The Accuracy, Market Ethic, and Individual Morality Surrounding the Profit Maximization Assumption

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Abstract: This paper hinges on the distinction between "maximizing profit" and "making profit." It recounts from Adam Smith the ethical basis for profit making, and observes from Augustin Cournot why the maximization assumption was introduced. Several introductory texts are examined to observe how profit maximization is presented. The veracity of the assumption is challenged by considering: owner/managers who focus on utility rather than profit, corporate maximization of shareholder wealth, corporate managers who pursue personal benefits, and evidence of "corporate social responsibility." Milton Friedman's 1970 *New York Times Magazine* essay, "The Social Responsibility of Business is to Increase its Profits" is used to support that the ethical justification for the market system does not rest on maximizing profit, and that individuals often have moral latitude to pursue non-pecuniary business goals alongside seeking profit. Teaching that all firms maximize profit poorly educates students concerning how some firms actually behave and it reinforces a pecuniary value.

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I. Introduction

The undergraduate introductory economics course, required of all business and economics majors and a "general education" elective for many other students, is for most collegians the only formal opportunity to learn "economics." Hence the economics commonly taught in this course is foundational to the college graduates' understanding of how the economy operates. Key to the theory that is developed in the introductory texts is to present firms as aiming to maximize their profit. This paper challenges the accuracy of this presentation, and addresses the related issues of the ethic of the market system and the moral latitude available to those who run businesses.

This analysis hinges on a distinction between the meanings of "making profit" and "maximizing profit," and it will begin by contending that this contrast is consequential. It will then highlight some concepts from Adam Smith to recount the ethical basis for profit making, and will observe from Augustin Cournot why the maximizing assumption was introduced and how it became the convention. Next the paper will examine several introductory texts to observe how the profit motivation is presented and explained. Then the veracity of this assumption is challenged by exploring alternative goals for firms, namely (1) owner/managers who focus on their utility rather than their profit, (2) corporate maximization of shareholder wealth, (3) corporate managers who to some extent enhance their personal well-being, a possibility allowed by the separation of management from ownership, and (4) aiming to adhere to various tenets of "corporate social responsibility." This fourth alternative will receive special attention, as it was the initial motivation for the paper. The discussion will then return to the ethical dimension of profit maximization including the argument as famously advanced by Milton Friedman in his 1970 *New York Times Magazine* essay, "The Social Responsibility of Business is to Increase its Profits." The paper will end by recognizing that firms generally do *enjoy* and thus *seek* profit, but the assumption that firms *maximize* profit poorly educates students concerning how firms actually behave and it reinforces a pecuniary value.

II. "Making profit" versus "maximizing profit"

An overlooked distinction by many academic economists between "profit making" and "profit maximizing" makes for a disciplinary chasm between them and many of their business colleagues. These seemingly simple semantics are loaded with meaning that is crucial to the understanding of firm behavior, and that is also paramount as businesspeople make both day-to-day decisions and as they construct their firms' overarching strategic visions. At issue is the very purpose of the company. Is it seeking to be profitable alongside other goals, or is it seeking to obtain all the profit that it possibly can? Being profitable, or "making profit," is both an incentive and a reward for providing the good or service that a firm brings to the market, and it is essential to the functioning of the market system. "Profit maximization" is a much more stringent purpose. It requires that all firm behaviors be directed at making profit as large as possible. The implications of this distinction are significant.

Consider a firm that has an unprecedented accident that generates some toxic solid waste. One of the firm's options is to pay a considerable sum to treat this waste in a way that is consistent with government environmental regulations. A second option is to illegally dump the waste and pay a relatively small fine that the firm knows it will be assessed. Putting aside the potential impact on the firm's reputation that may or may not affect its financial future, a *for-profit* firm may nevertheless decide to treat the waste. Conceivably this could be out of a commitment to the environment, an unwillingness to impinge on people who might live or work in the vicinity of the dumpsite, or a simple fidelity to the law. However, a firm committed to *maximizing* its profit will necessarily decide otherwise. It will carefully weigh the considerable cost of treating the waste against paying the small fine. It will elect to dump the waste and pay the fine.

This example is not a straw man. According to EPA testimony before a US Senate committee, polluters have "over and over again" paid a fine rather than clean up their operations. Weyerhaeuser is an example of a firm that over a period of several years opted to pay fines rather than discontinue illegal discharges (Goodstein 2011:288). The financial sector provides additional illustrations. The record of fraud settlements of the Securities and Exchange Commission reveals a pattern of institutions' repeated violations of federal securities laws. Citibank is among those who paid a fine, promised to not repeat an illegal activity, and then replicated the abuse. A US District Court judge included Citibank among the "recidivists" who have time and again paid sizable penalties for activities that remain profitable after the fines are discharged (Stiglitz 2012:204-5).

