Why Profits Are Good

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THE chief social role of business is to produce the goods and services that people need in their daily lives. By making better and cheaper products, and creating new ones, firms raise living standards and countries grow richer. Business is the wealth-creating institution of society.

I propose to examine this core function of business and set it against the backdrop of recent economic history. I take a very positive view of the primary role of business. In this I differ from those who believe that the alleged effects of globalization mean that business must accept new and potentially costly obligations.

Business is the instrument that has freed many people from mindless toil. Over the past 200 years it has transformed the way we live. It has expanded opportunities, unleashed advances in technology and even civilization, and has allowed countless individuals to apply their talents to achieve their own aspirations.

Competitive economies are organized in the interests of consumers, not producers. Consumers are the employer's employer. Firms respond to the demands of customers by keeping down costs and prices, and by timely innovation. They supply jobs and generate returns on the investments that savers make in them. Through competition, companies are forced continuously to give better value for the consumer's dollar.

On a practical level, one could say that business is just the ordinary stuff of life. It is about trading in the marketplace for mutual gain, as has happened from time immemorial. If firms do their job well and persuade customers to part with their money, they will flourish. If they don't, they won't.

Ordinary the role of business may be, but boring it is not. It has produced amazing products from penicillin to Prozac, and from gramophones to iPods. As historian and journalist Paul Johnson has written, business is creative:

> [T]his is a point often missed about the capitalist system. We have been taught to see it, particularly by Marxists and their contemporary successors, purely in financial terms … But capitalism also involves starting from nothing, building vast factories, digging mines and launching exciting new products onto the market.

All of this ingenuity is a natural consequence of the central impulse of business—to achieve profits by delivering products at prices that at least cover their costs of production. Or, in common parlance, to make money. This is what people seek to do in their working roles every day. Teachers, for example, seek a return on their human capital just as investors in a firm seek a return on the financial capital they have contributed. Investors who don't care about the returns on their savings are rare creatures; so too are teachers who don't care how much they are paid.

Of course, money must be made honestly. Businesses must operate lawfully and ethically. Situations can arise in which directors and managers, and shareholders too, need to consider what it is right for a company to do, not just what is legally permitted or required.

To be successful, a business has to have regard to the views and interests of a range of stakeholders—including consumers, employees, suppliers and the communities in which it operates. Even if it were true that shareholders are only interested in a company's bottom line, its profitability is sensitive to the firm's reputation among its stakeholders. Simply because of their size, large firms are more visible to the public and therefore more vulnerable than small firms to negative perceptions affecting their reputation. While a small firm in the fast food industry would seldom be attacked on the grounds that if you eat too much of its products you will become fat, that is precisely the basis of recent adverse publicity aimed at McDonald's.

So there is no argument that businesses have social responsibilities, as do other organizations such as partnerships, co-operatives, clubs, trade unions, universities, charities and churches in which people join together voluntarily to pursue common goals.

The only debate—and it is an important one—is about the specific roles and responsibilities we should ascribe to businesses on the one hand and governments on the other. Establishing and maintaining an open and competitive market economy is a matter for public policy. It lies outside the power of an individual business. Economic progress does not depend on a commitment by businesses to bring it about, but on the twin stimuli that a market economy provides: wide-ranging entrepreneurial opportunities and pervasive competitive pressures. It is governments that determine public policy, which includes creating the policy environment in which businesses must operate.

In a forthcoming study, *The Role of Business in the Modern World*, British economist David Henderson looks back over the past half-century. He finds that the 'record of unforeseen economic achievement often goes unrecognized or undervalued'. He notes that, generally speaking, sustained high growth rates have owed little or nothing to direct foreign aid, to public-spirited conduct by large international firms, or to collective resolutions and initiatives on the part of 'the international community'. Instead, everywhere, 'the material progress of people, rich and poor alike, depends primarily on the dynamism of the economies in which they live and work' and the performance of businesses within them.

Martin Wolf, the economics editor of the *Financial Times*, argues in his new book, *Why Globalization Works*:

> The active force of profit-seeking business people exploited and drove the economic transformation, as it continues to do to this day. It is they who choose the investments and make the technological innovations. The market economy is, as a result, the only human institution that generates a 'permanent revolution'.

There are those who oppose this 'permanent revolution'. I will look at two of the most common threads of this debate: the pot-shots often aimed at globalization and the argument for new forms of 'corporate social responsibility'.

The myths about globalization include the idea that it is a sudden, new development that has been forced on reluctant governments; that it has 'marginalized' poor countries; conferred undue benefits or new powers on multinational enterprises; deprived governments of the power to act; and created a need for new procedures for 'global governance'.

Contrary to assertion, the closer international economic integration of recent years is not a new phenomenon. It was strongly in evidence over the century that ended in 1914, and though reversed between World Wars I and II, was clearly re-established, albeit with many limitations, in the decades following 1945. It did not assume a new character, nor create a radically new situation, in the 1990s.

Governments have made trade and capital flows freer in recent decades, and some of them have even made international migration flows freer, because they considered with good reason that this was in the interests of their citizens. But governments have remained sovereign; they continue to lay down the rules for business operation, whether liberal or illiberal. They may voluntarily sign up to international agreements, such as those arising out of the World Trade Organisation, but equally they are free to reject or (subject to meeting procedural commitments) withdraw from them.

