

## Why Firms should not always Maximize Profits

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**WP 2006: 11**



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Price: NOK 50

ISSN 0805-505X

ISBN 82-8062-154-7

This report is also available at:

[www.cmi.no/publications](http://www.cmi.no/publications)

### **Indexing terms**

Profit maximization

Business ethics

Corporate social responsibility (CSR)

JEL codes: D63, M14

### **Project title**

CSR

### **Project number**

25001

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## 1. Introduction<sup>1</sup>

“The social responsibility of business is to increase its profits” (Friedman, 1970). In the past, many business executives have voiced their support for the idea that a business should be run exclusively with a view to profits or shareholder returns. Today, however, most executives would be disinclined to express themselves this bluntly. The increased focus on corporate social responsibility (CSR) or corporate citizenship, might even give the appearance that corporations may have strayed from the narrow path of profit maximization, focusing instead on a wider or different set of goals.

Appearances can, however, be deceiving. Upon closer scrutiny, it becomes apparent that CSR is in many cases simply viewed as an instrument to increase profitability, rather than a fundamental goal in itself. The following quote from a top executive of one of the world’s largest oil companies provides an illustration of this:

“Corporate social responsibility is not itself our business but rather it is a way of conducting our business which, we believe, helps us to be more successful over the long-term. To commit to a socially responsible way of working is not, as some critics claim, a distraction from our core business. Nor does it in any way conflict with our promise and our duty to deliver value to our shareholders. In fact, just the reverse is true. This agenda is an attendant duty to our shareholders who make investments for the long-term and who need to have confidence they will see a return on those investments over the long-term” (Adrian Loader, Director of Strategic Planning, Sustainable Development and External Affairs, Royal Dutch/Shell Group)<sup>2</sup>

In other words, CSR is not a fundamental end for corporate action, it is a means to the fundamental end of increasing shareholder returns. The above statement is by no means unique, which indicates that profit maximization or maximizing shareholder returns, remains the fundamental principle many corporate executives live by.<sup>3</sup> This has led some observers to argue that CSR policies are basically insincere (Bakan, 2004).

Some corporate executives do, however, take a less direct approach, eschewing the question of whether CSR or profitability is the fundamental end. A common argument used is that CSR and profits go together. This is voiced for instance in the following excerpt from a speech given by the CEO of the world’s largest corporation (in terms of market value):

“What I really want to talk about today is how a CEO or what business leaders can do to create a great and good company. Great in the sense of tremendous results for our investors and for our customers, growth and profitability, and good in the sense of connection to the world, adding to the quality of our work force and our customers and the communities we’re a part of. Because profits alone cannot build reputation. And I also believe that doing things right ultimately will lead to more profitability” (Jeff Immelt, CEO, General Electric)<sup>4</sup>

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<sup>1</sup> The author thanks Arne Wiig and Bertil Tungodden for helpful comments.

<sup>2</sup> [http://www.shell.com/static/media-en/downloads/speeches/adrianloader\\_sg\\_csr\\_23022004.pdf](http://www.shell.com/static/media-en/downloads/speeches/adrianloader_sg_csr_23022004.pdf)

<sup>3</sup> Granted, executives often pursue their own self-interest to the detriment of shareholders, but the publicly asserted normative basis of their actions is maximizing shareholder returns.

<sup>4</sup> [http://www.ge.com/files/usa/en/company/news/Jeff\\_Immelt\\_BC\\_Speech.pdf](http://www.ge.com/files/usa/en/company/news/Jeff_Immelt_BC_Speech.pdf)

If the argument holds, and CSR and profits go together in a systematic way, it does not really matter whether the corporation treats advancing one or the other as its fundamental goal. If all good things go together, corporate executives never have to face dilemmas or make trade-offs between social and profitability objectives.

What we might term the neo-Friedmanian position on CSR, thus argues that out of all possible CSR policies, corporate executives should adopt those, and only those, that increase ownership returns. In contrast, the dilemma-less position on CSR, posits that whatever CSR policies a corporation adopts, will promote ownership returns. This article argues that neither of the two positions presented here, stands up to closer scrutiny. In section 2, the arguments for the Friedmanian view of profit maximization are refuted. Furthermore, it is argued that profit maximization cannot be a fundamental principle of any reasonable ethical theory. And if a maxim of profit maximization is derived from other fundamental principles, it will be subject to exceptions. Solely using CSR as a means to a fundamental end of profit maximization, is thus not ethically defensible. In section 3, it is shown that the notion that CSR and profits always go together in a positive way, is not theoretically feasible, nor underpinned by empirical evidence. Section 4 concludes.

