will generate” (2012: 313). What seems important for Jensen about “long-run value,” however, is that the streams of benefits and profits brought about by investment will not be uniform throughout time and will also entail varying degrees of risk. Because of this, to calculate long-run market value we need a proper interest rate and price of risk in order to value correctly the likely future return on investment. As Jensen (2002: 241) puts it:

it is the risk-adjusted interest rate that is used in calculating the market value of risky claims. ... It tells firms to expand output and investment to the point where the market value of the firm is at a maximum.

The reason why this is significant is that a risk-adjusted interest rate will be best discovered in the context of competitive securities markets. Indeed, Hussein betrays the tension here between profit

maximization and value maximization when he asks, in a footnote, why Jensen emphasizes capital markets instead of simply talking about profits. He answers this by saying that it must be either because Jensen assumes capital markets are best at predicting a company's future earnings or because capital markets produce expert guidance as to what will produce profits (Hussain 2013: 315). The question, of course, is *why* capital markets would be seen as providing this type of information. The answer can be gleaned from Jensen's at-length quotation of Hayek's *The Fatal Conceit* as well as Jensen's prior work (e.g., Jensen 1998): the importance of capital markets is not the particular knowledge of market participants but the contention that such markets produce a set of prices. By emphasizing capital markets, the point is to subject managers to the discipline of the market, a discipline the corporation otherwise evades by virtue of suspending the price mechanism in coordinating its internal affairs (Coase 1937).

This is essentially an adoption by Jensen of the Hayekian point which even most of us on the left have accepted: the virtue of markets is the information they convey to producers and consumers through prices (Hayek 1945). How do we make sure corporations are producing in accordance with the needs of society? Jensen's answer is that securities markets force firms to be guided by the price mechanism. When deciding on business strategies, corporate managers must take into account the capital they will be able to raise (by selling stock at a higher price) or lose (if the price of their stock is devalued); in this way the prices of securities discipline the types of decisions corporations make. The significance of maximizing long-run market value as opposed to profit is that it emphasizes the price constraints introduced by capital markets. So although Hussain contends that EAMP is primarily concerned with aggregate social welfare, this is not quite the case. Profit is to be maximized insofar as it maximizes long-run market value, yes, but this is for the sake of correct prices, the aim of which, strictly speaking, is efficiency-gains, not welfare maximization in the aggregate. The Paretian argument for the efficiency of competitive market prices² kicks in here, which Jensen (2002: 240) makes clear:

² Some translation for those uninitiated in the art of economic jargon: The idea of "Pareto efficiency," simply and non-technically put, says that an allocation of goods is more efficient if one party sees it as benefiting them without another party seeing it as harming them.

Because the transactions are voluntary, we know that the owners of inputs value them at a level less than or equal to the price the firm pays or they wouldn't sell them. ... Likewise, as long as there are no externalities in the output markets, the value to society of the goods and services produced by the firm is at least as great as the price the firm receives for the sale of those goods and services. If this were not true, the individuals purchasing them would not do so.

The point about competitive pricing is important because the social good being produced is simply an aggregation of individual decisions, which is why Jensen notes that the transactions are voluntary. Corporations are to maximize long-run value because doing so allows for transactions to occur which maximize gains in Pareto efficiency (assuming the absence of externalities, which Jensen says should be handled by government).

We can see here the problem with Hussain's takedown of Jensen. Hussein wants to argue that the EAMP intolerably restricts the personal freedom of people – trespasses on their “personal sphere” – by imposing a norm of profit maximization. However because the rationale is to maintain competitive markets that are efficient, it is not clear precisely why this restricts personal freedom; only if the transactions are voluntary will the result be efficient. It does not seem that the corporation is as constrained in choosing its ends as Hussain maintains. Hussain wants to say that it is restrictive because it imposes a particular good to be achieved by the corporation – long-run market value – and in so doing restricts the goods we choose to seek. Again, the examples of hybrid corporations, B corporations, and non-profits make these concerns quite concrete.

Hansmann (2000), amongst others, has made a compelling case, from the standpoint of efficiency, that the various forms of corporate ownership – capital-owned, worker co-operative; customer-owned, non-profit, etc. – represent in various situations the least-cost assignment of ownership rights, and are all in fact completely compatible with an efficient economy. Hussain can't make recourse to these arguments, however, because he distinguishes Jensen's argument from other arguments (like those coming from shareholder primacy and law and economics) that privilege profit for instrumental reasons. As I have been arguing, this is mistaken since Jensen's argument is that value maximization is itself instrumental to the achievement of correct prices and efficient markets. In this sense it is not actually clear that

Jensen's argument restricts personal space in the way that Hussain is concerned.

This is where my second objection to Hussain comes into play. Hussain's argument hinges on a view of the corporation as private. That is, he assumes that the corporation is composed of private people pursuing privately-determined aims (Hussain 2012: 326). This view of the corporation is essential for Hussain, who wants to argue that whatever social optima we might wish collectively to pursue, those optima must also respect – and at times be limited by – personal freedoms. Because the corporation is an extension of such freedoms, a demand that we impose any single good upon corporate pursuits will always be problematic. However, as we can see now, the idea that the corporation is a private association is really not at odds with the underlying Hayekian premises of Jensen's argument. By asking corporations to maximize value, Jensen mainly wants to allow as many other people as possible in the economy to be able to achieve their goods as well. So what do you do if you have social concerns other than value-maximization? Simple: don't form a corporation or, as we generally do, form a different type of corporation. Surely, Jensen's argument would not require all *associations* to maximize value or profit; the Toastmasters need not hire market analysts. More to the point, according to Hussain's argument we would have no reason to grant non-profits special tax status since they are simply corporations pursuing different goods than profit-driven firms. What Hussain needs is a theory of why we have corporations and what distinguishes them from other organizations. The most compelling candidate for such a theory is, of course, that corporations procure efficiency gains, but even if that is not what Hussain wants to put forward, the fact that corporations exist to achieve some social purpose does not really seem escapable.

There is also a normative problem with seeing the corporation purely in private terms, which is that it obscures relations of power and domination within the corporation. If we take the corporation to be purely a private matter then it follows that private individuals enter into these relationships for their own reasons; in terms of public intervention, this would imply a strong presumption against interference. To understand the corporation as an extension of the private

sphere then is to be overly-permissive with regards to normative constraints on corporate organizing. Instead of seeing the corporation as a private space that is resistant to the demands of social welfare, we ought on this view to see the corporation as either an extension or concession of government used for and constrained by concerns for social welfare. As Hussain notes, this is clearly historically accurate, but it also reflects the contemporary fact that corporations are structured, privileged, and bound by statutory constraints and are in that sense fundamentally political. There is a growing interdisciplinary interest in this political view of the corporation, a view that is attempting to issue in normative theories of corporate behaviour while distinguishing itself from both stakeholder theory and shareholder primacy.³ This allows for concerns of economic efficiency to be addressed while also allowing for the creation of space for other pursuits through tax exemptions and subsidies. This appears a more viable theoretical account of why we should reduce the emphasis on profit.

Received 19 Apr 2013 / Posted 13 May 2013

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³ In addition to recent debates in this publication regarding the political nature of the corporation see Ciepley (2013).