Excerpts from

In Praise of Profits!

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On the target audience

This book is dedicated to progressives. I couldn't have written it without them. I hope they will read it. Any explicit or implicit criticism is offered in the spirit of helping progressives reach a more balanced view of the problems they bring to light and the cures they champion.

On acknowledging progress made by progressives

Over the years, progressives have made a great deal of progress in expanding the social safety net provided by the government to help people in need. Among their major achievements are Social Security, Medicare, Medicaid, Unemployment Insurance, and the Supplemental Nutrition Assistance Program. The marginal tax rates on individual incomes have been very progressive for a very long time. The tax code also includes the Earned Income Tax Credit and the Child Tax Credit.

Progressives no doubt mean well. They are always finding income and wealth inequality and recommending policies to fix these problems. In many ways, they succeeded with their New Deal, Great Society, and Obamacare. However, "mission accomplished" is not part of their lexicon.

I acknowledge that progressives have some legitimate current concerns that should be addressed. In particular, shareholder capitalism needs to be reformed so that corporate governance isn't corrupted by crony capitalists, as most clearly evidenced by the excessive pay packages received by some CEOs.

On the basic theme of this essay

"Profits" isn't a four-letter word, but progressives have managed to make it so, as more and more business executives prefer not to even mention it in their public statements about their goals for their companies.

I hope to convince progressives that they should be mindful of the profit motive as a key driver of productivity and prosperity. They can redistribute income with their progressive policies, but aggregate income won't grow if they place too many hurdles in the way of profits.

On confusion about profits

There has been much confusion about corporate profits. That's because there are several measures of profits and very little understanding of, or even interest in, how they differ. As a result, there has been lots of sloppy analysis and misinformed discussion of such important issues as the central role of profits in economic growth, the trend of profits, the corporate tax rate, the profit margin, profits' share of national income, and corporate share buybacks.

On why progressives are wrong about entrepreneurial capitalism

The confusion has played into the hands of progressives. They claim that free-market capitalism, driven by the profit motive, causes wage stagnation and results in both income and wealth inequality. They want the government to redistribute income and wealth by increasing taxes on the rich and on corporations. They refuse to acknowledge that profit-driven capitalism is the source of our nation's widespread prosperity. They say that the relevant data support their claims; that's not so, as I demonstrate in this book. I conclude that the entrepreneurial variety of capitalism—as opposed to crony capitalism, the other variety—should be allowed to flourish. If it does so, so will we all.

As I will show in this study, the progressives' narrative of the relationship between profits and prosperity is wrong and misleadingly pessimistic. In short, it's backward: Market-driven profit is the source of prosperity, not its nemesis. Ironically, profit is what drives the progress in standards of living that progressives champion and try to foster with their policy approaches. But progressives seem blind to the progress that has been achieved and perpetually want to do more. In my opinion, progress has been made despite their persistent policy interventions thanks to the power of the profit motive to deliver profits and prosperity in a free-market economic system.

On why prosperity worsens economic inequality

To be fair and balanced, I acknowledge from the get-go that income inequality is an inherent consequence of capitalism. Perversely, capitalism causes the most income inequality during periods of prosperity. The rich do get richer, but almost everyone's standard of living improves during good times. However, the wealthy get richer faster than everyone else. Entrepreneurs get richer during periods of prosperity by improving the standard of living of their customers.

On competition and technological innovation

In competitive markets, there are no barriers to entry. Ambitious entrepreneurs with access to the right resources can start a business in any industry. In addition, there's no protection from failure. Unprofitable firms restructure their operations, get sold, or go out of business.

Competition is inherently deflationary. No one can raise their price in a competitive market because it is determined by the intersection of aggregate supply and demand. However, anyone can lower their price if they can cut their costs by boosting productivity. The best way to cut costs and boost productivity is with technological innovations. Companies that can innovate on a regular basis ahead of their competitors can cut their prices, gain market share, and be consistently more profitable than their competitors.

