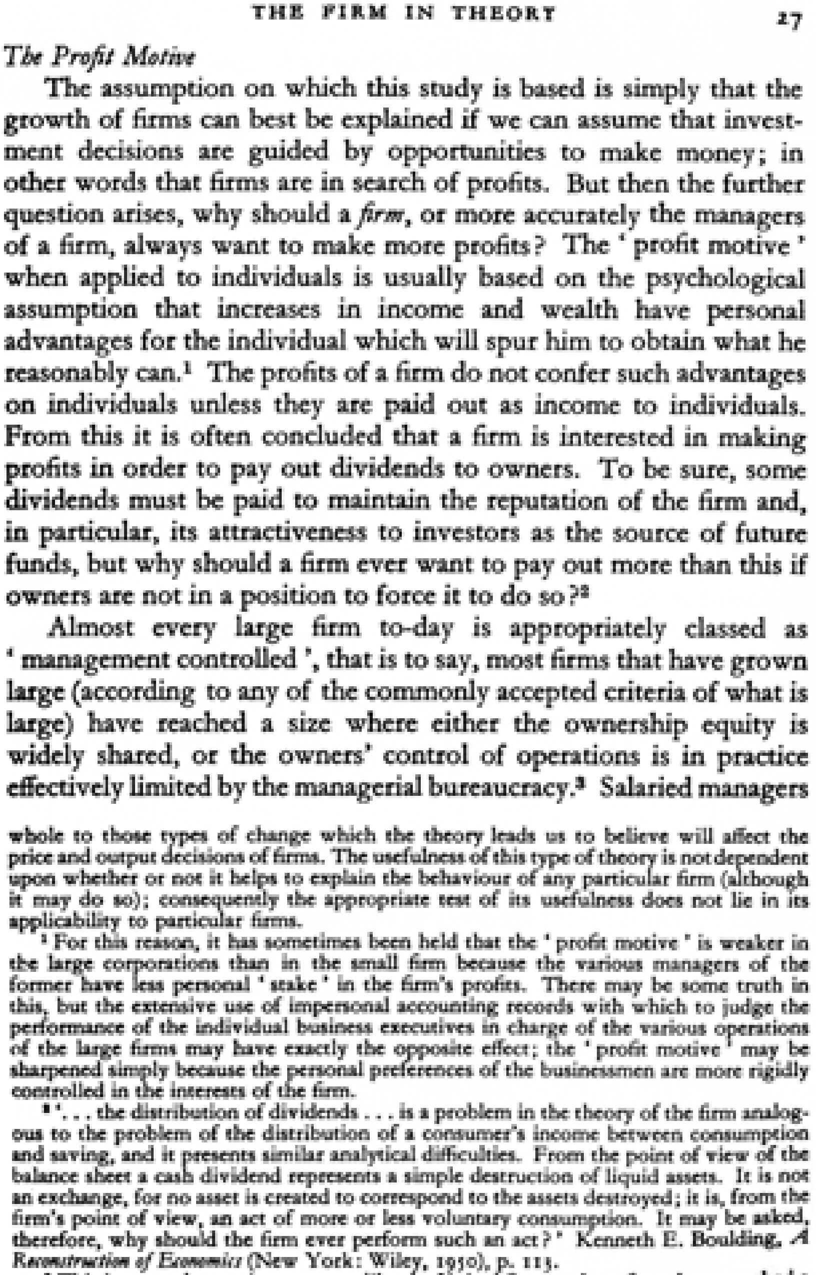


The Profit Motive

The assumption on which this study is based is simply that the growth of firms can best be explained if we can assume that investment decisions are guided by opportunities to make money; in other words that firms are in search of profits. But then the further question arises, why should a *firm*, or more accurately the managers of a firm, always want to make more profits? The ' profit motive ' when applied to individuals is usually based on the psychological assumption that increases in income and wealth have personal advantages for the individual which will spur him to obtain what he reasonably can.[1] The profits of a firm do not confer such advantages on individuals unless they are paid out as income to individuals. From this it is often concluded that a firm is interested in making profits in order to pay out dividends to owners. To be sure, some dividends must be paid to maintain the reputation of the firm and, in particular, its attractiveness to investors as the source of future funds, but why should a firm ever want to pay out more than this if owners are not in a position to force it to do so?[2]

