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WHANGAREI BUSINESS AND PROFESSIONAL COMMUNITY

PROFITS OR PEOPLE: A BOGUS DILEMMA

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This talk is dedicated to John Campbell. Most Saturday mornings, on Radio New Zealand, John instructs his listeners, in his very amiable style, about the evils of profits. A self-confessed "liberal leftie", he tells us that people should come before profits. During the week he fronts *3 News* with Carol Hirschfeld, whose wish is to see "an end to global capitalism".[1] Such perspectives are not unknown elsewhere in the news media. Given the importance of the media for public understanding, they help explain why New Zealand is not achieving the economic success of other countries and why too many people are struggling.

There are some initial ironies here. The only alternative to some form of profit-oriented capitalism is some form of socialism. For some people the fall of the Berlin Wall and the collapse of the Soviet Union still do not seem a sufficient demonstration that socialism has been always impoverishing, variously repressive and sometimes murderous wherever it has been tried. Secondly, John and Carol both work for TV3. Its owner, CanWest, is a foreign privately owned company – an example of 'global capitalism' – and if it doesn't make adequate profits they won't have jobs. Thirdly, if media reports are accurate, television presenters seem to be at least as interested in their incomes as most entrepreneurs; certainly their pay rates don't appear to violate the minimum wage.

Some people think that profits are wrong because they introduce a commercial orientation. But television presenters, academics and even most members of the clergy work for money in return for services rendered. Doctors and dentists and other professionals running their own practices are even more obviously commercially oriented. None of these people generally work for free. Most would rather have higher pay than lower pay. We don't seem to have a problem about people benefiting from their human capital. Why should we have a problem about them benefiting from their financial capital?

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[1] *Sunday Star-Times*, 26 December 1999.

Of course money and profits are not supreme measures of value. They are but means to an end, which is human welfare broadly conceived. No economist that I am aware of would assert that welfare can be adequately expressed by monetary measures alone. We all have other goals in life. The average person in employment only spends about 20 percent of their time at their job – at an income-earning pursuit. Nevertheless, material welfare is important to most people. We can't be genuinely concerned about poverty if we are not concerned about what makes for material welfare.

It also needs to be said that the policy regime that most reliably links economic activity to human welfare is one that maximises economic freedom rather than gross domestic product (GDP). In the great majority of circumstances, individuals are the best judges of their own welfare and should therefore be left free to make choices in the light of their judgments. Because most people care about their material living standards, economic freedom is very likely to lead to higher incomes and economic growth as they work to get ahead – as indeed a great deal of research confirms. But some people are not especially interested in money, at least beyond a certain amount, and many others at some point will trade off higher incomes for more leisure or some other goal. Provided they don't expect other people to support their lifestyles, they should be perfectly free to do so.

Economic growth, as expressed in changes in the volume of goods and services produced in an economy, is widely taken to indicate that human welfare is increasing. But we need to be aware of qualifications to this proposition. It is easy to think of ways in which public policy could force up economic growth but curtail economic freedom and reduce welfare. The Soviet Union, for example, recorded rapid growth in the 1930s but it was achieved by the forced collectivisation of agriculture and an artificial expansion of heavy industry. The result was a disaster for the Russian people, one from which they have still not recovered.

Similarly, some people believe a compulsory retirement savings scheme would increase national savings and economic growth. However, it would obviously reduce consumption opportunities of low income people in particular, and alter many decisions that would have been made differently in circumstances of greater economic freedom. This would be welfare-reducing. Governments could no doubt increase output, incomes and economic growth by legislating for a 60-hour week. Would we regard this as an improvement in living standards? There is also the obvious point that development can occur at the expense of the environment, and reduce rather than improve the overall quality of life.

Even where welfare can be expressed in monetary terms, it doesn't follow that only the profit motive can produce it. The non-profit motive has always been important in health, education, welfare and other personal services. A Business Roundtable publication *From Welfare State to Civil Society* by David Green advocates moves away from state provision of a range of social services and greater reliance on a reinvigorated 'civil society' in which voluntary activities flourish. There is strong evidence that charitable associations relying on voluntary donations can do a much better job than the state in tackling many of the symptoms and causes of poverty. Green argues that they must be allowed far greater scope to do so if we are to achieve the more compassionate and public-spirited society that most of us want.

There are many other types of non-profit organisation. Great universities like Harvard and Stanford are not-for-profit. In some cases, the distinction between for-profit and not-for-profit organisations is not large. Non-profits must be able to achieve operating surpluses to service their borrowings and help finance their assets. The main difference is that they do not pay dividends on equity capital.