Aside from unlawful behaviors there are many legal actions by firms that seem best understood as a careful design to squeeze out the greatest possible profit. Some of the activities of Walmart appear to fall into this category, including locking nighttime employees into stores (Greenhouse 2004:1), and purchasing from vendors who produce in unsafe factories (Greenhouse 2012:1). The food industry is rife with legal but exceedingly harsh efforts to boost profits, e.g., slaughterhouse jobs have exaggerated injury rates due to the high speed imposed on the workers (Dillard 2008:392-3), and the introduction of the inhumane treatment of animals in "concentrated animal feeding operations."

These examples illustrate the distinction between callous "profit maximization" that goes beyond what is required of the less stringent goal of merely being profitable. Profit maximization requires a rational weighing of the costs and benefits of any potential action; if and when that careful calculation is put aside or placed second to other more basic goals, the firm is no longer in the maximization mode. This is, of course, very often the case. Basic considerations for employees, the environment, or the law are among the commitments that often take precedence over obtaining the greatest possible profit.[1]

III. Adam Smith and Augustin Cournot

With the distinction between profit seeking and profit maximizing in mind, it is instructive to revisit the writings of Adam Smith. In the paragraph from *The Wealth of Nations* in which he attributed the social benefits of the market to "the invisible hand," he credited the individual who "intends only his own security," "intends only his own gain," and who is “pursuing his own interest.” These characterizations are common to the tome and leave no doubt that Smith viewed employers of capital to be profit seeking. He used additional language that approaches profit “maximization,” but when carefully examined it falls short of endorsing the inflexibility that maximization requires (1937:423). To the contrary, Smith implicitly contrasted the socially beneficial “self-interest” of capital owners to a “mean rapacity … of merchants and manufacturers” who sought mercantilist favors from government and who perniciously gained public support for impediments to trade among nations (1937:460). This greedy portrayal of these agents is consistent with the no-holds-barred maximization of profit. So while Smith had the language of “mean rapacity,” he did not apply it to “self-interested” agents whose pursuit of profit made for a socially beneficial market system.

There are other indications in *The Wealth of Nations* that Smith did not assume “mean rapacity” to be an accurate generalization. For example, in contrast to that tenor was his vision of “commerce [as] a bond of union and friendship” (1937:460-461). He also observed that some owners of capital are more profitable “in consequence of a long life of industry, frugality, and attention” (1937:113), and that higher profit goes to those engaged in “disagreeable” businesses, e.g., the innkeeper dealing with “the brutality of every drunkard” (1937:101). By implication, other owners choose to sacrifice profit by being less economical, by working less diligently, and by enjoying more agreeable livelihoods; all are not profit maximizers.

More significant than these indications from within *The Wealth of Nations* is the entirety of Smith’s prior major work, *The Theory of Moral Sentiments*. A fundamental connection between the two works is the vision of individuals as self-serving. In *The Theory of Moral Sentiments* this did not extend to selfishness. That is, although individuals are self-interested, they are nevertheless capable of self-restraint. The basis for self-restrained moral behavior is the ability to "sympathize," or in modern language, "empathize" with others (Ekelund and Hébert 1990:121). This view of people as self-regulated moral agents is consistent with a view of self-interested economic agents who keep a check on unbridled greed, even though a tempering of "mean rapacity" may well diminish profit from the highest achievable level.

Smith's academic position was a chair in "moral philosophy," and he lectured on both "moral sentiments" and political economy, so it is certainly to be hoped that the that first volume, which developed the basis for individuals' moral behavior, is consistent with the second, which established the ethical legitimization for an economy based on the market system.[2] Nonetheless this consistency has been contested among scholars. "Das Adam Smith Problem" refers to the dispute dating to the nineteenth century concerning whether the two books are compatible, for example as described above, or alternatively if the self-interested agent from *The Wealth of Nations* is a contradiction of the moral agent in *Moral Sentiments*. In a 2003 analysis of that debate, Leonidas Montes cited a 1978 *JEL* review article and other circa-1980 sources that declared the issue resolved in favor of the two works being complementary, although not all detractors from the dominant view have conceded (78-79).

Montes advanced his own support of complementarity, and his argument culminated in a perspective that will be relevant later in this article. Namely, he described Smith's "sympathizing" as a process that plays out as individuals interact, as each person is "led to form 'certain general rules concerning what is fit and proper either to be done or to be avoided'" (Montes 2003:86; quoting Smith 1976:159). That is, "For Smith, moral judgment is socially embedded since moral codes emerge from social interaction" (Montes 2003:84). This implies that an individual's sense of morality evolves; and as s/he engages with others, their sense of morality evolves; and in this way, society's sense of morality evolves.

The essential point to be drawn from this consideration of Adam Smith is based on the vigorous case that his two books are consistent. Accordingly, the moral agent of *Moral Sentiments* is not a contradiction of *The Wealth of Nation's* self-interested profit seeker, but is at odds with the greedy "mean rapacity" akin to profit maximizing. That is, based on his astute observations of market behaviors, it was self-interested profit seeking that Smith advanced as a socially beneficial behavior.

