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America and the Profit Motive - Our Reason Not to Abandon It

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Abstract. The paper aims to illustrate the necessity of a profit motive system in the American economy. It explains the basic principles of why America has a profit motive system and demonstrates the consequences of abandoning it, by comparing the functionality of for-profit and non-profit institutions. Further, it lays open the weak point of the system, using the example of CDOs during the financial crisis. The paper comes to the conclusion that the profit motive is necessary for a stable economic growth, but there has to be an enforcement of policies to make it less susceptible to greed.

Keywords: profit motive, financial crisis, greed

1. Introduction

The financial crisis of 2008 had a significant impact on many Americans; jobs, homes, and life savings, all vanished in less than a week. Everything was blown away with the burst bubble of the real estate market in the midst of 2008. The crisis was a result of many factors, including so-called "toxic assets," or "financial weapons of mass destruction" as famous investor, Warren Buffet, likes to call them. These were, amongst others, subprime mortgages, collateralized debt obligations, and credit default swaps. These financial WMDs are hard to understand, even for experts with a financial background. Because of the complicated nature of the crisis, it is likely that the average American does not fully understand what happened and why his mortgage is now underwater. Without the whole picture and comprehensive knowledge of what happened, one might come to an over-simplified conclusion: Wall Street's greed and profit motive are the reason that I lost my home and my savings. The media has used this simple conclusion to heat up an old discussion, one that follows many similar crises: does the profit motive system really serve the society as a whole?

1.1. Structure

In this paper, I will demonstrate why a profit motive is necessary and helpful for the whole economy. We will see, on the basis of a simple economic case, that the profit motive indeed serves social responsibility. Later, we will consider institutions that run without a profit motive and see what we can learn when we compare them with similar institutions that have a profit motive. We shall also take a look at the feasibility of any potential non-profit economy, and I will also illustrate some possible scenarios. Last, we are going to revisit the crisis and the problematic greed within the profit-motive. After reading my paper, I hope the interested reader will better understand why America runs on the profit motive and why we ought not abandon it.

2. The Business Purpose

Let us assume that a company is represented by an individual who acts in his own interest to maximize profit. The individual acts in his own interest to use his given resources, whether labor, land, or capital, in the most efficient way. By focusing on his own profit, without trying to serve any social responsibility, the individual actually creates profit for everyone within his society. The reason for this is simple: since he is not forced to use his capital for other motives that do not fit his skills and know-how, he will be likely to make the most efficient use of his given resources.

By employing his capital most efficiently he can simply produce more goods and increase his output. This not only leads to increasing employment in his firm, but also an increase in the total annual revenue of

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the society, which is equivalent to the annual production of the industries (Smith 1902). Adam Smith, the pioneer of modern political economy, formed this theory and summarized it as follows: "By pursuing his own interest [the individual] frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good" (Smith 1902, 161).

Milton Friedman, world-renown Nobel Prize winner in economics, further exemplifies the difficulty for a listed corporation to explicitly and deliberately serve the public good. Friedman argues in his book *Capitalism and Freedom* (1962) that the corporate executives act on behalf of the owners, which are the stockholders of a listed company. The stockholders, as owners of the company, have the motive to maximize their profit and hire the corporate executive in order to do so. Now, if the corporate executive were also to have the responsibility to provide a public good and be socially responsible, how could one individual decide exactly which social responsibility he is supposed to primarily address? Eventually the public decides what is socially responsible. If the owners are not the ones who determine the ultimate goal of their company, but rather the public, in a democracy, this electorate would have to select the corporate executives via public election and appointment. In other words, the public decides who will lead a corporation, and a form of nationalization would take place. Friedman concludes in his thesis that, "… there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits…" (Friedman 1962, 133).

In conclusion, because the companies' executives do not know the primary social problem to address, and because the companies automatically serve the public, by focusing on their business goal, they should not be forced to lose their incentives to strive for a profit, within the legal framework.

3. For-profit versus Non-profit

If one seeks to omit the profit motive, one wants the company to not distribute the surplus to their owners, but rather reinvest everything, specifically in order to achieve their business purpose. While this sounds interesting, we should compare two familiar organizations with the same purpose. For-profit organizations usually serve a broader spectrum of sectors than non-profit organizations, which tend to be in sectors that provide more public goods, such as health care, education, and social services. To avoid comparing apples with oranges we should compare a sector important for both non-profit and for-profit organizations. In 2002, more than fifty percent of non-profit employment was in hospitals and other healthcare-related industries, we will therefore take a closer look at the performance of both non-profit and for-profit hospitals.

The legal difference between a non-profit versus a for-profit hospital is that non-profits are usually owned by some kind of government, typically local or state, while private investors usually own for-profit hospitals. Again, the privately owned companies can decide how to allocate their surplus while the state-owned are obligated to reinvest in their purpose: to provide healthcare to the public. A study in 2005 by Mustafa Younis, professor at Jackson University, and Dana Forgoine, professor at Florida International University, focused on the profitability of hospitals. Their research analyzed that for-profit hospitals usually generate higher surplus, which they could evenly distribute to their private owners and reinvest in better technology and medical equipment. They stated, "… there was an ownership status effect on the hospitals profitability. The [for-profit] hospitals had a higher profit margin … than [non-profit] hospitals." (Younis, Forgoine 2005, 2). Therefore, we can see that for-profit hospitals are usually more fiscally and profitable than non-profit ones.