On why Marx and Engle were so wrong

Hey, Karl and Friedrich were only 27- and 25-year-old wannabe revolutionaries when they wrote that nonsense. Even as they got older, though, they never figured out that capitalism's process of creative construction improves the standard of living of the consuming class, i.e., all of us. That's right, Marx and Engels erroneously focused their analysis on class warfare, pitting industrial workers against their capitalist employers, who were caricatured as greedy, exploitive, and imperialist. They failed to understand that the only class that matters in capitalism is the consumer class, which includes everybody. In a capitalist system, producers, workers, merchants all compete to cater to needs of the consumer class.

On focusing on the winners of capitalism not the losers

Schumpeter's process of creative destruction naturally leads to the "paradox of progress." On balance, society benefits from creative destruction, as this creates new products, better working conditions, and new jobs, thus raising the standard of living. But it also destroys existing jobs, companies, and industries—often permanently. Calling this process “creative destruction,” as Schumpeter did, places the focus on the losers, while calling it “creative construction,” as I do, focuses on the winners—which, by the way, includes all the consumers who benefit from new or better goods and services at lower prices!

On Adam Smith’s big mistake

Sadly, entrepreneurial capitalism has gotten a bad rap ever since 1776. Perversely, that’s when Adam Smith, the great proponent of capitalism, published *The Wealth of Nations*. He made a huge mistake when he argued that capitalism is driven by self-interest. Marketing capitalism as a system based on selfishness wasn’t smart. Then again, Smith was a professor, with no actual experience as an entrepreneur.

The butcher, the brewer, and the baker get up early in the morning and work all day long, trying to give their customers the best meat, ale, and bread at the lowest possible prices. They don’t do so because of their selflove, but rather because of their insecurity. If they don’t rise and shine early each day, their competitors will, and put them out of business. Entrepreneurial capitalism is therefore the most moral, honest, altruistic economic system of them all. Among its mottos are: “The customer is always right,” “Everyday low prices,” and “Satisfaction guaranteed or your money back.”

On crony capitalism

In other words, capitalism starts to morph into corruption when “special interest groups” try to rig the market through political influence. These groups are totally selfish in promoting the interests of their members rather than their members’ customers. At least Smith got that concept right when he also famously wrote, “People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.”

Successful entrepreneurial capitalists become crony capitalists when they pay off politicians and hire lobbyists to impose legal and regulatory barriers to market entry to keep out new competitors. It doesn’t seem to matter to them that they themselves succeeded because there were no such barriers or because they found ways around any barriers. Rather than cherish and protect the capitalist system that allowed them to succeed, they cherish and protect the businesses that they have built.

On socialism

Crony capitalism tends to flourish in political and economic regimes that are socialist. Socialism is unambiguously bad for entrepreneurial capitalism, but it provides fertile ground for crony capitalism—that is, if it doesn't lead to communism. Under socialism, private property remains mostly private. Under communism, there is no private property; everything is owned by the state. In either system, the government gets bigger. Under socialism, the ruling regime enacts more laws and regulations that force businesses to manage their affairs increasingly to satisfy their socialist political overseers rather than their capitalist shareholders.

On how profits drive prosperity

Notwithstanding politicians' claims, it is profitable businesses that create jobs, not US Presidents or Washington's policymakers and their economic advisers. To be more exact, over the long haul, most of the jobs in our economy are created by small businesses started and run by entrepreneurs that grow into bigger companies. No matter their size, companies behave the same way over the course of the profits cycle. When their profits are growing, they expand their operations. When their profits are falling, they cut back as best they can.

On the role of S corporations

The IRS reports that there were 5.0 million S corporations in the United States in 2020—almost three times the number of C corporations. The NIPA report cited above shows that in 2017, the 1.6 million C corporations employed 55.9 million workers with an annual payroll of $3.5 trillion, while the 4.7 million S corporations employed 34.6 million workers with an annual payroll of $1.5 trillion.

This suggests that S corporations have had a significant impact on exaggerating the increase in corporate profits' share of National Income over this period. Obviously, I am implying that S corporation dividends are more like labor compensation than profits. Excluding these dividends from profits shows that this adjusted measure's share of National Income has been significantly lower than the all-inclusive measure of profits. The flip side of this story is that labor's share of National Income is higher if we treat dividends paid by S corporations as labor income.