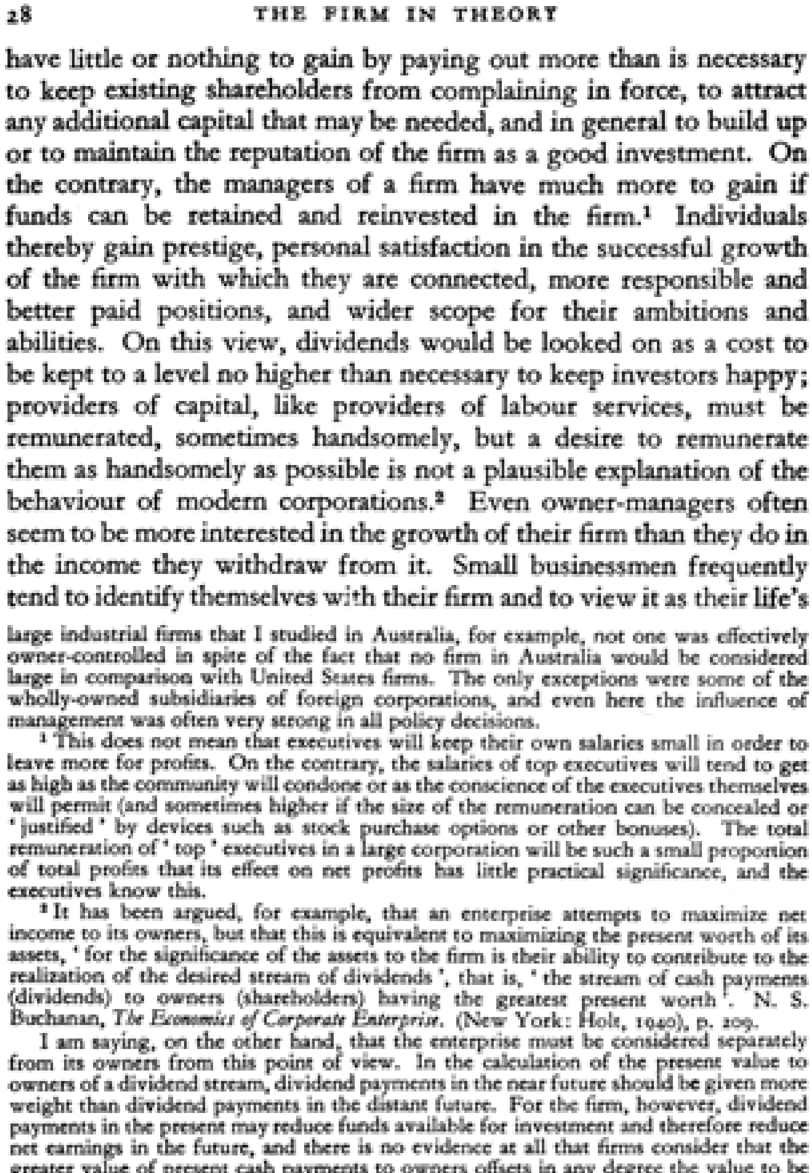
Almost every large firm to-day is appropriately classed as ' management controlled ', that is to say, most firms that have grown large (according to any of the commonly accepted criteria of what is large) have reached a size where either the ownership equity is widely shared, or the owners' control of operations is in practice effectively limited by the managerial bureaucracy.[3] Salaried managers

whole to those types of change which the theory leads us to believe will affect the price and output decisions of firms. The usefulness of this type of theory is not dependent upon whether or not it helps to explain the behaviour of any particular firm (although it may do so); consequently the appropriate test of its usefulness does not lie in its applicability to particular firms.

[1] For this reason, it has sometimes been held that the ' profit motive ' is weaker in the large corporations than in the small firm because the various managers of the former have less personal ' stake ' in the firm's profits. There may be some truth in this, but the extensive use of impersonal accounting records with which to judge the performance of the individual business executives in charge of the various operations of the large firms may have exactly the opposite effect; the ' profit motive ' may be sharpened simply because the personal preferences of the businessmen are more rigidly controlled in the interests of the firm.

[2] '. . . the distribution of dividends . . . is a problem in the theory of the firm analogous to the problem of the distribution of a consumer's income between consumption and saving, and it presents similar analytical difficulties. From the point of view of the balance sheet a cash dividend represents a simple destruction of liquid assets. It is not an exchange, for no asset is created to correspond to the assets destroyed; it is, from the firm's point of view, an act of more or less voluntary consumption. It may be asked, therefore, why should the firm ever perform such an act? ' Kenneth E. Boulding, *A Reconstruction of Economics* (New York: Wiley, 1950), p. 115.