Nevertheless, most of the goods and services that people value for their material welfare are produced by the commercial, profit-driven sector. In search of profits, Bill Gates and Microsoft have improved the lives of millions of people on earth. Under free and fair competition and the rule of law, self-interest is a positive force because in order to benefit ourselves, we must benefit others. Voluntary market exchanges driven by people's perceptions of their own interests benefit all parties to a transaction. Hence

Adam Smith's famous remark that we rely on the self-interest of the butcher, the brewer or the baker to meet our needs, not on their benevolence.

However, it does not follow that profit is always an accurate measure of the contribution of the commercial sector to the well-being of the community. On the contrary: high profits may, for example, reflect government privileges and low profits may reflect poor protection of property rights. A firm that is protected from competition by its rivals, whether domestic or foreign, can increase its profits by producing less and charging more. Competition, by contrast, limits profits by forcing firms that want to survive to offer consumers better or cheaper products. The Business Roundtable has consistently advocated the extension of competition, including where this would reduce the profits earned by private monopolies. Of course, globalisation – the operation of competition in the international sphere – is sometimes attacked by opponents of economic freedom as giving free rein to multinational corporations. That the same people can welcome import protection, which enables local firms, often owned by multinational corporations, to freely exploit consumers with higher prices and profits, is one of the great mysteries and ironies in the economic policy debate.

Business people are also driven by all manner of visions and ideals beyond short-term profits. Take the great American entrepreneurs of the nineteenth and early twentieth centuries, like Rockefeller, Frick and Huntington. These men were motivated by the need to prove that certain things that had never been done were possible, or by the desire to promote philanthropy or foster the arts. They have left behind famous foundations devoted to these goals. I suspect that many entrepreneurs who start up businesses and innovate are likewise motivated by things beyond profit: by a desire for independence or adventure, or by curiosity, or by a simple need to express their creative urges.

It is true that the typical publicly listed corporation, whose managers are closely scrutinised by anonymous shareholders, has to keep a careful watch on its bottom line. This is exactly how it should be: often tens of thousands of small shareholders have entrusted their money to such firms, either directly or through investment or superannuation funds, and they depend on returns on their savings for their retirement and other needs. Those running public companies are not entitled to play Father Christmas with other people's money. The reality of commercial life is that sometimes a firm has to close operations and lay off staff in order to survive; sometimes negligence or bad luck results in a defective or dangerous product being sold; sometimes changing market conditions oblige a firm to raise its prices. It's then that we're likely to hear the complaint that companies 'put profits before people'.

But 'profits or people' is one of those bogus dilemmas that are invoked in public debate to score easy but erroneous rhetorical points. If a firm makes sustained losses it goes out of business. People that put money into it lose their savings and people working for it lose their jobs. But the deep and venerable prejudice against profit, based on the conviction that a firm can make profits only if others lose, persists even among people who recognise that there is no viable alternative to private enterprise.

For example, the author of a letter to the *New Zealand Herald* last year argued that the profits of the self-employed and of small businesses were 'nearly' the equivalent of wages (and hence presumably justified), whereas medium to large corporations "can be monopolistic, self-serving entities with no obligation to the country they reside in, its environment or its future". The author went on to argue that Telecom's profit of $830 million could provide for nearly 2.2 million children in developing countries for a year. It's odd that someone who accepts that small businesses have to make profits can believe that profits are optional for big businesses. The correspondent made no attempt to work out if the achieved rate of profit exceeded Telecom's cost of capital; a total profit of $830 million was self-evidently unfair. Nor was there any recognition of the fact that many of those who own shares in Telecom are poorer than many people who have put their money into their own businesses.

Profit is the difference between a firm's revenue or gross income and its costs, including interest paid on borrowings. It is the residual accruing to the firm's owners. It is a small margin – typically profit before tax accounts for about 8.5 cents of every dollar of gross income. From an economic perspective, the return on equity capital, like interest on debt, is a cost of production – the opportunity cost of not using the capital elsewhere. If the achieved profit is less than the return that could have been achieved from other investments, society is worse off. Investments that just produce the required return are said to produce normal profits.

Profit performs two main functions. First, whether or not a business earns a normal profit indicates whether resources are being efficiently allocated – whether the business is creating wealth or destroying it. This is true under any kind of economic regime – whether capitalist or socialist. If firms don't achieve normal profits on a sustained basis they are failing their shareholders. They may be in the wrong line of business, they may be poorly managed, or the market may have moved against them. Sustained losses are an indication that society would be better off if the firm's resources were reallocated to other uses or taken over by other managers. Subsidising loss-making firms to keep them going is the road to ruin. If we care about people we should beat up on loss-makers not profit-makers.