On our nation of proprietors

S corporations are one of three main types of pass-through businesses. The other two are sole proprietorships and partnerships. Nevertheless, just the sum of S corporations and sole proprietorships increased 59% from 20.3 million in 1999 to 32.2 million in 2018. These figures strongly suggest that the US continues to evolve into a nation of more and more entrepreneurial proprietors.

The remarkable proliferation of pass-through businesses in the United States suggests that the distinction between employers and employees isn't as rigid as it has been in the past. Clearly, more and more Americans are running their own businesses, providing employment for themselves and for others. They have a lot of skin in the game. If their businesses fail, they also lose their jobs along with their employees. They are likely to know their employees personally and have lots of incentive to keep them happy. In turn, most of their employees are likely to want to do whatever they can to make the business successful, knowing that it is small and more exposed to competitive pressures than are most large corporations.

On capital spending and cash flow

My conclusion is that profits and proprietors' income are the key drivers of the economy. On a pre-tax basis, they reached a record high of $4.1 trillion during the first quarter of 2021. There is no evidence to support the progressives' claim that the managements of C corporations haven't spent enough on fixed investment. All the measures of capital spending rose to record highs in early 2021.

On the true story about stock buybacks

Buybacks are not solely used "to return cash to shareholders," as commonly believed. While dividends are paid directly to shareholders, buybacks don't directly benefit investors if they simply result in equities being purchased in the open market to offset stocks distributed to employees.

Buybacks shouldn't be compared to profits. The cost of buying back shares for the purpose of offsetting the obligations of employee stock grants is reflected for repurchasers in the compensation-related expense in calculating profits.

On the myth of the productivity-pay gap

It has been widely asserted by progressive politicians (and the liberal economists they rely on) that a gap between productivity and real hourly compensation has been widening since the mid- 1970s. This myth has been promoted by the Economic Policy Institute (EPI) in Washington, DC for a long time.

The productivity-pay gap is a myth based on RHC [real hourly compensation] data derived using the CPI. The gap narrows significantly using the personal consumption expenditures deflator (PCE deflator), which is widely recognized as a more accurate measure of consumer prices. The gap almost disappears using the nonfarm business price deflator (NFB deflator), which is also reported in the BLS's *Productivity and Costs* release.

On the wage stagnation myth

The data clearly belie the productivity-pay gap claim often made by progressives. Also not supported by the data is their related claim that workers' pay has stagnated for decades. Nevertheless, wage stagnation remains a widely believed myth among progressives and others. The BEA series for personal income, disposable personal income, and personal consumption expenditures—on a per-household basis and adjusted for inflation using the PCE deflator rather than the CPI—all strongly refute the stagnation claims of pessimists and progressives.

On productivity, technology, and inflation

The productivity boom I am anticipating in coming years should be driven by demographic factors that are depressing the growth in the labor force. The response is likely to be a revolution of technological innovations that will augment both the physical and mental productivity of the labor force.

I conclude that profit-led prosperity shouldn't be inflationary since it is likely to boost productivity growth. Progressives need to be aware that prosperity resulting from their well-intentioned stimulative fiscal and monetary policies can be inflationary. Inflation is the same as a very regressive tax that hurts low-income households much more than high-income households.

On a stark choice

Take your pick: Do you prefer a capitalist economic system that provides plenty of upward income mobility along with lots of opportunities and incentives for entrepreneurial capitalists to increase everyone's standards of living but results in more income and wealth inequality? Or do you prefer a more collectivist economic system, such as socialism, that provides a more equitable distribution of income and wealth as a result of more downward economic mobility and with fewer opportunities and incentives for entrepreneurs to improve consumers' standards of living?

It is the profit motive that drives entrepreneurs to innovate. Tthe profit motive drives entrepreneurs to search for new products and services that would benefit the most consumers. In other words, successful entrepreneurial capitalists are first and foremost thinking about their customers, not about themselves. It is the popularity and rapid proliferation of "new, new things" sold by innovators that contribute to widespread increases in standards of living and general prosperity. Entrepreneurs are always worrying that their competitors will put them out of business by offering consumers newer, better, and cheaper products. In this sense, entrepreneurs are driven by insecurity, not by selfishness.

