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Why corporate purpose matters

A plea for responsible profit-making

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INTRODUCTION

After several decades in which shareholder value has been promoted as the most rational goal a corporation should pursue, questions are being raised, doubts are arising, and criticism is becoming louder and louder. Among the alternatives to shareholder value that are emerging, the idea that managers should be attentive to the interests of all stakeholders is gaining ground.

In this paper, three questions are examined:

- How could shareholder value be so successful? There must be economic mechanisms that make it a prominent option for the organization of the business sector.
- What is the contribution of a productive firm to society and how can it be maximized? A firm does benefit many stakeholders, and it is possible to rigorously define the total benefit it brings to them.
- How can the stakeholder approach be promoted and implemented concretely in a market economy that puts pressure on most firms to maximize profit rather than focusing on the total surplus generated?

¹ The group included Andy Haldane, Michael Jacobs, Nora Lustig, Mariana Mazzucato, Robert Skidelsky, Dennis Snower and Roberto Unger.

THE FIRM AS A COOPERATIVE VENTURE

What is a firm? At the most fundamental level it is a cooperative venture that connects the wants and desires of its customers and the abilities and resources of its producers and suppliers. Can we measure the benefits that the firm brings to society through its operations linking customers, producers and suppliers? A simple option is to simply sum up all the surpluses of the parties to the firm's operations, and add the net (i.e., positive minus negative) value of externalities. After some basic accounting calculus, one finds that the sum of surpluses is simply equal to the difference between the willingness of customers to pay (i.e., the maximum amount they would accept to pay) for the product they get, and the willingness of producers and suppliers to accept a certain payment (i.e., the minimum compensation they would require) for the effort and resources they provide. This provides a very clear conceptual notion of value contributed by the firm to society:

Sum of surpluses + net externalities
= willingness to pay for product – willingness to accept for inputs + net externalities

The point of this paper is that the purpose and governance of the productive firm, especially whether it maximizes profit or the total surplus, is absolutely central for understanding essential features of current varieties of capitalism, and for imagining possible reforms in order to design more equitable and sustainable institutions.

PROFIT FROM NECESSITY TO PURPOSE

The firm produces social welfare by realizing the benefits of cooperation between customers, producers and suppliers. We have shown that the total value of this co-

operation to society involves adding up all the surpluses of the parties. However, for this to be a viable operation, the firm must be able to pay its bills from the cash flow it receives from its sales. While financiers provide seed funding in the beginning, the firm cannot continue for long if it loses money in its daily operations. In other words, a non-negative profit is a key viability condition for any firm.

»The firm produces social welfare by realizing the benefits of cooperation.«

Profit is primarily a viability variable, but one can identify three channels by which such a viability variable is ultimately likely to become the paramount objective of most actors in the game. These mechanisms probably explain why profit has become such a prominent value in business culture.

The first mechanism is competition by entry. When various firms in an industry pursue a diversity of goals, those that do not maximize profit leave opportunities for profit on the table. Profit-seeking actors can then enter and reap some of these opportunities. As a consequence, constant pressure by the entry of profit-maximizing competitors can contribute to disciplining firms.

The second mechanism involves differential resilience to shocks. Shocks to input prices or to demand that reduce profits for all firms threaten their viability, and those that start out with lower profitability are the first to be eliminated, unless they have special mechanisms to shoulder the shocks temporarily.

The third mechanism that pushes profit is competition by takeovers. If a firm pursues other objectives and fails to maximize its profit, a corporate raider can raise capital, buy the firm and make a benefit by reorienting it toward greater profit, selling it afterward at a greater value. This mechanism supposes that it is possible to "buy the firm" and change its management, which requires a specific capitalist legal setting.

This list of mechanisms is not exhaustive. For instance, the creation of firms is a moment when pressure for granting control and guarantees to financiers is highest, leading most firms to adopt a conventional structure and a conventional shareholder value approach.

In addition to imposing profit as the corporate purpose for most of the competitive firms, these three mechanisms have some beneficial functions. First, they serve to weed out the firms that are badly managed or rely on outdated technology and methods. They therefore serve the beneficial function of allocating productive resources to their most effective uses. But while the efficiency and innovation-enhancing effects of competition are widely celebrated, the negative effects are often ignored, and this may prevent us from understanding the roots of our current failures.

SYSTEMIC FAILURES OF UNFETTERED CAPITALISM

Market failures have been analyzed thoroughly by economic theory, and they include phenomena related to externalities, public goods, commons, market power, adverse selection and moral hazard. But the fact that competition pushes firms to maximize profit is seldom depicted as a systemic failure. On the contrary, it is usually viewed as promoting efficiency. Unfortunately, in the most common circumstances, this is actually a source of serious problems.

Here are the main undesirable consequences of the profit motive. First, the firms are induced to make use of their market power whenever they have the occasion. In simple textbook examples of linear consumer demand and labor supply with constant returns to scale, a firm that maximizes profit by using its market power reduces its production by half compared to what it would do if it maximized the total surplus, and this reduces the total surplus by 25%.

Another consequence of the profit motive is that, combined with the use of market power, firms enter industries in excessive numbers, because they do not take account of the fact that they reduce the potential surplus of the incumbent firms when their presence splits the available demand. This additional effect, in the long-run equilibrium in which profit is approximately null, produces a further substantial reduction of the total surplus in the industry.

The tendency to have excessive entry is paralleled by a tendency to have excessive profit-enhancing innovation. In particular, the orientation of innovation is influenced by the profit motive and is unlikely to cor-

respond to welfare-maximizing innovation.

Another consequence of the profit motive is that, if workers are not involved in the daily management of the work program, the non-contractible aspects of work are determined by the firm in a way that inefficiently handles the costs imposed on workers.