[3] This is not only true in a country like the United States where firms have reached a very large absolute size, but also in some smaller countries as well. In the sample of



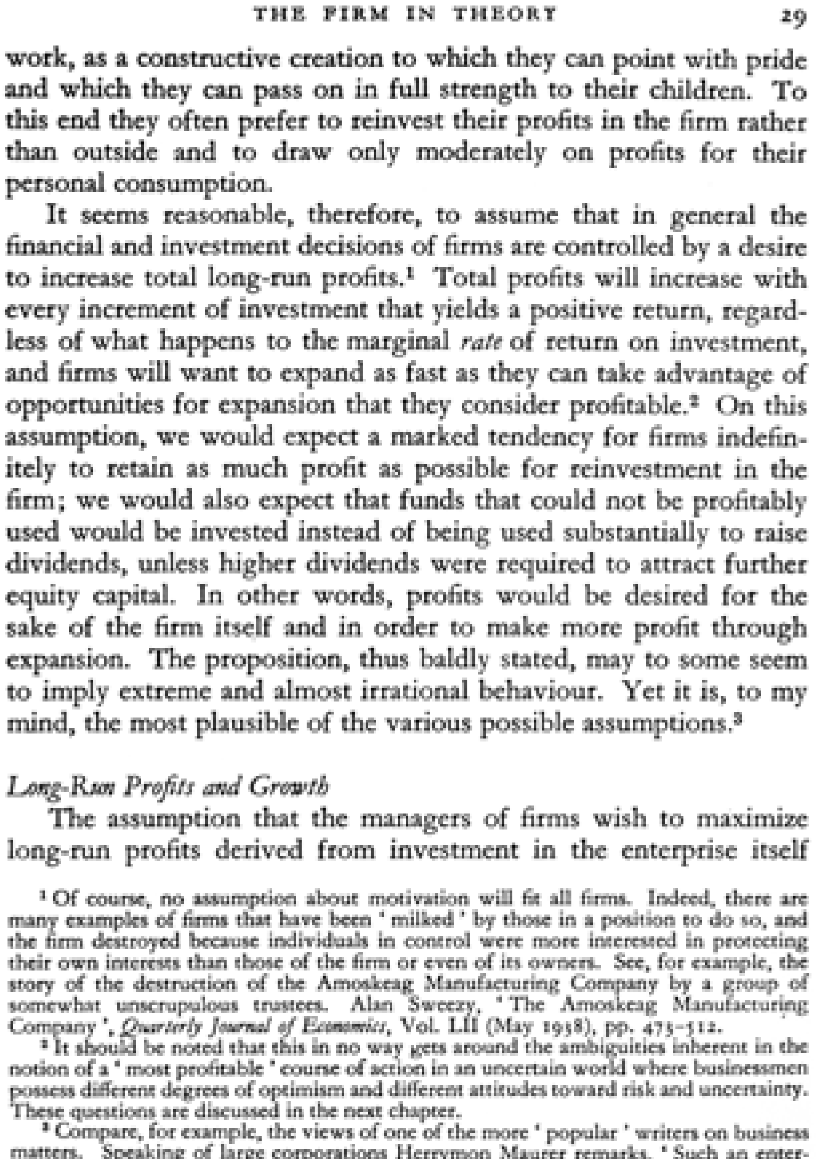
have little or nothing to gain by paying out more than is necessary to keep existing shareholders from complaining in force, to attract any additional capital that may be needed, and in general to build up or to maintain the reputation of the firm as a good investment. On the contrary, the managers of a firm have much more to gain if funds can be retained and reinvested in the firm.[1] Individuals thereby gain prestige, personal satisfaction in the successful growth of the firm with which they are connected, more responsible and better paid positions, and wider scope for their ambitions and abilities. On this view, dividends would be looked on as a cost to be kept to a level no higher than necessary to keep investors happy; providers of capital, like providers of labour services, must be remunerated, sometimes handsomely, but a desire to remunerate them as handsomely as possible is not a plausible explanation of the behaviour of modern corporations.[2] Even owner-managers often seem to be more interested in the growth of their firm than they do in the income they withdraw from it. Small businessmen frequently tend to identify themselves with their firm and to view it as their life's

large industrial firms that I studied in Australia, for example, not one was effectively owner-controlled in spite of the fact that no firm in Australia would be considered large in comparison with United States firms. The only exceptions were some of the wholly-owned subsidiaries of foreign corporations, and even here the influence of management was often very strong in all policy decisions.