The depiction of firms as "maximizing" profit entered economics nearly sixty years after *The Wealth of Nations* with Augustin Cournot's *Researches into the Mathematical Principles of the Theory of Wealth* (1971). In contrast to Smith's approach, Cournot's representation was not the consequence of observing firms' activities, and the book contained no accounts of greedy or ruthless behaviors. Rather, representing firms as profit maximizers became necessary by the employment of a new methodology. According to Irving Fisher, Augustin Cournot was the "principle founder" of the mathematical school of economics as he was the first "writer … to apply mathematical processes to political economy … [and] win substantial results" (1898:120

and 135). More specifically Cournot was the first to employ differential calculus to model economic behavior; and in that context and to suit that purpose he introduced the stringent maximizing assumption.

Cournot wrote, "We shall invoke but a single axiom, or, if you prefer make but a single hypothesis, i.e., that each one seeks to derive the greatest possible value from his goods or his labour" (1971:44). While this assertion is remarkably similar to a statement from *The Wealth of Nations* (Smith 1937:423), neither version necessitates profit maximization. That it, "deriving the greatest possible value from his goods," is arguably to *sell* one's output for as much as possible. This is not the same as using callous or inhumane methods in order to *produce* the goods at the lowest achievable cost; and profit accounts for both revenues and costs. However, Cournot took the unambiguous next step when he modeled the decision for choosing the price and quantity combination that yields the "greatest possible profit" (1971:56).

This limited need and narrow application at the introduction of the assumption of profit maximization is significant. As calculus became the language of economic theory, the maximizing assertion was adopted; and the adoption came, seemingly unwittingly, to extend well beyond the specific mathematical application of selecting the quantity and price. Thus, it is common today to assume that *all* decisions of the firm are motivated to garner the largest possible profit.[3] Accompanying this extension is that profit maximization, and not just making a profit, has come to be seen as inherent to the market system, and accordingly is considered an essential ingredient to realizing the social benefits of a market economy. Milton Friedman made an explicit statement of this conflation (of maximizing profit with making profit) in *Capitalism and Freedom* when he wrote, “Few trends could so thoroughly undermine the very foundation of our free society as the acceptance by corporate officials … [to do] other than to make as much money for their stockholders as possible” (1962:133). This focus on maximizing profit is found across the introductory economics texts.

IV. Profit maximization in introductory texts

Profit maximization is universal to the introductory texts, but there are noteworthy differences in how it is presented. Some books *announce* that firms maximize profit, while others explicitly *assume* that firms maximize profit. In addition, some presentations include a rationale while others do not. As will be pointed out, those rationales seldom stand up under scrutiny.

Roger Arnold is among those authors who simply announce, without explanation or any further comment, that the “firm’s objective is to maximize profits” (2014:498). Michael Parkin makes the same proclamation when he writes, “A firm’s goal is to maximize profits.” But unlike Arnold, Parkin does include a basis for profit maximizing by reasoning that a “firm that does not seek to maximize profit is either eliminated or taken over by a firm that does seek this goal” (2014:224). However this stated rationale falls short most obviously in that Parkin fails to indicate that he is implicitly assuming a publicly traded corporation, a condition that is hardly universal. Krugman and Wells arrive at depicting firms as profit maximizers by a more circuitous route, and like Arnold, they fail to explain their assertion. They begin with the “principles of decision making [weighing costs and benefits] that lead to the best possible - often called ‘optimal’ -

outcome" (2013:243-44). In considering "economic" outcomes, and when applying the principles to firms, the optimal outcome is that which yields "the highest possible total profit" (3013:253). They also maintain, "people *should* use the principles of economic decision making to achieve the best possible economic outcome" (emphasis in the original; 2013:243).

Rather than *describing* firms as seeking to maximize profit, many texts *assume* that firms maximize profit. Greg Mankiw arrives at this assumption by entertaining, but also trivializing alternative goals. He offers that a bakery owner might have opened her firm to altruistically provide cookies to the world or "out of love for the cookie business." He reasons instead that it is "more likely" that her motivation was to "make money." He then leaps from making profit to assuming profit maximization, asserting, "this assumption works well in most cases" (2012:236). The book by Case, Fair, and Oster makes the same leap. After reporting that "most firms exist to make a profit," they move to: "The analysis of a firm's behavior that follows rests on the assumption that *firms make decisions in order to maximize profits*" (emphasis in the original; 2012:48). Pages later they add, "[a]ll firms have an incentive to maximize profits" (2012:147). Perhaps so, but some firms have additional motives that may redirect them from profit maximization.

Compared to other texts a more thorough presentation is provided by Gerald Stone who states that alternative assumptions "have been tested." These include "sales maximization, 'satisfactory' profits, and various goals for market share." He explains that because the predictions based on these assumptions are not better than those following the profit maximization assumption, economists assume the profit maximizing behavior. He concludes, “it is the primary economic goal of firms” (Stone 2012:163). Irvin Tucker also affirms the “basic assumption in economics” of profit maximization, and he too acknowledges some alternatives. Namely, “managers of firms sometimes pursue other goals, such as contributing to the United Way or building an empire for the purpose of ego satisfaction.” But he maintains, “the profit maximization goal has proved to be the best theory to explain why managers of firms choose a particular level of output or price” (2011:182). Here Tucker has correctly noted the narrow instrumental basis for the assumption.

