Chapter 6

Profit

The Principle of Prosperity

David Smith

Old-fashioned people think you can have a soul without money. They think the less money you have, the more soul you have. Young people nowadays know better. A soul is a very expensive thing to keep: much more so than a motor car.

George Bernard Shaw, Heartbreak House

Money earned is proof of value provided. Money earned is proof of worth recognized.

Hendrith Smith

Ours is not an anti-profit philosophy. On the contrary, we believe that one of the greatest contributions of business is the generation of wealth. Wealth raises the standard of living in communities. Wealth provides opportunities to create jobs, sustain livelihoods, and make resources available to others who share an entrepreneurial spirit.

Economic sustainability is the ability to financially support the needs and goals of an organization's mission and purpose for its intended duration while simultaneously distributing prosperity and value—tangible or intangible—ethically and fairly to all stakeholders.

Having money can dramatically increase the amount of good you can do in the world. Making money is vital to continued operation. Sacrificing value, values, and shared prosperity can turn the generation of wealth into a vice, but a recognition of money as a means to generate value—and not the other way around—can maintain profit motives as a healthy component of mission fulfillment.

The problem is that a focus on financial wealth can erode the deep truth: The only good thing about money is that it allows us to purchase some things that we value. In other words, money is always a mere means to an end. Sacrificing values in order to make money is a deep irony that erodes the core of the economic soul. Because as we are all aware, not everything of value can be purchased with money. In the words of Clare Boothe Luce, "Money can't buy happiness, but it can make you awfully comfortable while you're being miserable."

Economic sustainability is imminently consistent with the principles of a virtuous organization. The organization needs to create and distribute value in order to be virtuous, and in many cases the best way to provide that value is to ensure that the organization continues to survive for the intended and reasonably expected life of the purpose it serves.

Not all organizations need to be sustainable indefinitely in order to be virtuous. Nor do all organizations need to close their doors. As with all other principles in support of the virtuous organization, the most important thing is the fulfillment of the organizational mission.

Give the shareholders what they want

Let’s get this out of the way right at the outset: We do not believe that corporations exist solely to maximize profit for shareholders, nor that the law compels organizations (or the people who run them) to sacrifice any other organizational interests in favor of dividend checks. We agree with the analysis of Lynn Stout, who wrote a compelling argument in the *Virginia Law and Business Review*, suggesting that any reference to case law requiring profit maximization was patently false.

In part, Stout argued:

“Different shareholders have different investment time frames, different tax concerns, different attitudes toward firm-level risk due to different levels of diversification, different interests in other investments that might be affected by corporate activities, and different views about the extent to which they are willing to sacrifice corporate profits to promote broader social interests, such as a clean environment or good wages for workers. These and other schisms ensure that there is no single, uniform measure of shareholder 'wealth' to be 'maximized.'”[1]

As even Milton Friedman—an economist famous at least in part for railing against corporate social responsibility—pointed out, shareholders are people. And they invest in ideas and philosophies and values as well as opportunities for financial gain.

There is a relatively large body of research that suggests that investments in social performance also increase financial performance. While the details of the mechanisms behind this phenomenon are still a matter of debate, one thing is clear: people (customers and investors) respond positively to opportunities to involve themselves with businesses that are interested in social value and not just financial value. Not everyone appreciates the specific social values espoused by some companies, and some people prefer companies that focus just on the (financial) bottom line. But there are enough investors and customers who do prefer that companies be socially and environmentally minded that many such companies continue to thrive.

This suggests that transparency is central to real fiduciary responsibility. So long as investors know what the company stands for and how it intends to spend their money, the choice of whether or not to invest—to risk their own capital—belongs to investors themselves.

The virtue of creating paydays

It is obvious that if we value people, we should value jobs.

Jobs allow people stability. They pay for meals and mortgages and college. They provide an essential fabric that is woven through our families and social networks and create the rhythm of our days and weeks. Jobs provide much more than just paychecks.

Jobs also provide paychecks.

The old adage suggests that money doesn’t buy happiness. But the more relevant question is whether or not money can help people to buy what they need. And for many types of need, the answer is yes.

Having commonly recognized currency that allows individuals to make complicated trades in a free market has exponentiated human growth, development, innovation, and prosperity.

With money, people can purchase what they value. They can buy food, shelter, medicine. Plane tickets to visit loved ones, or tickets to see *Hamilton*. If a person values a television or smartphone more than food one particular month, as Naimil Shah points out, she is free to buy it.[2]

This freedom to choose is one of the reasons money is such a close approximation of the *util*, which is economists' unit for measuring individual value preferences. The freedom to choose with one's own resources—assuming they have such resources—is a powerful force in support of self-actualization.

Most of us at some point in our life have been asked the question, "What would you do with a million dollars?" It wouldn't be surprising (especially since you a reading a book about virtuous organizations) to find out that you wanted to contribute some part of the allotment to a charity or socially good cause. Most, if not all of us, have an innate desire to do something "good" with our lives. We want to contribute in meaningful ways, leave the world a better place, help someone who is in need, alleviate some conflict. When we are asked the million-dollar question, we often see the money as a way to fill this need in our lives. Perhaps you recognize the thought in your own mind, "If I just had more money, I would do such-and-such great thing!" With the way the world works, we see money as an instrument for doing good.

