Economic systems are differentiated according to how the dominant class within that economic system gets control of the surplus. In capitalism, the dominant class—the employers—gets control of the surplus because they own the capital goods necessary for production. The legal system that develops within capitalism gives to the owners of a firm the right to the surplus the firm generates.

Privately-owned business firms are the most important actors in a capitalist economy. Business firms are (1) the site of production, (2) a key site of the generation and capture of the surplus, (3) and the decision-maker about what to do with the surplus. The main goal of firms in capitalism is simple: to make surplus for their owners. In capitalism, the generation of a surplus is the beginning and end of production. Indeed, in capitalism business firms exist only to generate surplus.

**THE SURPLUS IN CAPITALISM**

In all economies the surplus is what is left over after all inputs used in production have been replaced or compensated.

In capitalism, a firm uses various inputs (people, materials, machines, tools,) to produce output. All this output belongs to the firm because the laws in capitalism specify that the firm has a legal right to all that is produced by the firm. The firm then sells the output for a sum of money.

From this revenue, the firm must pay for all the costs it has incurred in production. Again, they are legally obligated to pay these costs. The surplus is what is left over after the firm pays for all the inputs it uses.

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1 To economists, “firm” is merely a shorthand expression for a “business,” a “business firm,” a “company,” a “corporation,” or a “partnership.”
The surplus generated by capitalist firms within the US economy is about $1,450,000,000,000 per year.² This is a vast sum.

**PROFIT**

In capitalism the surplus is labeled as “profit.” More concretely,

\[
\text{Profit} = \text{Revenue} - \text{Cost}
\]

Revenue is what the firm has earned in income. In most cases, this income comes from selling the goods and/or services that the firm sells to customers. A bookstore earns income from selling books to customers; a steel firm earns income from selling steel to its customers. Many firms, of course, earn income from selling many different, perhaps unrelated, products. A single capitalist firm might sell toothpaste, soap, canned soup, cereal, and on and on. In addition, a firm might earn income from financial investments such as stocks and bonds.

The costs for a business are many. In capitalism these costs represent what must be subtracted to replace used up inputs, used up machines and equipment, and what goes to the direct producers (the employees). The largest single cost for many businesses is what the business pays to its employees. “Labor costs” (the costs associated with employees) includes the total value of the wages, salaries, commissions, and benefits a business pays its employees. Labor costs also include other items such as state unemployment insurance and workers’ compensation insurance.

Other costs for a business include the materials it uses to make their product. For instance, a steel firm buys coal, iron, scrap metal, various chemicals, and electricity to produce steel.

An additional cost for a business is for the “physical capital” they use. Physical capital refers to the machines, buildings, and tools a business uses to produce their product. A steel factory uses, for instance, huge containers for holding molten steel, machines that turn molten steel into sheets of steel, and so on. Many businesses also have substantial costs for interest payments on money (“money capital”) they have borrowed in the past, sometimes to pay for the physical capital they use in production.

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² This estimate is derived from National Income and Product Accounts, Table 1.14. It includes an estimate of the profit portion of proprietors’ income with inventory valuation and capital consumption adjustments, corporate profits income with inventory valuation and capital consumption adjustments, and net interest.
Taking into account all the above details would lead to a very messy and complex analysis of business behavior. The approach I will take, therefore, is to simplify as much as possible without eliminating the key issues involved in business decision-making.

The formula above, Profit = Revenue – Cost, can refer to a complete capitalist economy, such as the United States. In this case Revenue equals all revenue earned by all capitalist firms while Cost equals the costs for all these businesses. Profit, then, will be profit for the complete capitalist system.

Alternatively, the formula above, Profit = Revenue – Cost, can refer to a single capitalist business, such as General Motors or a local copy center. In this case, Revenue, Cost, and Profit refers to the revenue, cost, and profit for the single business.

I will focus here on a single firm. I will assume that a business sells a single product and sells all units of this product at one price. In this case,

\[
\text{Revenue} = \text{Price} \times \text{Quantity}.
\]

Or, replacing “Price” by the letter P and “Quantity” by the letter Q,

\[
\text{Revenue} = P \times Q = PQ.
\]

Finally, I can express profits thusly:

\[
\text{Profits} = \text{Revenue} – \text{Costs} = PQ – C
\]

where C replaces “costs” in the equation.

This last equation above just restates—using shorthand—how I started this section: profits equals to what is left over from income (PQ) after all costs (C) are paid.

**THE GOAL OF CAPITALIST FIRMS**

The primary goal of a business firm in capitalism is to earn profits for the owners of the firm. Indeed, the only reason that a business is formed is to earn profits for its owners.