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Globalization has brought gains to people in all countries, rich or poor, where market economies are sufficiently developed for business enterprises to be able to profit from greater economic freedom. In China, India and many other developing countries, moves from plan to market have lifted millions out of poverty. The usual problem with the most backward countries is not too much globalization but too little.

The further liberalization of cross-border transactions has opened up new opportunities for enterprises to innovate and has strengthened the competitive pressures on them to do so. In this process, the primary role of business—as agents of change within a market economy—has neither been undermined nor put in question: to the contrary, it has been confirmed and reinforced. Multinational enterprises are under greater pressure than ever to perform.

Mistaken ideas about globalization have, however, helped fuel the argument for the adoption of 'corporate social responsibility' (CSR). Using the claim that 'the business of business has changed', advocates of CSR tell us that today's company should meet 'society's expectations' by pursuing the goal of sustainable development and thus consciously contributing to the public welfare. They also seek to impose on firms new obligations, such as 'triple bottom line' reporting, and the requirement to consult and negotiate with non-governmental organizations (NGOs) and other 'stakeholders'.

The term 'sustainable development' is problematical. Nobody is for 'unsustainable development'. But the idea that economic growth is the antithesis of sustainable development is flawed. Growth typically leads to improved environmental quality by raising the demand for it and providing the wherewithal to meet that demand.

The additional obligations proposed by advocates of CSR would be likely to raise the costs of firms and reduce shareholder value and national income. Firms adopting the doctrine of CSR have an incentive to ensure that competitors are forced to follow their example. This makes for over-regulation and a weakening of competition. Moreover, CSR requires companies to make highly debatable political judgements. By diverting the focus of boards and managements from shareholder value maximization, it also allows them to escape accountability for poor financial performance.

Martin Wolf, in an article, *Sleep-walking with the enemy* (Financial Times, 17 May 2001) has pointed out that:

> … behind the pressure to adopt social responsibility lies hostility to the profit motive itself. What is needed, critics argue, is to put 'people before profits'. The truth is the opposite. It is by seeking out opportunities for profit that business contributes to economic and social development. Competitive businesses are forced to seek new markets and employ previously under-used resources. In so doing they benefit their customers, their employees and the countries in which they operate.

Economic profits reflect the difference between what consumers are willing to pay for goods and services and the costs of producing them. In a well-functioning market economy, enterprise profits are performance-related: they can only be earned by serving consumers in resourceful and innovative ways. Profits can thus serve as an indicator of each enterprise's contribution to the welfare of people in general. As such, profits and losses provide an indispensable economic signalling function. How well they serve this purpose depends largely on the extent of competition and economic freedom—they cease to perform the same role if they are due to subsidies, protection or exploitation of a monopoly position.

The American economist Thomas Sowell in his book, *Basic Economics: A Citizen's Guide to the Economy,* has responded to critics of the profit motive by saying that:

> The greatest contribution that a business makes to the economy and the society is in producing the most goods with the least resources … What matters is not the motivation but the results. In the case of business, the real question is: What are the *preconditions* for earning a profit?

From an economy-wide perspective, David Henderson argues that the right preconditions are: a reasonably stable government that acts responsibly in matters of public finance and the control of the money supply, well-maintained property rights, and freedom for individuals and enterprises to control their own economic decision-making.

A key element is economic liberalization. Liberalization has two related purposes. First, it enlarges the domain of economic freedom for people and enterprises alike. Second, it furthers the material welfare of people in general. From a liberal standpoint, both purposes can be viewed as ends in themselves, while the first is also a means to the second.

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The *Economic Freedom of the World 2004 Annual Report* showed that economically free nations achieved an average of 3.4 per cent per capita growth a year from 1980 to 2000, compared to 1.7 per cent for countries with middling economic freedom and just 0.4 per cent for 'unfree' nations. The results are even more startling for poor nations. Economically free poor nations had an average growth rate of 5.2 per cent compared to 1.7 for the middle group and 0.6 per cent for the least free group.

Let me therefore summarize the points I have been making, which are essentially those in David Henderson's forthcoming book.

First, business is the wealth-creating institution of society. Its prime social role is to meet consumers' needs in the most efficient manner, and thereby raise living standards.

Second, it is the responsibility of governments to create an open and competitive economic environment in which business can make its most effective social contribution.

Third, alternative notions of corporate social responsibility should be rejected on the grounds that they are based on incorrect premises and would deflect business from its primary role. One of the mistakes of our time is to divert people or organizations from the good they do for society by performing their roles well and to assign them instead the problematical role of trying to do good directly.

Fourth, profits and losses serve an essential function in a competitive economy; generally speaking, they signal where society's resources can be put to best use.

And fifth, there is ample scope in most countries for further economic liberalization. Recent trends in the opposite direction here are worrying. As Henderson puts it:

> Measures and policies that narrow the scope of markets and reduce economic freedom can do extensive harm. Not only do they act as a brake on economic progress, but they are liable to impair the quality of individual and social life. A well-functioning market economy gives people the freedom to act in ways that will make their lives more complete, as well as materially richer.

This is a reality that should be taken to heart by those who wish to see our prosperity continue.

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