While money is not required to do good in the world, it does enable us to do a few good things. First, it increases the variety of options we have to do good. Without money or other material valuables, the resources we have to do good are limited, and, in extreme cases, our only options might be saying kind words and volunteering our time.

With money, on the other hand, your options are much more broad. You might have money to feed the poor, shelter the homeless, or create a business with a socially good mission and that creates employment.

Reinvestment and value creation

There is value in working for pay that extends beyond the size of the paycheck. It is inexplicable that we frequently think of profit as antithetical to social benefit. The presence of such new business forms such as B-corps and LC3s suggests a belief that the pursuit of social welfare and profit maximization automatically live in tension. We believe that this is not naturally the case.

The social value of money is not to be underestimated.

In general, if you value something more, you are willing to pay more money for it. This suggests that if you make something people value, you can charge more money for it. There is a corollary even for charities: If you produce something of value, people will donate more money for the cause. In this way, the ability to generate wealth is itself a signal of social value.

And money attracts money: if you generate wealth—which can be a natural result of creating something of value that people will pay for—then your activities can be seen as a good investment. Being viewed as a value creator attracts additional money in pursuit of even greater value. This, in turn, fuels innovation, expansion, and quality improvement. Value attracts money, and money drives value.

Reinvestment in the activities of the organization is key to this virtuous cycle of value enhancement. Innovation, expansion, and quality improvement only result if the invested funds can be used to generate them through research and development, excellent strategy, and wise infrastructure investments. This sort of reinvestment in the organization's capacity is necessary for achieving expanded value from the organization. It's what is expected by investors. It's what they are investing in.

We borrow the term "reinvestment" here from the nonprofit sector, where there is no such thing as distributions to shareholders. By legal constraint, any profit earned by a nonprofit (the term "nonprofit" is such a misnomer! Well-run charities make more money than they spend!) must be reinvested in the firm. So the concept of reinvestment emphasizes that the value intended from this kind of capacity-building activity can be viewed as independent from financial returns on shareholders' investments.

A wise company takes investors' money and devotes it to increasing the firm's ability to create value. Not necessarily money. Value.

Optionally, organizations can sell the additional value they have created with investor's funds and do so at a profit. This results in additional financial resources that can, in turn, either be reinvested in the company or distributed to shareholders, owners, or other investors. It can also be distributed through corporate philanthropy.

If an organization is mission-focused and working toward its vision for the world, greater reinvestment can translate to real gains for society. An organization that is committed to such a vision will align their growth and innovation strategies with new, better, cheaper, faster ways to get things of value—things people need—to the people who need them.

That means more and better medicine. More shelter. More education. More art. Cleaner energy.

The value of markets

Markets are perhaps the most elegant value distribution function ever seen by humankind. We can track the growth and decline of human prosperity by tracking the sale of certain goods. We can predict hardships and buoyant circumstances by looking at the prices of milk and gas—we can tell at both individual and societal levels what we value by looking at what we buy, how much we buy, when we buy, and where we buy it from.

Markets are made up of people, and those people make choices. On a daily basis, we make dozens of decisions about what we want, what we need, and what we will buy. Milton Friedman suggests that this freedom of choice in the marketplace makes free competitive markets a natural precursor and necessary condition for political freedom. He writes,

"The world runs on individuals pursuing their separate interests. The great achievements of civilization have not come from government bureaus. Einstein didn't construct his theory under order from a bureaucrat. Henry Ford didn't revolutionize the automobile industry that way. In the only cases in which the masses have escaped from the kind of grinding poverty you're talking about, the only cases in recorded history, are where they have had capitalism and largely free trade. If you want to know where the masses are worse off, worst off, it's exactly in the kinds of societies that depart from that. So that the record of history is absolutely crystal clear, that there is no alternative way so far discovered of improving the lot of the ordinary people that can hold a candle to the productive activities that are unleashed by the free-enterprise system."

Pricing and the true cost of doing business

Markets are beautiful, elegant mechanisms for distributing value—except when they aren't.

Several specific types of institutional malfunctions can cause markets to behave in ways that create systemic problems for the maximization of social value and social wellbeing. These primarily result from ways in which the individualistic, competitive forces that drive prices down are not properly functioning. For example, if only a single organization produces a good, then there is no "market," so there is no competition. The lack of competition, in turn, decreases the incentive to innovate (thus reducing the incentive to increase value) and prices can be artificially inflated. Many characteristics of this kind of market failure—monopoly—are also present when barriers to entry are present. Barriers to entry describe situations (such as major infrastructure needs) that prevent competitors from entering the market.

The functioning of the market also presumes that consumers, when making their decisions about what to purchase and from whom, have good, fair, and honest information on which to base their decisions. When choice is manipulated by faulty information, freedom to choose means nothing. This problem of information asymmetry—in which firms withhold or manipulate information about their own products or services from customers or internal company information from investors—is particularly problematic when the hidden information relates to the possibility of harm. Harms can exist in the form of either products or byproducts. In either case, full disclosure is preferable.