However, we also have to take a look at the kind of services provided by non-profit and for-profit hospitals. The research paper *Making Profits And Providing Care*, by Jill Horwitz, an assistant professor at the University of Michigan, focused on the difference in the service of non-profit and for-profit hospitals. He also came to the conclusion that for-profits are more likely to be more profitable than non-profit hospitals. Yet, more intriguingly, his research showed that for-profit hospitals tend to offer more specialized services, such as open-heart surgeries and chemotherapy (Horwitz 2005, 2). Non-profit hospitals usually cannot afford these specialized services, because they require highly skilled doctors and machinery, which would consume a great amount of their budget. While the research also shows that non-profit tend to provide a broader variety of common services, it is nevertheless important to consider that, without for-profit hospitals, complicated and life-saving services would be harder to access. However, it should be said that non-profit hospitals with their broader medical services are important, because they maintain certain services that are abandoned by for-profit hospitals due to the lack of profitability. One should consider the important distribution of highly skilled services and basic-services is only possible because non-profit and for-profit hospitals exist simultaneously. It is highly likely that if either one of these is missing; it would cause a shortage for that particular service in the healthcare market.

I should mention that his paper does not argue whether or not non-profit or for-profit hospitals are better, the information above merely serves to add new thoughts to the discussion of whether or not the profit motive is good. The topic itself is quite complicated, because of details regarding law and government spending, but the idea shows one possible problem regarding efficiency with an economy that only has non-profit institutions.

4. What If

I have tried to discuss this issue in the most concrete and practical terms possible, but now I would like to introduce the reader to a more theoretical way of thinking about this topic. Imagine we only have non-profit organizations. As I argued previously, it is highly questionable whether non-profits better serve the whole society. However, let us assume that institutions are no longer eligible to provide profit to their owners; instead they have to reinvest in a way that fulfills their business purpose. We then hope by doing this that the negative effects of the profit motive disappear. Greedy corporate executives cannot cause harm anymore, firms should not move to foreign countries, and no one should be fired. Everyone is going to benefit and we are able to prevent future crises. Certainly these points sound interesting but I am now going to demonstrate different possible scenarios, of what could happen under such circumstances.

If the owners of a company do not receive private benefits by owning that particular company, they don't have many incentives to hold onto their ownership. If the owners don't receive dividends, or any other benefits from their company, why should they be the ones who carry the equity risk without receiving appropriate benefits in return? This could lead to pressure on owners to sell their company – but to whom? The US government might serve as a potential buyer, as it carries the responsibility to focus on the public good and not private benefit. Obviously, private owners would be unlikely to voluntarily give the government their stake for free, but would rather sell it. This might lead to an increase in governmental debt that can hinder growth. This is just one scenario among many unpredictable outcomes, but I am trying to give the interested reader an impression of the impact that such a simple decision has.

However, we have to think one step further and consider what could happen to the US in our globalized world? As we can only change our own state, what happens if America alone gets rid of the profit motive but stays within the global market? Since investors are not expected to receive profit from American companies that they own, they are likely to move their capital abroad, where they are still allowed to receive profit for their risk of investment. This could support the financial strength of foreign companies, enabling them to invest more and gain a competitive advantage. Also, wages in foreign companies might become higher as they try to attract human resources with their recently gained financial strength. With now higher wage levels abroad, labor tends to migrate to another country, because the salary there would be higher. With increasing wages in other countries, young, flexible, and talented labor might be particular interested in moving to Canada or countries paying more for their human capital. This decrease in highly skilled labor would hurt the American economy in the long run.

In addition, with less highly skilled labor, corporations are probably not as good at inventing in new technologies and gaining competitive advantage against foreign companies. This could result in American companies' need to import new technologies and could produce greater dependency on other countries. The competitive advantage of producing high-technology products and services could slowly shift to other nations. The careful reader might have recognized many hedging words in this paragraph. My intention is not to claim that those chains of events would happen, nor that they are precise economic predictions, it simply serves to make one consider long-term consequences of such a claim. With feelings of exasperation and anger that crises like the current economic crisis usually bring with them, one easily forgets to consider the complexity of consequences and that these might not be predictable and could result in something different than intended.

5. The Public's Opinion

An illustration of such a case is the movie *Capitalism: A Love Story*, by Michael Moore. The movie was released in 2009 when many people were still more emotional than rational about the financial crises. It makes the point that "there is democracy under capitalism "and shows a "solution" by having a socialist economy that would end the problem of crises (Michel 2009, 1). The movie demonstrates the problem of oversimplifying the crisis and heading in the wrong direction without considering every fact. I have shown that there are distinctive reasons for the government to avoid trying to control the services of a firm to be socially responsible. In fact, corporations are socially responsible for their own sake; it is just a part of their business strategy. By being socially responsible and "giving back to the public," firms usually try to build up their corporate identity. It is an image the public associates with that particular company. The better the public's perspective of the company, the more likely it is they will receive greater revenue due more loyal costumers– simply a part of the corporation's profit motive.