This brief examination of texts illustrates that the goal of profit maximization is asserted in a variety of ways. However a more general aspect of the presentations is its placement in close proximity to solving for the firms’ preferred quantity of output. Just as Cournot needed the axiom to employ his mathematical method, modern texts bring it to bear on the same purpose. Yet in most cases the authors do not recognize this methodological motivation for the assumption. Nor do the texts offer the moral counterpoint as Adam Smith did with *The Theory of Moral Sentiments*. In the absence of an explicit moral context, the texts’ emphasis on carefully calculated decision-making aimed at profit maximization teaches and (thereby intentionally or not) encourages this one approach to understanding and thus participating in the world of business.

V. Recognized alternatives to profit maximization

The introductory version of economics that presents firms as profit maximizers is at significant odds with other well-recognized models of business motivations. In fact the academic literatures from economics, finance, and business have advanced a number of firm motives that compete with profit maximization. A sampling from those literatures will demonstrate that the characterization of firms as profit maximizers meaningfully misrepresents the diversity of actual firm orientations.

A first counter to the profit maximization portrayal pertains to the operations of proprietorships and partnerships. In these cases there is no market disciplining by shareholders, and the owner/manager is at liberty to maximize his/her utility in running the business. This is reminiscent of Smith's description of proprietors who have distaste for "industry" and "frugality" and who forego higher levels of profit for more personally agreeable lifestyles. In a different spirit, profit might be willingly sacrificed to provide more generous wages and benefits for employees, to allow production processes that are more environmentally sustainable, or to provide monetary or in-kind support for community charities. From yet another angle businesses may choose to forego profit to make nepotistic hires; indeed a "family business" is in a sense nepotistic by definition. In the United States in 2002 approximately 80 percent of all US businesses were non-corporate (US Department 2006). As of 2008 there were over 21 million firms that had no payroll, and these unincorporated self-employed individuals comprised nearly three-quarters of all businesses (US Department 2012). There is no *a priori* basis for assuming that the owners of all of these establishments have identical utility functions that lead each of them to sacrifice all competing goals to the one aim of achieving the highest possible level of profit.

Turning to the corporate structure, a very common critique of assuming profit maximization is highlighted in the introductory chapter of *Fundamentals of Corporate Finance*, a college text by Brealey, Myers, and Marcus. They argue that profit maximization is an ill-defined corporate objective due to the ambiguity concerning which year's profit is to be maximized. To illustrate they point out that cutting current maintenance budgets can raise current profit to the detriment of profit in later periods, and that investing more of the firm's funds today would reduce current profit but potentially expand future profitability. Instead of profit maximization they reason that "a natural financial objective on which almost all shareholders can agree [is to] maximize the current market value of shareholders' investment in the firm," a position which quickly morphs into their assertion that "**the natural financial objective of the corporation is to maximize market value**" (bold in the original; 2012:12-13).

The wide acceptance of this approach is asserted by Danielson, Heck, and Shaffer who state, "Shareholder theory defines the primary duty of a firm's managers as the maximization of shareholder wealth ... [This] theory enjoys widespread support in the academic finance community and is a fundamental building block of corporate finance theory" (2008:62). Thus maximizing shareholder wealth is a commonly accepted alternative to profit maximization. That said, this particular alternative is akin to profit maximization it in two essential regards: a *pecuniary* value is being *maximized*. In the analysis to follow, those commonalities will be the usual focus.

There are, however, standing challenges to maximizing the pecuniary benefits of the corporate owners, whether those benefits are considered to be profit or shareholder wealth. A first alternative stems from the separation between the ownership and the control of corporations, the principal-agent problem, which can allow management to pursue its own interest, even to the detriment of shareholders. Due to the wide recognition of this conflict of interest for managers, “incentive pay” schemes have been implemented with the intention of aligning manager interest with shareholder interest. But as summarized by Joseph Stiglitz, systems of corporate governance continue to allow “executives to do what is in their interest - including adopting compensation systems that enrich themselves - rather than in the interests of … shareholders” (2012:111). A consequence is the dramatic increase in executive compensation commonly reported as the swollen ratio of CEO compensation relative to that of workers. Mishel and Sabadish found that when including the stock options that CEOs exercised, the ratio of executive compensation to worker compensation rose from 20.1:1 in 1965, to a 2000 peak of 383.4:1. From there the ratio fluctuated and ascended again to 231.0:1 in 2011 (2012:2).