Who are these owners? Many different type of ownership arrangements exist in modern capitalism. The simplest type of ownership of a firm is the “sole proprietor.” This is a single individual who owns the business completely by
her/himself. Alternatively, a group of owners can jointly own a firm if a “partnership” exists involving two or more owners. Finally, the shareholders own a business that has been incorporated. In a corporation, stock is issued to the owners of the firm and if you own a share of stock, you are a part owner of the firm.

How much profit do the owners of a business want? One simple answer is close to the right answer: owners want the most profit they can earn.

This does not mean, however, that in any given year a business seeks the highest profits it can earn in that particular year. Often the goal for the firm is to earn the most profit it can over a long period. For instance, a business might accept lower profits today by selling its product at a low price in order to expand its market share. (I discuss later the relationship between price and market share later). Such a firm might hope that by grabbing a large market share today—and so sacrificing profits today—it might earn big profits in the future and over the lifetime of the firm.

Why do capitalist businesses seek maximum profits? The answer is complicated. On the one hand, the owners of the firm prefer more profit to less profit. That’s simple.

On the other hand, systematic forces within capitalism force firms (and their owners) to seek maximum profits. High profit is often necessary for survival in capitalism. For instance, if the corporation TechnoTools (or, TTools) disappoints its shareholders by earning less profit then other firms, the shareholders might sell their shares of TechnoTools. Share prices for TTools will fall as a result. When TTools wants to expand, perhaps by selling more shares of stock, it will find that it is not able to raise as much money as they might need because of the low stock price. TTools might, therefore, be at a competitive disadvantage compared to other firms with higher stock prices.

Alternatively, if TTools earns lower profits than a competitor (say, Hammers&Things, or H&T), then they might be at a competitive disadvantage. With greater profits, H&T might be able to invest in new and better machinery and, so, be able to make better tools than TTools. TTools might, therefore, find it loses out in competition as their rivals benefit from, say, the lower costs associated with the new machines.

For firms in a capitalist economy, high profits are necessity. The desire for money—perhaps even greed—might be one reason a firm seeks high profits. But greed alone does not explain why firms seek high profits; survival in a competitive capitalist economy requires that firm earn high profits.
How can TechnoTools increase its profits? The profit equation above is:

$$\text{Profits} = PQ - \text{Costs}.$$ 

TechnoTools can increase its profits by increasing $P$, by increasing $Q$, and/or by reducing Costs. Because of competition, TechnoTools will be forced to look for ways to increase $P$, increase $Q$, and/or reduce costs.

**THE LOGIC BEHIND OBSERVED BUSINESS BEHAVIOR**

A look at the business section of a general newspaper or, say, the *Wall Street Journal* reveals a business world of constant change with little apparent logic to it.

The businesses you read about in the paper are often very different from one another: some are big while others are little, some sell primarily goods while others sell primarily services, some are domestic firms while others are foreign firms. And, these firms are engaged in an astounding array of different activities: introducing new products, defending themselves from lawsuits, entering into mergers, expanding into new countries, hiring new management, downsizing their labor forces, and so on.

It is hard to see any pattern in the messy world of business—so many firms doing so many apparently unrelated things on a daily basis.

Nevertheless, behind the apparent helter-skelter of the actions of millions of businesses is a simple logic: businesses want to increase or maintain their profits. As noted above, firms can increase their profits by:

- Increasing revenues (by increasing $P$ and/or $Q$) and/or
- Reducing costs

Indeed, most business activities and decisions can be simply categorized one or both of:

- The business did it to increase revenue ($PQ$) or
- The business did it to reduce costs.

Looked at this way, the daily actions of businesses are really quite simple. Virtually all business activities are attempts to increase revenue or to reduce costs.

This simple insight helps tame—at least in the reader’s mind—the apparent helter-skelter world portrayed in the business section of the newspaper. On the one hand, the business world is a complex entity with many stories; on the
other hand, only a few simple plots exist for most of these stories: the firm did it to boost sales or prices or to reduce costs.

**IS PROFIT-SEEKING GOOD?**

Thoughtful people have long thought that a good person is one who acts in moral or ethical ways. In turn, the presumption has been that the best society is one in which everyone is a good person. Good people, most would accept, often put aside their own best interests in order to act in ways that benefits society as a whole. Selfishness is generally considered poor behavior.

The above should cause us to pause when we consider a capitalist economy. In capitalism business firms seek to earn the most profit they can. They do not concern themselves with the fate of other firms (or other people) and they do not concern themselves with the public interest. They simply are “looking after Number One” in the crudest way possible: they seek to earn the most money possible no matter what the cost to others or to society.