Crony capitalists, on the other hand, are selfish. They tend to collude with their competitors on ways to share their market among themselves while erecting barriers to entry to keep new competitors out of their business. They also spend lots of time figuring out ways to please and work with government officials and regulators rather than consumers. They especially love and promote government regulations that keep competitors out of their market.

On what progressives get wrong about income inequality

Furthermore, the progressive analysis of income distribution over time fails to consider that widespread upward income and wealth mobility may be distorting their simplistic analysis. They are comparing two static pictures of income distribution at two distinct points in time and failing to see the dynamic action in the film rolling in between their two freeze frames. Along the way, while some of the rich get richer, some of them get poorer. Similarly, some of the poor get poorer, while some of them get richer. On balance, the data strongly suggest that income mobility is to the upside.

Progressives look at the same data as I do and see inequality and an increasingly unfair economic system. I look at the data and see rising prosperity that is mostly fairly distributed *over time* through upward income mobility.

On the taxing fairness question

What should be the fair share for the One Percent? Instead of about 40% of the federal government's tax revenue, should the One Percent be kicking in 50%? Why not 75%? These taxpayers would be less well off, but everyone else would be better off—unless paying more in taxes saps the incentive for entrepreneurs to keep creating new businesses, jobs, and wealth.

On the bottom line of wealth inequality

The bottom line is that wealth inequality has worsened slightly during this period. That's because the major source of wealth inequality is ownership of equity in publicly traded and closely held corporations. Wealth inequality, like income inequality, tends to worsen during periods of prosperity, because strong profits growth increases the market value of corporate equities.

There's risk in constraining the ability of the wealthy to seize opportunities since that would affect the economic wellbeing of us all. The wealthy tend to diversify their stock market windfalls, benefitting diverse industries. They invest in private equity deals, and they fund startups; the easy availability of capital provides up-and-coming entrepreneurs with the financing they need to fund their ventures, helping them to give it a go.

On the demography of economic inequality

Most of the Forbes 400 tend to be older Americans. Income and wealth inequality may be less about rich versus poor than old versus young. As *Star Trek's* Mr. Spock once said: "Live long and prosper."

On stakeholders versus shareholders

As I observed in the Introduction, progressives have been pushing corporate managements and boards of directors to respond to the demands of their stakeholders, not just their shareholders. Stakeholders are much needier than shareholders. Meeting stakeholders' long list of needs requires corporations to be managed for the benefit of a multitude of special-interest groups that hold no interest in the company's profitability, being neither investors, customers, employees, nor suppliers! Meeting the needs of shareholders simply means growing profits by satisfying customers and attracting more of them.

The central premise of many progressives' stance is that corporations are getting away with something. Those that are primarily managed for profit growth instead of according to progressive principles of social wellbeing must be exploiting someone, the thinking goes. Or at least they must be taking unfair advantage of the economic system. Their profits must come at the expense of someone, whether underpaid workers, overcharged customers, or polluted local communities or society at large. Furthermore, progressives charge that companies don't pay taxes commensurate with their use of public infrastructure.

On the Business Roundtable's redefinition of a corporation's purpose

Almost in passing, the statement endorsed "the free-market system" as "the best means of generating good jobs, a strong and sustainable economy, innovation, a healthy environment and economic opportunity for all." The statement then defined "the purpose of a corporation" as fulfilling several commitments to six stakeholders, including customers ("meeting or exceeding customer expectations"), employees ("compensating them fairly" and "supporting them" to "develop new skills" and fostering "diversity and inclusion"), suppliers ("serving as good partners" so they can "help meet our mission"), and communities (protecting the environment "by embracing sustainable practices").

Remarkably, last, and by implication least, is the corporation's commitment to its owners, the shareholders. The word "profit" isn't mentioned once. The only commitment to shareholders is "transparency and effective engagement."

On the "Friedman Doctrine"

It's up to Congress to enact laws that require corporations to behave in ways that benefit society. It's up to corporate executives to maximize profits within the context and spirit of the laws of the land. Social responsibilities should be determined by the political process, not by corporate managers, who "can do good—but only at their own expense."