This conflict between owners and managers has been in the literature at least since 1932 when Adolf Berle and Gardiner Means originally published *The Modern Corporation and Private Property*. More recent literature described how managers can protect their jobs by exploiting asymmetries of information to reduce the prospects of being taken over by rival firms. This can be achieved by extending the corporation into areas better suited to the manager’s particular management skills, and poorly suited to the management abilities of rivals. Another way for managers to discourage rivals is by undertaking investments with a high degree of uncertainty. This clouds the value of the corporation and reduces the likelihood of a takeover (Edlin and Stiglitz 1995:1301-2).

When managers engage in such activities to secure their own jobs, the firm is not attending to a primary goal of pecuniary gain for the shareholders.

VI. Corporate social responsibility

The business literature on corporate social responsibility (CSR) is extensive and replete with alternative approaches, priorities, and terminologies. “Social issues management,” “stakeholder management,” and “corporate sustainability” are but three of the numerous approaches that have garnered focused academic and practitioner discussions. In “Corporate Social Responsibility: Mapping the Territory,” Elisabet Garriga and Doménec Melé (2004) reviewed the CSR literature and constructed four broad categories of CSR theories.

Their first category sees firms using CSR as an “instrument” to achieve the overriding goal of wealth creation. So this variety of CSR does not place it as an alternative to pecuniary maximization, but rather subservient to that aspiration. Consequently this type of CSR is not a challenge to the exclusive monetary aim of corporations. However, Garriga and Melé’s remaining three CSR classifications are alternatives to the sole focus on pecuniary gain. These are “political theories” that address the responsible political use of corporate power, “integrative theories” that have corporations addressing various social issues as the causes take on societal prominence, and “ethical theories” that center on businesses doing “the right thing to achieve a good society” (2004:63-64). The ethical theories are arguably the furthest removed from the agenda of the pecuniary maximizers.

Among the ethical theories is the “universal rights” approach illustrated by the United Nations’ Global Compact. Through this program the UN solicits commitments from firms to observe ten principles concerning labor, the environment, corruption, and basic human rights. As introduced by the UN webpage, “The Global Compact asks companies to embrace universal principles and to partner with the United Nations. It has grown to become a critical platform for the UN to engage effectively with enlightened global business.” The 10,000 firms that have signed on include Seimens AG, PepsiCo, and Unilever, and the companies come from 140 different nations (United Nations).

According to the CSR classification by Garriga and Melé, firms that engage in a “universal rights” version of ethical CSR are not first and foremost seeking to maximize pecuniary gain, but rather they hold a conviction to support some universal principles. However, a persistent question remains concerning the firms’ ultimate motivation. For example, maximizing firms’ profit is not the UN intention in promoting the Global Compact, and the UN appeal to potential signatories is not made on that pecuniary basis. Nevertheless the corporate decision to commit to the Compact could conceivably result from a financial calculation by the signatories, i.e., the anticipated extra cost of abiding by the principles could be outweighed by the expected benefits of a strengthened corporate reputation. Any such ambiguity concerning the corporate motivation is cause for doubt among economists who were taught, and who have taught others, the axiom of profit maximization. This axiom predisposes economists to interpret all CSR measures as instrumental, regardless of how they are framed.

Skepticism among economists concerning whether any CSR is ultimately "ethically" motivated must, however, contend with the practice of many corporations to publicly pronounce that they are attending to the environment, customers, employees, communities, and others with a "stake" in the firm. These are corporate proclamations that fiduciary commitments to other stakeholders sit alongside, and not below, the commitment to shareholders (Garriga and Melé 2004:64). Such a public announcement seemingly puts the company at explicit odds with pecuniary-maximizing shareholders, be they current or prospective owners. That despite this disadvantage some corporations still make public their management orientation to serve multiple stakeholders, lends credence to the authenticity of their claims to CSR.

A recent vintage of the stakeholder model is "conscious capitalism," which was given a decidedly mixed evaluation by business ethicists James O'Toole and David Vogel. They begin by listing the characteristics of this model including consideration for the firm's multiple stakeholders, a significant role for employees in decision making, relatively modest executive compensation, and viewing profit, not as the primary goal, but as necessary to achieving a higher purpose. Among the companies they associate with conscious capitalism are Whole Foods, Southwest Airlines, and Starbucks. While they "applaud" and "admire" what such firms have accomplished, they warn against the hyperbolic claims of some promoters of conscious capitalism. An example of this exaggerated enthusiasm is evident in the subtitle of advocate Michael Strong's book: *Be the Solution: How Entrepreneurs and Conscious Capitalists* ***Can Solve All the World's***

Problems (bold added; 2009). At root O'Toole and Vogel are skeptical that the stakeholder model is suitable for wide adoption by firms (2011:61).

Their skepticism is based on their sense that the firms that are adhering to this model are typically selling comparatively expensive goods and services to somewhat affluent consumers. This puts those firms in the fortunate position of being able to afford to follow the stakeholder model by passing along some of the costs. This important assertion has empirical support. In their review of the CSR literature Markus Kitzmueller and Jay Shimshack state, "marketing survey, stated preference valuation studies, and revealed behavior econometrics papers all concur that … consumers appear to bear at least some of the costs of CSR" (2012:74). As O'Toole and Vogel see it, most firms are not in the position to pass along the CSR costs to consumers.