Most people probably are aware of this fact, but they still argue that because of the profit motive, in particular during times of a crisis, corporations abandon attempts to build up their corporate identity to decrease fixed costs. Grigoris Giannarakis, professor at University of the Aegean, concluded a study about the "Corporate Social Responsibility" (CSR) performance. The CSR is based on the stakeholder value idea. It measures how far companies address social and environmental issues within their business model. Intuitively one thinks that the financial crises caused corporations to reduce their expenses and cut down on their CSR – because it creates no obvious revenue and does not require a lot of effort to be cut down. However, the study discovered a surprising fact, it turned out that during the years of the financial crisis, from 2007 to 2009, the CSR performance of companies had significantly increased. There are several reasons for this unexpected trend. Most importantly, companies have realized the growing importance of social responsibility among businesses, in particular during the financial crises they wanted to reestablish the trust of consumers in corporations (Giannarakis 2011, 6). This case illustrates the problem of intuitively criticizing a problem, without further research or consideration. Moreover, it also demonstrates the importance for a company to be socially responsible, even with a profit motive they have to consider and maintain a good public image.

6. The Purpose of Financial "WMDs"

We can see from the examples given that there is nothing wrong with the idea of a profit motive itself. However, what happened that we eventually ended up having a severe financial crisis? In order to find an answer to this question, I will briefly explain the role of collateralized debt obligation (CDO) in the crisis. First, I would like to briefly explain the basics of a CDO, in order to understand the purpose of this financial product. One can think of a CDO as an independent entity, that has one special purpose, which is to hold other financial assets. These assets are usually corporate loans or mortgage backed securities with different credit ratings. Within the CDO entity they are all pooled together and restructured. The new entity then issues different tranches of debt, which are backed by the financial assets the CDO entity is holding. Those tranches then have different ratings that can range from AAA to BBB-, and usually sold separately to investors.

CDOs have three main purposes that help both, banks and investors (Lucas 2006, 6). First, CDOs as special purpose entities enable banks to shrink their balance sheet by swapping assets from the bank's balance sheet to the balance sheet of the newly created entity. This makes it possible to reduce the bank's required regulatory capital and therefore reduces the cost of banks to refund themselves. Hence, they can issue loans with lower interests rates to investors. Second, it enables arbitrage, asset managers want to gain assets under management while investors seek someone with expertise in asset management. As I have mentioned, a CDO contains several financial assets and therefore can serve as a kind of mutual fund. However, the difference between a mutual fund and a CDO is that CDO investors' returns differ by the rating of the tranches, while the returns of a mutual fund share don't differ. This enables investors and asset managers to achieve better risk diversification and asset allocation. Third, a CDO makes it possible for smaller banks and insurance companies to originate capital. Small institutions can issue notes directly to a CDO and bundle these notes there, hence increasing the liquidity of their notes. This method enables small allied banks to refinance themselves quite efficiently and cheaply. Not only the small banks benefit from the ability to cheaply and efficiently refinance, but also their clients who would otherwise be granted a loan that has a disadvantaged contract (Lucas 2006, 8).

These principles show that a CDO is actually beneficial for investors, and banks that create them. However, how is it possible that something, which is supposed to benefit both sides, in the end hurts everyone? In order to better understand the problem, one can look at an insightful story by Michael Lewis called *The End*. The story tells us about the past experience of Steve Eisman, a corporate lawyer that got rich by betting against the crisis. Eisman's story makes it clear that not the product themselves were the problem but the way the banks traded them. After a securitization-forum, focused on assets like CDOs, Eisman figured: "[the banks] weren't satisfied getting lots of unqualified borrowers to borrow money to buy a house they couldn't afford ... they were creating them out of whole cloth" (Lewis 2008, 5). In the end, the market for CDO tranches has collapsed and became illiquid, because the assets they contained were not of reasonable risk anymore. With the collapse of the CDO market, banks had to write the CDO tranches they owned off, leading to massive losses on their balance sheets. This irresponsible behavior of abusing a CDO by backing them with many sub-prime loans, and creating "fictional" CDOs out of nothing, one can see that this excessive greed for profit has distorted the purpose of CDOs. It turned from a product that was once beneficial for everyone, to something that was detrimental for everyone.

7. Conclusion

Finally, we can analyze the problem of the distortion of CDOs on the concept of profit motive. As long as we do not have excessive greed within the system, the profit motive benefits everyone. Nevertheless, the system is susceptible to greed. Our country needs political changes that understand the importance of our concept of the profit motive, but focus to undertake structural changes that eventually make our system less prone to greed. Increasing the penalty for companies that act greedy, and recklessly take risks to gain profits, will make it possible for everyone in this country to receive longer and sustainable benefits from the profit motive system. Therefore, America should not think about abandoning the profit motive, but about retaining and protecting it.

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