## 2. Why profit maximization cannot be a fundamental principle in any meaningful ethical theory

The idea that corporations should pursue the interests of their shareholders, takes its starkest form in the sentiment expressed by Milton Friedman, that “the social responsibility of business is to increase its profits” (Friedman, 1970). Friedman is very clear in stating that it is illegitimate for a corporation to act in a way that is detrimental to shareholder returns.<sup>5</sup> Profit maximization is thus a moral imperative for corporate executives. The interests of groups other than the shareholders, should thus only be given weight to the extent that meeting these interests, also benefits the shareholders. The implication is that corporate social responsibility is permissible only if it is insincere, i.e. used as an instrument to promote shareholder interests (Bakan, 2004).

To assess whether the Friedmanian position is tenable, we must consider the arguments used to support it. There are four basic arguments that underpin this position. Firstly, it is argued that the contract between the shareholders and a manager of a firm, binds the manager to pursuing the interests of shareholders, and therefore makes it illegitimate to pursue other ends. Secondly, pursuing other ends to the detriment of shareholder returns, is equal to taxing the shareholders, and taxation is a task for democratically elected governments, which it is illegitimate for managers to assume. Thirdly, if businesses focus on too many tasks beyond their core operations, they become less efficient. An efficient division of labour between businesses and government, is for businesses to create value, and the government to redistribute it. Fourthly, a business that assumes responsibilities beyond maximizing profits, will incur added costs, and will therefore be wiped out in competition with firms that do not assume such responsibilities. In other words, assuming costly responsibilities will be self-defeating, and ultimately futile. Let us review each of these arguments in turn.

The first argument, that managers are bound by contract to act only in the interest of shareholders, is obviously too simplistic to hold. Two parties that enter into an agreement of any kind, cannot reasonably argue that this releases them from responsibility for third parties. For instance, two

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<sup>5</sup> More precisely, Friedman argues that corporate executives should pursue shareholder interests. In many cases, shareholders might be willing to forgo profits for other ends. Even if shareholders do have other interests than maximizing profits, this does not reduce the validity of the following arguments, as long as there is some deviation between shareholder interests and an ethically motivated social welfare function, which is a reasonable assumption.

people that get married, cannot claim that this bond precludes responsibilities for other human beings. If this were the case, we would see a proliferation of agreements expressly designed to limit the responsibilities of the parties involved.

The second argument, that it is illegitimate for managers to tax owners, treats the question of corporate responsibility in an unnecessarily complex manner. The key question here is not whether managers should redistribute wealth from the owners to others, but whether shareholders ought to give up some of their returns to promote other ends. If one can demand that shareholders sacrifice some of their returns for other important ends, the fact that a manager is the one to put this into practice, does not nullify the demand on shareholders.

The third argument proceeds from an idea of an ideal division of labour between government and business. Both are claimed to be more efficient if they focus on their respective tasks, which works to the advantage of society as a whole. The problem with this argument is that the situation is often not one which permits the ideal division of labour envisioned. In many countries, especially in the third world, governments and public institutions are incapable or unwilling to assume many of the duties implied by the ideal division of labour. Given imperfections or restrictions of this kind, it is not inconceivable that the most efficient division of labour entails a greater responsibility for corporations than focusing on its core business operations. This argument is pursued further in Cappelen and Kolstad (2006).

The fourth and final argument in support of the Friedmanian view, states that taking an extra responsibility would put a firm out of business. A common way to meet this argument is to say that some firms do act responsibly, and are not eliminated by competition. If consumers, workers, or shareholders value corporate responsibility, a responsible firm could survive and even thrive. In a context of less than perfect competition, corporate responsibility could even confer a strategic advantage on a firm. And in fact, empirical studies show that the population of firms in a given market is often remarkably heterogeneous.

However, all this counter-argument does is show that the Friedmanian survival argument is overstated, it does not fully refute the argument. A more effective counter-argument is to say that if acting responsibly puts a firm at a disadvantage in the marketplace, other agents may be responsible for lessening the disadvantage. For instance, it may be the responsibility of consumers to pay a higher price for goods from responsible firms, or for shareholders to add a responsibility return to the standard financial return of firms when allocating investment funds. What the survival argument does, is to take too narrow a view of responsibility; when discussing the responsibility of business, we need not confine ourselves to just discussing the responsibility of business, we can also take the duties of other agents into account.

The arguments put forth to justify a claim that corporations should act in the interest of their shareholders, thus do not hold up to closer scrutiny. That these particular arguments fail does not immediately imply that an ethical perspective which includes the profit maximization by firms is impossible to conceive of. In general terms, there are two ways in which to fit profit maximization into an ethical theory. One is to say that profit maximization is a fundamental principle of the theory, from which other principles are derived. The other is to argue that profit maximization can be derived from some set of fundamental principles which constitute the ethical theory.