Their doubtful assessment is further fueled by their observation that "virtuous capitalism is difficult to sustain." They provide specific examples of firms that had been heralded for their principled practices and social commitment, but which were subsequently taken over by firms that lacked those commitments, went bankrupt, or over time simply failed to live up to the professed ideals. BP is an unfortunate exemplar. Based on a laudable environmental record it received high profile press accolades for its virtuous performance. Then came a refinery explosion in Texas, pipeline spills in Alaska, and the 2010 Gulf of Mexico drilling explosion that killed eleven workers and allowed an unprecedented spill (O'Toole and Vogel 2011:64-65).

For O'Toole and Vogel the "zone of opportunity" for applying stakeholder capitalism is limited in practical terms to the availability of win-win activities, meaning that the activity is profitable for the firm as well as promoting the other social aims. They note that Walmart has undertaken numerous environmentally friendly changes that have also cut its costs, but the company has not proceeded to other measures that would not provide financial reward. However the Walmart example does no more than to illustrate that for many companies CSR is "instrumental" and aimed at profit maximization, rather than "ethical," as promoted by conscious capitalism and other stakeholder models. The Walmart example does not contradict the stakeholder model, but merely illustrates the instrumental model.

It is important to notice that O'Toole and Vogel's skeptical view of "ethical" CSR is the logical outcome of their explicit convictions that "the interests of stakeholders can and often do diverge," and that "at publicly traded corporations … managers have no choice but to put the interests of shareholders first" (2011:67). But despite basing their argument on these two suppositions that together virtually preclude CSR (apart from the instrumental varieties), they nevertheless do recognize that conscious capitalism is sustainable for at least some corporations, and for others it is attainable for at least some period of time. That being the case, their work positions stakeholder capitalism as a feasible exception to the axiom of profit maximization.

Apart from market forces that might limit the ability of managers to trade off shareholder interests to benefit other stakeholders is the more fundamental constraint that managers have a legal fiduciary responsibility to maximize the pecuniary interests of shareholders. Reinhardt, Stavins, and Vietor review the competing perspectives on the legality of CSR and find that the issue is not clearly settled. They conclude that "maybe"

US firms are prohibited from foregoing profit in order to serve the public interest, but that in any case such a prohibition is not enforceable (2008:223). That unenforceability is supported by the large number of firms that are openly pursuing many of the non-instrumental versions of CSR. These corporate pronouncements have continued despite the 2010 ruling by the Delaware Supreme Court that stated, "Directors cannot defend a business strategy that openly eschews stockholder wealth maximization." This ruling has particular significance due to Delaware's prominence among the states for the chartering of corporations, including large corporations. Indeed more than half of the Fortune 500 firms were incorporated in Delaware (Black 2007:1).

One recent response to the legal ambiguities has been the development of an alternative legal option for terms of incorporation known as a "benefit corporation." This possibility is currently available in eleven US states and is being pursued in an additional sixteen (B Corporation 2013). According to their charters, benefit corporations are required to extend their considerations beyond their shareholders to include other stakeholders, society at large, and the environment. They are also obliged to make annual public accountings of their social and environmental impacts (Benefit 2013). Some benefit corporations have elected to pursue third party certification for their *firm* through the non-profit organization, B Lab. Ben and Jerry's, Seventh Generation, and Patagonia are included in the 715 corporations have received certification. Certified corporations are in 24 nations and among the 60 industries represented are manufacturing, textiles, agriculture, and a variety of services (B Corporation 2013). Clearly this third party certification effort is both young and small, but it is seeking to follow the success of the established movement that certifies specific *products*, e.g., Fair Trade coffees and FSC lumber (Conroy 2007). Kitzmueller and Shimshack report, “more than one-third of large firms have voluntary external certifications for social and environmental standards” (2012:51), reflecting that this broader system of third party accountability has taken root.

An essential question remains concerning the financial impact of CSR on the firms. That is, whether corporations frame their motives as “ethical” or as “instrumental” to increasing shareholder wealth, does CSR have a positive pecuniary effect? The answer from the literature that statistically tests the effects of CSR on the financial performance of firms is not conclusive. A 2009 meta-analysis by Margolis, Elfenbein, and Walsh indicates that CSR is correlated with a small, positive, and significant improvement in firms’ financial performance (23). At first blush this could be used as evidence that despite all the insistence to the contrary, CSR does ultimately emerge as instrumental, and thus is not an alternative to the maximization of pecuniary gain. However the causative direction of the relationship has not been established in either theory or by empirical analysis, allowing that firms who see themselves as able to afford a higher standard of conduct, do so even though it reduces their monetary gain from a yet higher level (2009:29). Nor do the results indicate that the motivation to undertake CSR was to increase profit. Perhaps the firms really were sincerely seeking to “do the right thing,” and were nevertheless rewarded. And as the reviewers also point out, the magnitude is small. Should a firm engage in CSR to enhance its financial bottom line, it should not expect to be richly rewarded. Finally, as others have reasoned, since CSR is associated with such a small monetary reward, the evidence could be interpreted as only weak support for the instrumental hypothesis (Kitzmueller and Shimshack 2012:71).