[1] This does not mean that executives will keep their own salaries small in order to leave more for profits. On the contrary, the salaries of top executives will tend to get as high as the community will condone or as the conscience of the executives themselves will permit (and sometimes higher if the size of the remuneration can be concealed or ' justified ' by devices such as stock purchase options or other bonuses). The total remuneration of ' top ' executives in a large corporation will be such a small proportion of total profits that its effect on net profits has little practical significance, and the executives know this.

[2] It has been argued, for example, that an enterprise attempts to maximize net income to its owners, but that this is equivalent to maximizing the present worth of its assets, ' for the significance of the assets to the firm is their ability to contribute to the realization of the desired stream of dividends ', that is, ' the stream of cash payments (dividends) to owners (shareholders) having the greatest present worth '. N. S. Buchanan, *The Economics of Corporate Enterprise*. (New York: Holt, 1940), p. 209.

I am saying, on the other hand, that the enterprise must be considered separately from its owners from this point of view. In the calculation of the present value to owners of a dividend stream, dividend payments in the near future should be given more weight than dividend payments in the distant future. For the firm, however, dividend payments in the present may reduce funds available for investment and therefore reduce net earnings in the future, and there is no evidence at all that firms consider that the greater value of present cash payments to owners offsets in any degree the value to be attached to the prospect of higher earnings for the enterprise in the future. Furthermore, the ' significance of assets to the firm ' may just as well be considered to lie in their ' ability to contribute ' to meeting a ' desired ' payroll, a ' desired ' managerial bonus payment, or any other ' desired ' cost. Only if higher dividends in the present are expected to maintain or increase the availability of capital funds in the future will the firm have an incentive to make them.



work, as a constructive creation to which they can point with pride and which they can pass on in full strength to their children. To this end they often prefer to reinvest their profits in the firm rather than outside and to draw only moderately on profits for their personal consumption.

It seems reasonable, therefore, to assume that in general the financial and investment decisions of firms are controlled by a desire to increase total long-run profits.[1] Total profits will increase with every increment of investment that yields a positive return, regardless of what happens to the marginal *rate* of return on investment, and firms will want to expand as fast as they can take advantage of opportunities for expansion that they consider profitable.[2] On this assumption, we would expect a marked tendency for firms indefinitely to retain as much profit as possible for reinvestment in the firm; we would also expect that funds that could not be profitably used would be invested instead of being used substantially to raise dividends, unless higher dividends were required to attract further equity capital. In other words, profits would be desired for the sake of the firm itself and in order to make more profit through expansion. The proposition, thus baldly stated, may to some seem to imply extreme and almost irrational behaviour. Yet it is, to my mind, the most plausible of the various possible assumptions.[3]