To see whether profit maximization makes sense as a fundamental principle of an ethical theory, we need to take a closer look at what this would entail. An ethical theory built around (or consistent with) the idea that corporations ought only to pursue the interests of their owners, would include a strong element of egoism on the part of owners (through the construct of a corporation). This could take two forms: i) The ethical theory could argue that owners should maximize their own returns,

while other agents (some or all) should not in a similar sense act in their own self-interest, or ii) The ethical theory could argue that all agents should act in their own self-interest.

It is hard to see that the first version does not imply a breach with the principle of impartiality, which is a cornerstone of any reasonable ethical theory. It is difficult to argue that there is some morally relevant characteristic of owners, something that would set them morally apart from other agents, that would make it appropriate for them to pursue their self-interest, while it would be improper for others to do the same.

The second version would produce the oxymoron of an ethical theory devoid of ethical consideration. As Williams (1993:12) argues, “we have a conception of the ethical that understandably relates to us and our actions the demands, needs, claims, desires, and generally, the lives of other people, and it is helpful to preserve this conception in what we are prepared to call an ethical consideration”. An ethical theory based entirely on self-interest, thus leaves out an essential component of any reasonable ethical theory. Moreover, a theory of this kind is likely to be unstable, as promoting a state in which everyone pursues their own self-interest, could in some cases require non-selfish action.

An ethical theory based on (or including) a fundamental principle of maximization of shareholder returns, or profit maximization, is thus a non-starter. If profit maximization is to have a place in an ethical perspective, then, it must be as a principle derived from (or permitted by) other fundamental principles. Within a basic consequentialist framework, one could for instance argue that it is for the best (however that may be defined) that corporations maximize profits. As Williams (1993:13) argues, this is a more natural way to support a principle of self-interest. Similarly, within a deontological framework, profit maximization could be legitimate to the extent that it is consistent with the fundamental normative precepts for action.

If we accept that profit maximization is to be a derivative principle of an ethical theory, however, it can by implication no longer be an absolute guide of conduct for corporate executives. Given the imperfections of the world, there will be instances where the principle of profit maximization will have to be deviated from, in order for corporate action to fulfil the fundamental principles of the theory. For instance, within a consequentialist framework, it may be efficient for corporations to maximize profits and the government to take care of redistribution. This argument presupposes, however, that there exists some sort of government that can redistribute effectively, if there does not, the argument breaks down, and the best state of affairs is not necessarily attained by letting corporations maximize profits. In an ethical theory where profit maximization is a derivative principle for corporate action, it will therefore be subject to exception, it will sometimes have to be deviated from to meet more fundamental ends. This line of reasoning and its implications are analyzed in more detail in Cappelen and Kolstad (2006).

The implication of the arguments in this section is that the neo-Friedmanian position that CSR policies should only be used to further shareholder returns, is ethically indefensible. The standard arguments for the Friedmanian position do not hold. No reasonable ethical theory can include a fundamental principle of profit maximization. And if profit maximization is to be a derivative principle of an ethical theory, it will be subject to exceptions, which implies that CSR policies may sometimes have to be used to further other ends than profit maximization.

### 3. CSR and profits do not always go together

If all good things go together, there is not much point to ethical theory, beyond defining what actually counts as good. There would be no need for ethical reasoning in terms of making trade-offs and resolving dilemmas, for passing judgment in the hard cases where one set of interests or objectives is pitted against another. Much of what has been developed in the field of ethics would be beside the point; a utilitarian could simply maximize individual utilities rather than the sum across all individuals, which among other things implies that Arrow's theorem is not of much import (Arrow, 1951).

The idea that corporate social responsibility and profits go together is a narrow version of this more general notion. The idea does not hold up to closer scrutiny, however, whether from a theoretical or empirical perspective. From a theoretical point of view, the position that CSR always increases profits, is quite easily refuted. Certainly, a company may get a reputation boost by doing some kind of socially beneficial work that goes beyond its normal operations. But after the initial boost, a company will not get as much of an effect if it further expands its CSR activities. At some point, the costs of expanding CSR activities will outweigh the benefits to the company. Put simply, company profits do not increase indefinitely in the number of schools or hospitals it funds. If that were the case, we should leave all funding of the social sectors to the private sector, since they can build and run hospitals for free.