In sum, while firms with various levels of commitment to various versions of CSR all strive to make profit, there are ample theoretical and evidence-based grounds for accepting that for some companies, not every decision is based on whether or not profit is maximized. Thus CSR is an additional successful challenge to the axiom of profit maximization.

VII. The market ethic and individual morality

The ethical dimension of this discussion returns us to Adam Smith and Augustin Cournot. Though profit maximization was not what Smith defended, he did justify profit seeking. Having explained that individuals' "moral sentiments" temper their self-interested behaviors, he went on to expound on how the opportunity to obtain profit served to motivate owners of capital to contribute to society. On these grounds he advanced the market system as an ethical system, meaning that it worked to serve the common good.

However Smith's *observation* of socially beneficial profit making was subsequently altered, initially by Cournot, to an *assumption* of profit maximization in order to accommodate the application of differential calculus to predicting the firm's production level. As this mathematical approach and its requisite assumption were adopted, the view that firms maximize profit became the conceptualization of all firm behaviors, and not just the output decision. As the motive of profit maximization became conflated with profit making, advocates of the market system became advocates of profit maximization.

It is in this vein that Milton Friedman famously promoted profit maximization in his 1970 *New York Times Magazine* essay, “The Social Responsibility of Business is to Increase its Profits.” Corporate social responsibility was being publicly debated at the time and his piece argued against corporations seeking to advance a social agenda. For the most part Friedman made a moral argument concerning how individuals ought to behave in their jobs as corporate managers. He wrote:

> 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.

Of course much of the CSR literature disagrees with Friedman’s perspective concerning the executive’s rightful responsibility, and it prescribes a different set of executive obligations. Hence the longstanding moral debate.

In this excerpt Friedman supported law and ethical custom as restraints on pecuniary maximization when he accepted that corporations should operate within those confines. What he failed to recognize is how the operation of corporations can determine and narrow those constraints (to say nothing of *whose* laws and customs should be followed). Based on public proclamations it is clear that many CSR efforts are seeking to change customary behaviors. For example, through The Global Compact the UN is "seeking to embed markets and societies with universal principles and values," i.e., it is attempting to transform conventional behaviors. To the extent that corporations sign on and maintain their commitment, customary behaviors will evolve and the standards facing the remaining corporations will be raised. Adam Smith supported this perspective. As Leonidas Montes emphasized (above), Smith viewed individuals to be forming their moral standards as they interact in society (2003:82-86).

Socially responsible corporations can also help advance the legislative process to make the legal constraints on firms more stringent. Auden Schendler, a corporate sustainability officer and author of *Getting Green Done*, prods firms to aggressively reduce their own carbon footprints and then to "force the leaders to lead." He admonishes firms to "use their own business as a club to batter legislators with advocacy" (2009:97). Firms also can play a role in the regulatory sphere. Schendler's own employer, Aspen Skiing Company, filed an amicus brief to support carbon dioxide regulation in the *Massachusetts v. EPA* case that went before the US Supreme Court. In this way the company contributed to the legal process that ended with an expansion of EPA regulation under the Clean Air Act to include carbon dioxide (2009:92-93). Milton Friedman overlooked that CSR companies have special moral authority to exert in changing society's legal standards for business operations.

In his essay Friedman also moved beyond promoting individual behaviors when he made an ethical defense of the market system. He asserted:

> The political principle that underlies the market mechanism is unanimity. In an ideal free market resting on private property, no individual can coerce any other, all cooperation is voluntary, all parties to such cooperation benefit or they need not participate. There are no values, no "social" responsibilities in any sense other than the shared values and responsibilities of individuals. Society is a collection of individuals and of the various groups they voluntarily form.

While Friedman was explicitly arguing against corporations taking on social responsibilities, what he overlooked here is that CSR is completely consistent with the ethical framework of the “ideal free market” that he espoused. CSR is not an abrogation of private property, it is not coercive (certainly as viewed by economists), and since it is voluntary it can be presumed to be mutually beneficial. Today (even if possibly less so in 1970 when Friedman published his essay) corporate owners are among the voluntary participants. As noted by Kitzmueller and Shimshack, the adoption of corporate social responsibility is currently common, with over half the Fortune Global 250 firms and 10 percent of the S&P 100 providing regular public CSR reports. They noted that *The Economist* is among those who now view CSR as mainstream (2012:51). Shareholders who are displeased with a firm’s CSR initiatives need not become or remain owners.[4] It is also noteworthy that in this excerpt in which Friedman was defending the ethics of the market system (and not providing moral instruction to executives), his justification did not hinge on profit maximization, but rather on voluntary behaviors. That is, there is nothing in this statement of the ideal free market ethic that either presupposes or requires making as much money as possible. So in this instance of promoting the market system Friedman did not conflate making profit with maximizing profit.