On Larry Fink and corporate governance

Tariq Fancy left BlackRock in 2019. In January 2020, the firm's chief executive officer, Larry Fink, said BlackRock put sustainability at the center of its investments by voting against corporate directors who fail to create plans to transition to a low-carbon economy as required by Fink & Co. In a March 16, 2021 *USA Today* op-ed, Fancy wrote, "In truth, sustainable investing boils down to little more than marketing hype, PR spin and disingenuous promises from the investment community." He charged that ESG is an investment fad marketed by promoters "all in the name of profits." He should know.

BlackRock's management has adopted a very progressive agenda for their company. That's fine. However, what gives BlackRock's management the right to impose their views on other company managements? Oh yes, the firm is a major shareholder of those companies. But in reality, the shareholders are individual and institutional investors who invest in BlackRock's funds. Does BlackRock's management really represent them?

Progressives are always championing antitrust laws to break up big business enterprises on the grounds that they have too much market power and reduce competition. It's time to consider whether the concentration of power over corporate governance matters by a handful of passive management firms meets the criteria for antitrust enforcement action.

On BlackRock and excessive CEO compensation

Meanwhile, perhaps BlackRock can use its power to rein in CEO compensation. The firm can set a good example on corporate governance by starting with its own executives.

On the Fed's role in worsening economic inequality

The Federal Reserve, it turns out, has played a very important role in boosting CEO compensation and exacerbating income and wealth inequality.

The consequence of the Fed's ultra-easy monetary policies in response to the pandemic was to send the stock market to record highs. The historically low interest rates resulting from the Fed's progressive monetary policies forced investors to overweight equities relative to bonds, thus pushing stock prices higher.

That certainly bolstered the incomes of lots of CEOs with pay packages heavily skewed toward stock compensation. Perhaps they are business geniuses and deserve every penny that they are paid. Then again, as Humphrey B. Neill, the father of contrarian investing, famously observed: "Don't confuse brains with a bull market!"

Meanwhile, lots of households that depend on fixed-income returns saw their incomes dive. Wealth inequality was exacerbated too by soaring equity values, though home prices also soared. The widespread appreciation of many asset prices raised concerns that the "bubble in everything" would eventually burst. I have to conclude that the Fed's progressive-leaning policies aimed at maximizing employment have contributed greatly to income and wealth inequality.

On the academic racket

I also agree with progressives on the importance of education in reducing income inequality and in enhancing upward income mobility. However, as progressives have gained more power to set the agenda for our institutions of higher education, the cost of education has risen prohibitively. The CPI for college tuition and fees has increased a staggering 1,435% from January 1978 through July 2021, more than four times faster than the overall CPI's 334% increase.

The academic market needs more competition. Colleges have been getting fat on the higher tuitions they can charge because of the availability of student loans. Ending federal student loan programs might force colleges to be run more like lean, profit-driven businesses and to do a better job for their customers.

Education as an employee benefit has been around for a while; some companies long have paid for business-school programs to help their white-collar workers advance. What's different now is that companies are extending this benefit to more of their employees and promoting it more than ever before. Employer-sponsored education is a win-win concept for all concerned. So is profit-driven prosperity.

On stocks as a birthright

Finally, I have a simple idea for increasing Americans' appreciation of the importance of corporate profits. The federal government likes to give money away. Why not establish an automatic $1,000 savings account for all babies born in 2022 and beyond? That would cost a bit less than $4 billion per year if live births rebound back to the pre-pandemic annual pace of about 3.7 million. The funds would be invested in an S&P 500 exchange-traded fund. Dividends would be automatically reinvested. Beneficiaries would be allowed to have access to the proceeds on a tax-free basis once they turn 65 years old.

Since the end of 1935, the S&P 500 total return index has been rising around 10% per year. Applying this growth rate to a single $1,000 investment starting next year and compounded annually would provide each beneficiary in 2087 with $600,000 in current dollars. That would teach Americans born from 2022 onward the power of profits and compounding dividends on a tax-free basis. Capitalism's fans would grow along with their "Birth Right Portfolios."

On conserving progress

I am an entrepreneurial capitalist. I am also a conservative who champions progress. Let's conserve the system of entrepreneurial capitalism that provides all Americans with the best opportunity to continue to progress.