If we look at empirical studies of how corporate social performance (CSP) affects profitability, we cannot conclude from these that the relationship is a generally positive one. In a review conducted by Griffin and Mahon (1997), 51 studies were identified which have explored this relationship. Though most of these studies found that CSP influences financial performance positively, a substantial number of studies found no effect, or even a negative effect. Hillman and Keim (2001) also suggest that some types of CSR affect profitability positively, whereas others do not. This would suggest that aggregating CSP dimensions into one would give different answers to the relationship between CSP and profits, depending on how the CSP dimensions are weighted.

In an attempt to reach a conclusive answer based on past studies, Orlitzky et al (2003) performed a meta-analysis which used a particular weighing technique. Their conclusion was that CSP is positively correlated with financial performance, or that "social responsibility ... is likely to pay off". However, given the methodological shortcomings of past studies, the meta-analysis of Orlitzky et al cannot be relied upon for a definite answer. Most past studies are based on limited data, and/or omit important control variables, and any attempt to aggregate their findings is therefore meaningless.

Addressing the point of omitted variables, McWilliams and Siegel (2000) show that adding R&D intensity as a control variable, changes the effect of CSP on profits, from positive to insignificant. They take this as evidence for a line of argument that holds that companies expand their CSR activities up to the point where the marginal revenues equal the marginal costs, which means that there is no profit to be gained from expanding these types of activities at the margin.

Further doubt is cast by the fact that past studies of CSP and profits have relied on cross-section techniques, not controlling for firm heterogeneity. In an important contribution, Elsayed and Paton (2005) show that while cross-section estimation yields a positive effect of corporate environmental performance on profits, panel data estimation reveals no significant effect. More efficient panel data estimation can thus substantially change results, and it is important that this be explored for dimensions of CSP beyond environmental performance.

Finally, a study by Darnall et al (2004) on environmental performance and profitability, suggests that “most estimation models used in previous studies did not consider that a firm’s environmental performance is endogenous”, i.e. influenced by financial performance. The study therefore concludes that “results of prior studies need to be interpreted with care and additional studies are needed to evaluate these relationships further”, a point which obviously extends to studies of CSP in general and profitability.

The most that can be said from empirical studies, is that the relationship between corporate social responsibility and profits has not been adequately determined. Based on reasonable theoretical arguments, however, there is no reason to expect empirical data to show that the relationship is a generally positive one. The dilemma-less view of corporate social responsibility, that CSR increases profits, and that the question of which end to pursue is therefore a trivial one, is consequently unsupported.

## 4. Conclusions

The comedian and film maker Woody Allen is reported to have said “I’m not afraid of dying, I just don’t want to be there when it happens”. Corporate executives today treat dilemmas in a similar fashion, they would rather not come face to face with one, and therefore prefer defining them away. As the previous analysis shows, however, there are real dilemmas that need to be faced. Corporate social responsibility does not generally increase profitability. And when corporate executives only implement acts of corporate responsibility that promote profits, and only as much of these activities as promotes profits, they are just being profit-minded, not responsible. This is in fact profitability in the guise of CSR. The correct way of approaching the issue of corporate social responsibility, is to first ask what a company is responsible for, and then implement these responsibilities, whether they increase profits or not. And in some cases they will certainly cut into the bottom line.

Here, the reluctant executive might resort to Friedman, and argue that the responsibility of business is to increase profits, and only that. However, as this article has argued, this is an untenable position from an ethical point of view. There is thus a very real possibility that corporations should in certain cases deviate from profit maximization, from maximizing returns to owners, to pursue ends that are more important from a social point of view. This does not mean that corporations should abandon profit maximization altogether, in certain cases the efficiency enhancing effects of this pursuit will make them legitimate, but in other cases other interests will take precedence.

Defining exactly what is the responsibility of corporations, is a question that would benefit from further research. One type of approach that can be taken, is that of Cappelen and Kolstad (2006), who attempt to derive an optimal division of moral labour between business and other institutions. One of the implications of their analysis is that whether corporations should maximize profits or not, depends on the ability of other institutions to fulfil other important functions. This entails that in countries where public institutions are unable to fulfil functions normally attributed to them, the responsibility of corporations increases, and profit maximization should be deviated from. In other words, this type of analysis implies that corporations have a greater social responsibility in poor countries than in rich countries.

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## SUMMARY

Though corporate social responsibility (CSR) is on the agenda of most major corporations, corporate executives still largely support the view that corporations should maximize the returns to their owners. There are two lines of defence for this position. One is the Friedmanian view that maximizing owner returns is the corporate social responsibility of corporations. The other is a position voiced by many executives, that CSR and profits go together. This paper argues that the first position is ethically untenable, while the latter is not supported by empirical evidence. The implication is that there may be good reason for firms to deviate from a maxim of profit maximization.

ISSN 0804-3639  
ISBN 82-8062-154-7

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