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PROFITABILITY AND RESPONSIBILITY:  
PUBLIC AND PRIVATE

Remarks of

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## PROFITABILITY AND RESPONSIBILITY: PUBLIC AND PRIVATE

I am most pleased to be here tonight since it gives me an opportunity not only to tell you of my high regard for Morris Miller--who represents this District on the Federal Advisory Council, the Federal Reserve's highest ranking advisory body--but also to discuss with you an issue that concerns us all--bankers, businessmen, the media, and the public. That issue is summarized in the question we hear from the whole spectrum of public opinion, from those who hurl it as a hostile challenge to continued freedom of enterprise, to the many in business and public life who are searching sincerely and with a sense of urgency for answers: What is the social responsibility of business and how should it be met? Can business, as many believe, best fulfill its social responsibility by concentrating solely on decisions aimed at maximum profits?

Satisfactory answers to these questions are essential, I believe, if free enterprise and the democratic way of life are to continue in being, here or elsewhere. Consequently, tonight, I want to concern myself first with some of the technical considerations that shape the problem and that cannot be ignored in the solution, and then take a brief look at some more general aspects.

Before that, however, I would like to emphasize my conviction that an important part of the answers to the problem of how profit-seeking free enterprise and social responsibility are to be mingled will emerge from the work of organizations promoting cooperation, such as the National Conference of Christians and Jews with its brotherhood ideal and from those who, like Morris Miller, put such ideals to work in their private and business lives.

The aims of the National Conference of Christians and Jews are for all times, but especially for times such as ours filled with many troubles and many possibilities. For they concern the improvement of human relations, the perpetuation of moral values shared by great religions, the pitting of information against untruth, and the search for islands of agreement as points of reference in navigating through seas of differences. They help keep us aware that we are a nation founded on law, and that exploitation through intolerance of the few by the many can but set the stage for the exploitation of the many by a few.

These are basics in the American dream of creating a better society. As we converted one of the world's last remaining wildernesses to a new nation, we could scarcely fail to include the creation of affluence out of our early poverty as one of the essentials of the better society. A life poor in material terms has a very hard time being rich in other ways. But the opposite is also true. We have been warned by one of our leading thinkers about the affluent society that there is danger in being a better provided people without being a better people. The concept of brotherhood has important work to do in preparing us for a future in which we shall deserve to be better off by being better.

### The Problem

The problem of the social responsibilities of business arises because we are no longer satisfied with the idea that business can fulfill its role in society simply by producing more goods and jobs in the most efficient manner.

It is true that a major function of business must be to make proper production choices. This is why some argue so strongly that our total welfare will be lowered if business stoops to consider effects of a decision other than profitability. They believe, with Adam Smith, that an "unseen hand" guides private enterprise to serve the common good when-- and only when--business is conducted on the basis of profit-maximizing decisions in a market context. Such a view, I believe, is far too narrow.

#### Decisions Affect More Than Firm's Profits

In the first place, the narrow view is based on an incorrect generalization of the over-simplified model derived from Smith. All around us we see many cases where the model cannot achieve the best results because it neglects important forces.

Economists, businessmen, and the public are becoming increasingly aware that many activities produce what are called "externalities," by-products whose costs (or benefits) are not fully reflected in the prices of goods and services.

These externalities can be of many types. A clear example occurs when the price of electricity generated by a smokey power plant does not reflect the cost which the polluted atmosphere imposes on the surrounding community. On the opposite side, the community profits from individual plant employment and training programs, creative use of space, and the public benefits which arise from inter-acting industries. We want the golden egg that business hatches for us. But we do not want the goose to foul our nest. In fact, we want it to help clean up dirt from other sources.

As another example, it has long been recognized that the manner in which lenders approach their lending decisions can have major impacts upon their communities. The decisions concerning what products to produce or services to perform, and where to carry out these activities, must always be colored by uncertainty regarding the ultimate profitability of the enterprise. If businessmen and financial institutions are only interested in the quick, sure profit, and disregard opportunities for equally profitable but longer run investments; or if they all play it safe by avoiding loans to small businesses or others which may have more than ordinary individual risks but may be profitable on the average, then there is a distinct danger that the needs of the community will go unmet. The void created by the private sector becomes an open invitation to be filled by government investment which may well be far less efficient.

Banks are in a particularly critical position in decisions of this nature, since in the vast majority of cases they hold the key which can unlock claims on resources for a large number of would-be entrepreneurs. Furthermore, they have by their charters been given important duties and semi-monopoly positions to aid in implementing them. Banks are a prime example of units to which the Government has delegated a critical power (that to increase the supply of money) on the assumption that they can make more efficient decisions to aid the public interest than if the Government attempted to make all lending decisions itself.

Thus, it can be argued that only by fully recognizing their public responsibility rather than adhering to a pure and immediate profit-maximizing rule of behavior will they properly perform their part of the function of the "unseen hand."

Business Leadership to Improve the Quality of Living

More important than the technical problem, however, the simple profit-maximizing role appears wrong to me because it neglects the major part which business can and must play in helping to solve our non-economic problems.

We are all aware of how complex our world is becoming. We are often told that it is later than we think. But we look around us and see the sun shining, our farms reaching ever higher levels of productivity, our forests green, and our rivers and lakes unchanged at least to the unaided eye--if not to the unaided nose. Let me repeat a little story that illustrates how illusory all this can be.

Imagine that our growing wealth and urbanization create an environment in our Great Lakes that enables amoeba to reproduce--that is, double their numbers--each 20 minutes. It has been estimated that at this rate the Great Lakes would be filled solid in 500 years. But note:

- It is also estimated that 24 hours before the Lakes solidified, you could dip from them a glass of water clear enough to appear to be free of contamination, and
- Only 20 minutes before the Lakes filled solid, they would be only half filled.