Secondly, profit plays a crucial role in what has been called the 'discovery process' of the market. The expectation of a favourable profit guides the central decisions that have to be made in any economy: what to produce, how much and at what price. Entrepreneurial profit provides the necessary reward for successful innovation. Most new products fail the test of the marketplace. Those that succeed earn profits that may be temporarily high until other producers enter the market, expand the supply or offer competing products, and bring down profits to normal levels. Often complaints are made about 'excess' profits, but in a market economy they serve an essential function. High profits reflect the greatest gap between what consumers value and what the market was hitherto producing. The hope of temporarily high profits spurs entrepreneurs to accept the risks involved in innovation; without them, innovation would largely dry up.

Consumers benefit from this process. The personal computer is a good illustration. When they came on the market about 20 years ago, personal computers cost several thousand dollars. Fierce competition forced suppliers to cut costs and produce new and better products in never-ending cycles to stay profitable. Now, some Internet service providers are giving personal computers away with e-mail subscriptions. Without profits, new consumer needs would never be satisfied or even discovered.

Of course, business people engaged in their day-to-day activities are not necessarily mindful of the economic (as opposed to the commercial) functions of profit. They are concerned with making the returns they need to stay afloat. But the profit motive is benign so long as it operates under conditions of fair and open competition – within a sound legal and ethical framework, including laws that prevent harm to others and the environment. Where competition exists, no producer can increase profits by charging more than a competitor, since this will mean a loss of sales. Instead, profits can only be increased by giving consumers better value. Market competition disciplines tendencies towards exploitation and greed far more effectively than the institutions of a socialist system.

In competitive markets businesses have to strive ceaselessly to meet consumers' changing needs. But it is here that much of the friction between the profit motive and community expectations arises. Sometimes firms have to put up prices, for example because the costs of their raw materials have gone up, to stay profitable. Sometimes they have to close operations or replace workers with machines. 'Downsizing' is one of the commonest cases of firms allegedly 'putting profits before people'. However, no one would sensibly describe the expansion or 'upsizing' of a firm as putting people before profits! Consider the alternatives: a firm that fails to adjust will go out of business altogether, thus throwing its entire workforce out of their jobs. Lots of small investors in the firm will lose their savings. The firm's profits belong to people too – in public companies they typically belong to thousands of small investors, not to a few wealthy people. So the debate is really about whether their property – their hard-earned savings – should be sacrificed in favour of other stakeholders in the firm. Investors surely have the same rights to withdraw their capital as workers have to quit their jobs. They have other investment alternatives, just as workers have other employment opportunities in a well-functioning and tight labour market.

Contrary to old-fashioned notions of class warfare, investors and employees have a common interest in the profitability of their firms and the business sector as a whole. This interest has become stronger as more workers have become shareholders and as capital markets have widened with the demutualisation of insurance companies, public listings of cooperatives and privatisation of government-owned businesses. Already around 52 percent of Americans and 44 percent of New Zealanders own shares, either directly or through vehicles such as unit trusts or superannuation funds. The more people acquire direct stakes in profits, and the more valuable those stakes become, the more irrelevant will the 'profits or people' catchcry seem.

Changes like the spread of share ownership give me confidence that the ancient superstitions about profits will fade away. A generation is coming to prominence (sometimes referred to as Generation X) that has grown to maturity in a world in which the private sector plays a much greater role than it did when their baby-boomer parents were growing up. It has been said that if the reigning ideas in a society change, it's not because anyone has changed their minds but because established generations retire and new generations with new ideas replace them. Only occasionally do we hear from those in younger age groups, as with the recent 'Generation Lost' advertisement. Normally it seems they are busy working to become independent and self-reliant and don't want to get involved in politics. Most want to work for private businesses or start their own, not work in the public sector. They understand that a profitable and successful business sector is the foundation not just of their own personal welfare but that of the poorest in the community. They are distrustful of governments, politics and socialistic solutions.

Thus I would like to conclude by challenging John Campbell, on air, to consider the issue of 'power versus people'. If the profit motive drives business people, the power motive surely drives politicians. We have seen this not just in totalitarian regimes but also in liberal democracies where governments have abused their powers and sacrificed the interests of the people to their own. A lesser role for profits and the market means a greater role for politicians and state power. Those who wish to end global capitalism must be aware that they are promoting bigger government. We need governments to perform important roles. But if there is one lesson the twentieth century taught us, I suggest it is that people's interests are better served by less government and by more market-based wealth creation in conditions of economic freedom. Will John Campbell rise to this challenge?