Rarely has anyone argued that profit-seeking—and more generally greedy behavior—is a “good” motivation for any action. Yet capitalism is dominated by entities—business firms—which are dedicated to the pursuit of earning profit.

**FROM "IMMORAL" TO "TOLERATED BUT NOT PRAISED"**

In ancient Athens merchants, money-lenders, and bankers did brisk business. Yet Athens society as a whole saw the people who engaged in such activities as outsiders and as not being worthy of citizenship because they were engaged in morally suspect activities. According to Plato, “The more men value money-making, the less they value virtue.” Aristotle likewise believed that commerce was a moral hazard to those engaged in such activities and threatened the health of the community.

Early Christian writers agreed with this point of view. In Matthew readers are warned that “You cannot serve God and mammon.” In Mark a striking image is offered: “It is easier for a camel to go through the eye of a needle than for a rich man to enter the kingdom of God.”

As commerce expanded in the Middle Ages in Europe, Christian thinkers such as Thomas Aquinas moderated this perspective. They argued that business activity was not truly sinful and actually served some benefit for society. Yet pure profit making—such as in money-lending for a profit—was still considered immoral. The person who desired to live a Christian life was advised to distain
commerce. Although most commercial activities were not seen as outright sinful, they were of doubtful moral status.

Today few people would claim that the profit-motive is outright immoral. But few would claim that the desire to make money is—in the abstract—a laudable motivation for any behavior. The modern consensus is that the profit motive is, at best, minimally acceptable. It is not worthy of praise and it is not “good”; it is merely tolerated.

WE HAVE A PROBLEM
Capitalism is dominated by entities that, at best, are amoral. Some might claim that business firms’ single-minded focus on earning profits does cross the line into “bad” behavior. After all these entities reject what most people consider as virtues: concern for others, concern for society, generosity, self-sacrifice for the benefit of society.

One might be tempted to reject capitalism based solely on the contemptible motivation of its central actor, business firms.

BENEFICIAL CONSEQUENCES?
In the early 1700s Bernard Mandeville offered a striking hypothesis: the true causes of social welfare, social progress, economic progress, and social stability are not the result of human virtues. Rather, they are the result of human vices. According to Mandeville, self-interest and hypocrisy pushes people to act polite to each other, cowardice leads people to obey the law, and greed drives people to work hard and produce much.

ASSESSING CAPITALISM
This hypothesis was soon picked up by supporters of capitalism. They granted that the profit-motive is morally suspect—perhaps even immoral—but argued that the morality of profit-seeking is not relevant to the judgment of capitalism. Following Mandeville, supporters of capitalism claimed that well-meaning individuals did not lay the foundation for economic bounty. Rather, profit-seeking (perhaps immoral) firms were responsible for the increasing economic bounty in parts of Europe observed in the 1700s. These supporters of capitalism claimed that although business firms’ motivations are not good, these firms collectively lead to good results for society.

More precisely, supporters of capitalism claimed that the profit-motive leads to unintended consequences that can potentially benefit society. The most
important unintended consequence is that consumers get what they want and they get these goods/services at the lowest price possible.

This claim about capitalism—and the profit-motive central to it—cannot be accepted or rejected out of hand. It might be true; it might not be true. The strength and weakness of this claim will be highlighted in many of the chapters that follow in this book and we must wait until later to fully evaluate this claim.

One of the many interesting aspects of this claim is how recently it was made. As capitalism is a relatively new economic system (less than 300 years old) so too is the claim that we should ignore motivations and, instead, look at consequences when we assess whether something is “good.”

CAVEATS

The hypothesis that consumers are benefited by the (amoral?) pursuit of profit by business firms comes along with numerous caveats and restrictions. I discuss two of them here.

Adam Smith, writing in the late 1700s, argued that a high level of competition was needed to force profit-seeking firms to act in the interest of consumers and society. Absent high competition, profit-seeking firms would be able to find a way to benefit themselves without benefiting consumers or society.

Smith’s perspective can be summarized as:

\[ \text{Profit-seeking Firms} + \text{High Competition} \Rightarrow \text{Good Results for Society} \]

but

\[ \text{Profit-seeking Firms} + \text{Low Competition} \Rightarrow \text{Poor Results for Society} \]

Smith provides a second caveat. Smith argued that profit-seeking behavior should be—and was—moderated by more noble sentiments if we wanted good outcomes from the economy. In Smith’s view, businesses shouldn’t cross certain lines when they attempted to earn profits. Business should seek profit, but they should also respond to notions of justice, fairness, and concern for others. They should also be, of course, law abiding. Smith believed that a single-minded pursuit of profit, at the expense of everything else, would represent a descent into barbarianism.