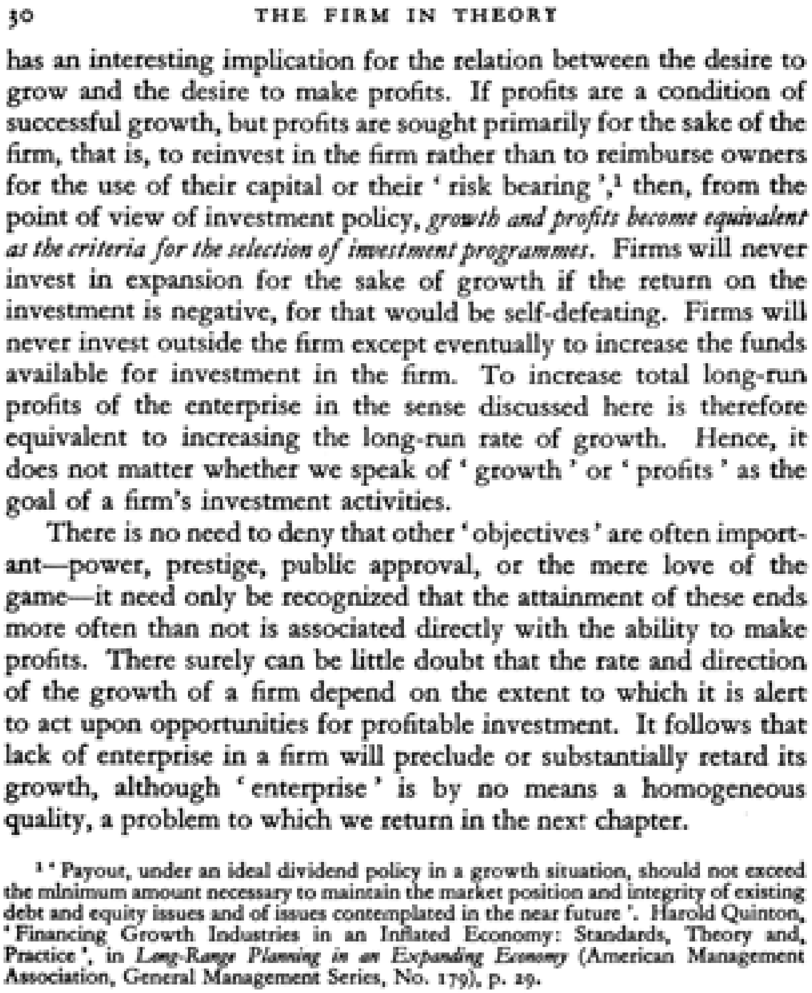
Long-Run Profits and Growth

The assumption that the managers of firms wish to maximize long-run profits derived from investment in the enterprise itself

[1] Of course, no assumption about motivation will fit all firms. Indeed, there are many examples of firms that have been ' milked ' by those in a position to do so, and the firm destroyed because individuals in control were more interested in protecting their own interests than those of the firm or even of its owners. See, for example, the story of the destruction of the Amoskeag Manufacturing Company by a group of somewhat unscrupulous trustees. Alan Sweezy, ' The Amoskeag Manufacturing Company ', *Quarterly Journal of Economics*, Vol. LII (May 1938), pp. 473–512.

[2] It should be noted that this in no way gets around the ambiguities inherent in the notion of a ' most profitable ' course of action in an uncertain world where businessmen possess different degrees of optimism and different attitudes toward risk and uncertainty. These questions are discussed in the next chapter.

[3] Compare, for example, the views of one of the more ' popular ' writers on business matters. Speaking of large corporations Herrymon Maurer remarks, ' Such an enterprise is too big for any one owner or group of owners to control. It is run, therefore, not primarily for the stockholders, who have generally become used to a socially approved return on their investment, but for the enterprise itself. The aim of the enterprise is not immediate or even future maximum profits, once thought to be the goal of all enterprise, but healthy future existence, to which the size of profits is an important but secondary consideration '. Herrymon Maurer, *Great Enterprise: Growth and Behavior of the Big Corporation* (New York: Macmillan, 1955), p. 186.



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has an interesting implication for the relation between the desire to grow and the desire to make profits. If profits are a condition of successful growth, but profits are sought primarily for the sake of the firm, that is, to reinvest in the firm rather than to reimburse owners for the use of their capital or their ‘ risk bearing ’,[1] then, from the point of view of investment policy, *growth and profits become equivalent as the criteria for the selection of investment programmes.* Firms will never invest in expansion for the sake of growth if the return on the investment is negative, for that would be self-defeating. Firms will never invest outside the firm except eventually to increase the funds available for investment in the firm. To increase total long-run profits of the enterprise in the sense discussed here is therefore equivalent to increasing the long-run rate of growth. Hence, it does not matter whether we speak of ‘ growth ’ or ‘ profits ’ as the goal of a firm's investment activities.

There is no need to deny that other ‘ objectives ’ are often important—power, prestige, public approval, or the mere love of the game—it need only be recognized that the attainment of these ends more often than not is associated directly with the ability to make profits. There surely can be little doubt that the rate and direction of the growth of a firm depend on the extent to which it is alert to act upon opportunities for profitable investment. It follows that lack of enterprise in a firm will preclude or substantially retard its growth, although ‘ enterprise ’ is by no means a homogeneous quality, a problem to which we return in the next chapter.

[1] ‘ Payout, under an ideal dividend policy in a growth situation, should not exceed the minimum amount necessary to maintain the market position and integrity of existing debt and equity issues and of issues contemplated in the near future ’. Harold Quinton, ‘ Financing Growth Industries in an Inflated Economy: Standards, Theory and, Practice ’, in *Long-Range Planning in an Expanding Economy* (American Management Association, General Management Series, No. 179), p. 29.