Finally, even if externalities are well covered by economic theory, what is less often acknowledged is that the profit motive by itself tends to push firms to externalize as much of their costs as possible.

It may sound surprising that the profit motive is such a source of multiple inefficiencies, in contradiction to basic economic teaching. The explanation is that economic theory is heavily influenced by the special case of perfect competition with complete contracts and no externalities. In this special context, maximizing the profit is equivalent to maximizing the total surplus, but this does not hold at all in more realistic circumstances.

RESPONSIBLE FIRMS AND SOCIAL WELFARE

Given that competition drives the profit motive, one may be tempted to think that one should tinker with the market system and the price mechanism in order to address the systemic failures of the capitalist economy. But this would be too hasty a conclusion. Changing the corporate goal of the firm may go a long way toward alleviating capitalist failures.

A responsible firm, by definition, does not squeeze customers, workers and suppliers to increase its profit by exploiting its market power, and instead it maximizes the total surplus, with adjustment for externalities.

The problem of business externalities due to entry gives very interesting results in the presence of responsible firms. In absence of externalities, one can show that under free entry conditions, responsible firms spontaneously select the optimal number of firms in the industry and collectively achieve the maximum potential surplus for the whole industry. In the presence of externalities, the optimal number of firms still emerges in the long-run equilibrium with free entry if and only if the viability condition now involves profit adjusted for a Pigouvian tax, i.e., an amount equal to the externality valued at a shadow price corresponding to the marginal social (dis) value of the externality in money terms. If this Pigouvian tax (or subsidy if the net externalities of the firm are positive) is enforced by the government, the profit net of the Pigouvian tax operates as a very natural viability condition.

Responsible firms do spontaneously solve the externality due to entry, without any specific adjustment, but other externalities may be harder to address. Since every firm tries to maximize its own surplus, it is likely to over-invest in differentiation and advertising in order to enlarge its customer group, at the expense of other firms.

Non-contractible parameters of work can be addressed by any firm via a bargaining process, but responsible firms may be more likely to actually do it if their governance rules involve a greater participation by workers qua stakeholders.

In conclusion of this section, the key lesson is that there is no need to tinker with the price mechanism, with competition, with free entry, or with profit as a viability condition (provided a Pigouvian tax

is in place), when responsible firms are the only game in town and profit-maximizing firms are not allowed to compete. How can this be achieved if the market system is left in place, with all its inherent incentives pushing for profit maximization?

»The profit motive is a source of multiple inefficiencies.«

HOW TO REPURPOSE THE CORPORATION

Two distinct challenges need to be addressed. The first challenge is that the objective of responsible firms is hard to measure. Profit relies on very objective accounting data, even if expected profit, which involves subjective expectations, is a much more elusive notion. For the surplus, there is nothing like accounting data in the subjective valuations that customers put on the product and that workers and suppliers put on their services and resources. The second challenge is the incentive issue due to the pressure of competition, which forces profitability, a mere viability condition, to become an existential goal for most firms.

The first challenge may have a rather unexpected solution in profit maximization. Indeed, a firm that maximizes the total surplus adjusted for the impact of externalities on social welfare would be

completely mimicked, in all its decisions, by a firm that maximizes profit adjusted for a Pigouvian tax on externalities, under the constraint of not making use of its market power, and of setting up inclusive management to eliminate inefficiencies due to non-contractible work parameters. Recall that this adjusted profit is also the correct viability constraint for responsible firms, therefore the identity between viability condition and goal can remain true for responsible firms. But just as responsible firms must be prevented from using other pricing systems than the standard price mechanism, they must be prevented from using their market power.

It is easy to check that firms use the price mechanism rather than alternatives, but can it be checked that they do not use their market power? Maximizing profit while taking prices as given parameters is done by simple management rules, which are well known thanks to the focus of economics on perfect competition. The central one is that the marginal sales generated by an input (at the current product prices) must equal this input's price. Internal cost and productivity measurements in the firm typically do produce this type of information and it can therefore be used in the appropriate way to ascertain that the firm maximizes profit, and does it without using its market power. Of course, for this scheme to work, suitable monitoring mechanisms must be put in place. Inclusive governance may be the simplest way to do this, because it would enable the stakeholders to blow the whistle when the firm exploits its market power at their expense. Similar management rules exist for the determination of non-contractible parameters of work.

»There is no need to tinker with the price mechanism when responsible firms are the only game in town.«

Inclusive governance cannot suffice to include all the interests affected by the firm's decisions, such as future generations and other species. Therefore, the

Pigouvian taxation adjustment mentioned earlier cannot be dispensed with. This raises a serious difficulty. Governments cannot be trusted to properly measure and apply the Pigouvian taxes and subsidies, and firms cannot be trusted to do it on their own. There is no miracle solution to this difficulty, and one may want to involve third parties, such as civil society organizations. These organizations could be given some power to lobby for particular levels of the Pigouvian taxes and for enforcing them, either by government intervention, or by responsible accounting by the firms themselves.

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¹ Kelly (2019) argues that a reform of the corporation is urgently needed to address current social, political and environmental challenges. See also Mayer (2018), Bower and Paine (2017).

² This paper is an abridged version of Fleurbaey (2020).

³ The idea that market competition selects the profit-maximizing firms has long been suggested, including by Friedman (1953). Blume and Easley (2010) review the literature on this selection mechanism.

⁴ See Fleurbaey and Ponthière (2020) for details.

⁵ Tirole (2006), in particular, argues that stakeholders' interests are hard to measure and aggregate. Jensen (2001) argues that stakeholder theory commits managers to serve several objectives (e.g., as with the so-called balanced scorecard), which cannot work to guide their decisions and monitor their performance.

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