We believe that it is the responsibility of organizations to not only actively research the impacts of their products and services on consumers and the world, but to share this information with consumers. This motivates organizations to remedy whatever harms they might identify.

In some cases, market failure results from the sum of individual biases in decision-making that ultimately lead to bad institutional results. Due to the natural limits and heuristics of human cognition, people sometimes make choices that are against their own long-term best interests, are biased in systematic ways, or harm others. When individual decision-making flaws are magnified by hundreds, thousands, or even millions of customers, even an “economically efficient” market can result in bad outcomes.[3]

We believe that a virtuous organization seeks to correct its own market failures.

Though correction of market failures has been commonly recognized as an important role for government, it is not always necessary for regulation, taxation, and subsidy to be imposed by an external force. Organizations can use pricing structures, information sharing, common access to infrastructure, and invitations to competition as tools to enhance the efficacy of the market platform in which they operate.

Pricing as a tool of virtue

Prices—particularly low prices—have been identified by some as an economic weapon to alter markets and destroy competitors. However, it is also true that in some cases, price adjustment can be a powerful tool for correcting market failures. This is particularly the case in the face of negative externalities, in which the costs of production—when accounting for the price of mitigating or addressing harms caused by generating products, products themselves, or byproducts—are higher than they might be in a distorted market. A virtuous organization prefers functioning markets because markets can efficiently distribute value. So a virtuous organization encourages or even self-imposes appropriate self-regulation or price increases that can account for these additional costs.

The fear is that investors might balk at such pricing decisions, particularly given the prosocial rationale of increasing customer prices to offset social or environmental harms that might results from the product.

Let the shareholders know that part of the cost of production—part of what they are investing in—is the need to overcome the externalities that are an ordinary function of doing business. Everyone knows that you need to pay for infrastructure, labor, and raw materials. There are also costs associated with other activities involved in fulfilling a value-driven mission. The cost of business also includes is the innovation, price adjustment, and other costs necessary for remedying the organization’s own market failures. While shareholders are hoping for returns—that’s why they are investing in your company in the first place—there is no shortage of investors who will knowingly, willingly, enthusiastically buy into your company without even knowing about your core value strategy.

So long as you have been clear with shareholders about your mission, and so long as you expend company funds in diligent pursuit of that mission, there is no reason to believe that shareholders—who can invest or divest monies at virtually any time—expect anything other than for you to do what your mission says you are going to do. Whether it brings financial returns or not.

Exploring the principle of prosperity

The first key to a virtuous perspective on wealth is equitable distribution of value or wealth. This does not mean that everyone gets the same amount. Rather, it suggests that consumers are receiving their goods or services for a fair price adjusted by efficient and proper market forces and that employers distribute wealth fairly to their employees and shareholders. Should the president of your organization make more than a front-line employee with a GED? It would be hard to make a valid argument against that. There is value in experience and level of responsibility that should be fairly compensated. Vertical equity suggests that gradation according to merit is to be expected. But should your front-line employee be struggling to make ends meet while the president takes a flight on his or her private plane to vacation on the family's private yacht? If that is the case, you might be missing the mark on equitable distribution. How much more a president should make than other employees is a complicated issue with many factors of varying importance unique to almost every organization, and honestly, the exact number isn't important. You can take steps today to move toward a more equitable distribution of value in your organization.

Imagine you work for a company that has wild success with profits through the roof. The company is making so much money that it can't grow fast enough. You've paid all your stakeholders well and you still have resources left over. What would you do in this situation?

There are several organizations out there with this kind of money, but one that seems to have a very public presence is Alphabet, the parent company of Google. This company has so much money that it can take on projects that very few have an opportunity to. One of their projects is to end human aging (Bylund, Hall, & Caplinger 2017)! This might be an extreme case, but it's important to recognize that there are several actions you can take when you have a profitable business and not all of them are of equal value.

The dangers of debt

Taking on debt as an organization is risky, but an appropriate amount of debt can leverage your company in a way that creates a tremendous amount of value. The appropriate amount of debt is up for debate among the financial experts. What makes organizations virtuous is when they are aware of the risks they are taking, whose money they are risking, and are honest and transparent about the risks involved to the stakeholders. Consider the big banks in 2008 who were irresponsible with debt and risk because they could be (Lenzner 2013). There was no one and nothing to stop them, police them, or hold them responsible.

History shows us that people are not always ethical or responsible. The path toward virtue is straightforward, but so many miss the mark. Like the banks, there are no laws requiring organizations to operate virtuously. The virtuous organization operates at a higher standard than the law. While straightforward, the path is not easy, especially when others don't play by the same rules.

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[1] https://web.archive.org/web/20120303074232/http://www.virginialawbusrev.org/VLBR3-1pdfs/Stout.pdf

[2] https://medium.com/@naimilshah/why-poor-people-buy-television-45f9ebc91adb

[3] Bozeman, Barry. "Public-value failure: When efficient markets may not do." Public Administration Review 62, no. 2 (2002): 145-161.