The ethical defense of the market system relies on the profit motive and behaviors being voluntary. Neither of these is challenged by CSR. When firms engage in CSR the financial incentive and reward of profit making does not go away; these firms still seek profit, but that goal is (in non-instrumental cases) placed alongside other motivations. And CSR measures are voluntary. What the mainstreaming of CSR has done is to expand the creative thinking around and the legitimacy of corporate organizations serving other values in addition to making profit. In essence, the expanded adoption of CSR has expanded the scope for individual moral agency within the ethical system provided by the market.

VIII. Teaching only profit maximization miseducates students

To represent companies as profit maximizers is to overgeneralize and to misrepresent firms. Proprietorships, partnerships, and non-publicly traded corporations do not face the takeover threat that is posited to enforce profit maximization and these firms are free to pursue additional goals of significance to the owners. Even corporations that do have shareholder pecuniary gain as their only goal may well sacrifice profit in order to maximize long-term shareholder value. In addition, advantaged by asymmetries of information corporate management may to some extent prioritize their personal aspirations for high compensation and job security and thereby reduce the corporate profit. Finally, consistent with various of the CSR models, corporations may orient their efforts toward multiple ambitions and not have a solitary goal of profit maximization.

This range of alternatives demonstrates that economists err when they teach only that firms maximize profit.

Economists further err when they rest the benefits of voluntary exchange on the motive to maximize profit. The ethical foundation of the market system rests on non-coercion, but not on profit maximization. Within that ethical system there is often latitude for alternative firm motivations and individual moral agency. To the extent that economists teach that firms must maximize profit in order to avoid various unattractive market disciplines (e.g., being taken over or going out of business), economists are fostering an exclusive business focus on profit. To the extent that students are learning what they are being taught, they are predisposed in any future roles in a for-profit business to focus on the financial bottom line. They will also be predisposed in their consumer role to be dubious of corporate CSR claims and will perhaps discount opportunities to support businesses that have values that align with their own. Thus the profit maximization presentation limits the moral imagination of students and discourages them from bringing their own diverse moral priorities to their market exchanges.

To the degree that the introductory economics texts support the market system, they are advancing that ethical system. This is often done with an approving reference to the working of Adam Smith's "invisible hand." To the degree that the texts rationalize and normalize profit maximization, they are rationalizing and normalizing one particular moral choice. But rather than explicitly advancing this moral position, the promotion is unwittingly implicit when alternatives to an exclusive pecuniary goal are assumed away or are not seriously entertained.

As educators, economics text writers and instructors should enlighten their students about the variety of business alternatives to maximizing the firm's pecuniary gain. While profit making is essential, profit maximizing is one viable purpose among many. As societies struggle to meet some recurrent problems (e.g., global poverty) and some unprecedented challenges (e.g., climate change), teachers of economics should acknowledge that some firms are elevating social and environmental objectives to a position alongside their profit objective.

Endnotes

[1] At first blush this decision calculus could be accommodated by the conventional model of maximizing profit subject to constraints, with the simple inclusion of one or more additional social or environmental constraints. However as will be illustrated below, the introductory texts do not explicitly present the firms' motive as maximizing profit subject to a constraint, and this paper concerns the introductory texts. In addition, in the usual model the constraints are exogenous to the firm, e.g., the market price of inputs, while in the current discussion some firms may opt for additional self-imposed constraints, e.g., "reducing CO_2 emissions 25 percent by 2015." Since any such added objective is optional, modeling it as a "constraint" is misleading in that the limitation could be set aside simply should the firm opt to do so. Finally, when voluntary goals are not rigidly defined, e.g., "reducing CO_2 emissions," they are often better conceptualized as a goal that could be more or less aggressively pursued in light of the amount of profit sacrificed, rather than as a fixed constraint on profit maximizing.

[2] Throughout this paper I will use "moral" in reference to *individual* behaviors, and "ethical" when referring to the market *system*. This word usage is at variance with common parlance that conflates "morals" and "ethics"; neither does it conform to a more nuanced distinction made by many philosophers. However, this simple distinction is useful in clarifying my argument.

[3] It is noteworthy that the assumption of profit maximization is common to mainstream economics and Marxian economics, and that the assumption was instrumental to the deductive logic of the models adopted in these separate traditions. However, while Cournot came to the assumption without reference to observations of actual business enterprises, Marx scrutinized the activities within the burgeoning industrial sector. What Marx saw is consistent with "meanly rapacious" profit-maximization.

[4] It is arguable that opting to not purchase shares in a CSR firm is altogether different from having to contend with a decision to adopt CSR by a firm in which a shareholder already holds stock. On the other hand, at this point CSR is mainstream, so shareholders should be aware that it is a part of the corporate landscape. And as reported above, CSR is correlated with a small increase in stock values, making it unclear that shareholders are harmed.

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