That is, we would move 499 years, 11 months, and 29 days along a disaster curve with hardly any outward notice. With the dawning of the next day, disaster would have struck. Many, perhaps most, of our environmental problems grow at a compound interest rate, and the question is: Where do we stand on the compound growth curve to disaster? The experts tell us we are alarmingly high on the curve. It is not important that they may not be

precisely right. The point is that they are not likely to be altogether--probably not even grossly--wrong.

We can take it, then, that the problem of saving ourselves from our own ingenuity in the destruction of resources is a real one; that it must be faced currently and overcome in the reasonably near future if we are to survive; and, that the only choices we have are choices as to how we deal with the problem. How we deal with the problem is a matter of first importance, involving what kind of people, and what kind of society, we shall be in the future.

A policy of business as usual up to the swift onset of disaster is clearly just as self-defeating for business as it is for all of us. The corollary to that is a decision by business to make use of its managerial and production skills to help avoid disaster--even at the expense of long-held notions as to what is profitable and what is not, and what is the proper separation of public and private functions.

We would be ignoring a great part of the driving force in our system if we assumed that business bears no direct responsibility for the solution to social problems and that business decisions can neglect their social impact simply because adding the social variables may appear to reduce short-run profitability or lead to investments that involve higher than usual risks, or involve considerations that are social and political more than economic.

The demands on all of us are increasing. We need the skills which business can bring to these tasks. This problem was well stated last week in a study on this question by the Committee for Economic Development.<sup>1/</sup>

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<sup>1/</sup> Social Responsibilities of Business Corporations, CED, New York, June 1971.

"Two-thirds [of the public] believe business now has a moral obligation to help other major institutions to achieve social progress, even at the expense of profitability . . . .

"Today it is clear that the terms of the contract between society and business are, in fact, changing in substantial and important ways . . . . Business enterprises, in effect, are being asked to contribute more to the quality of American life than just supplying quantities of goods and services. Inasmuch as business exists to serve society, its future will depend on the quality of management's response to the changing expectations of the public."

I have cited these conclusions not because they are new or remarkable in themselves, but because they are a statement of a group of the leaders of American business and finance. I think it can be concluded that any notion that business can be run in America on a pure marketplace decision-making basis--if that was ever the case--is now beyond the pale of possibilities.

However, we still have the problem of what kind of solution is preferable. To my mind, this is basically a question of what kind of solution is most compatible with continued operation of a system of allocation and use of our resources within the context of what we call free enterprise, because I know of no other system that allocates and uses resources more effectively.

#### Parameters of Responsibility

Let me become slightly more concrete by citing two examples from the past which I believe illustrate how we have all suffered as a result of lack of business leadership.

First, I want to examine the economically and socially vital job of restoring our inner cities to conditions that are livable for people and viable for business.

Although this example applies to lenders, I believe it throws some generally applicable light on the general problem of the assumption by business of non-economic responsibilities. Also, I think an example involving bank lending policy is appropriate because, as I have noted, banks have the power--which they exercise from governmentally sheltered enclaves--to make credit available, or to withhold it, and to establish norms for judging what are, and what are not, acceptable credit risks. I think that in making lending decisions banks may frequently give too much weight to short-term profitability calculations, and too little to long-term calculations. As a result, banks may allocate their resources so as to endanger their own long-term profitability, and also to reduce far below optimum the use of their communities' human and economic resources.

I do not suggest, and I have not seen it suggested, that business should singlehandedly take on the great social problems that concern us all and that are shaping our future. For one thing, business has no such mandate. The only mandate that exists is that given by the electorate to our elected governments--local, State, and Federal. But business lives and breathes in society, does its business both with and for society, and cannot, in the long run, be healthier than society. So I think that good profitability analysis must lead to the conclusion that business should be directly involved in such problems as the improvement of our inner cities.

We do not have the statistical breakdowns yet from the 1970 Census, but it is obvious that many of our worst ghettos lie in our inner cities. The inner city problem is consequently a problem of financing improvements where, to a substantial degree, blacks are in the majority or

nearly so. Financing inner city improvement is thus both a social and an economic problem.

Where black ownership is involved, or where chiefly black patronage is the determining market factor, it is more difficult for a loan officer--or a bank's loan committee--to determine the degree of risk, and the return to be expected, because the norms in use are generally rules of thumb applying to white ownership and predominately white spending. Thus, in terms of assuring short-run profitability, it may appear easier for a bank simply to ignore decaying areas of a city, where these are ghettos, for lack of information, if for no other reason.

This type of analysis plus oversimplified sociological theorizing led to the concept that it would be most profitable for lenders to concentrate their loans in new homogenous suburbs while red-lining major sectors of the inner city.

Many bankers must now be reconsidering the profitability of such action. It has helped create major social and economic problems of crime, decay, and segregation. Our major cities are tottering on the brink of breakdown and bankruptcy. I think there is a valid question whether a better considered lending policy would have been a sounder policy, not only for our cities, but for banks and banking as an institution.

I urge you here in Omaha--and bankers elsewhere--to give much more serious attention to your long-run profitability in connection with investment in the inner city. The financing for investment to improve living conditions and to provide increasing employment in viable businesses in the inner cities is the type of financing that would normally come from banks.

In assisting such investments, banks would normally establish the type of long-term business relationships as well as strength for the city that underpin profitability for decades ahead. In ignoring such investments, banks may insure short-run profitability at the costly premium of foregone long-run profitability.

Secondly, let me return again to the problem of pollution. It is a problem that I, as a Californian, feel especially keenly. In 30 years, I have witnessed what was a virtual paradise being converted in many places into something Dante might have considered for one of his levels of Hell had he been able to think of such conditions on earth. Mountains that once stood clear in bright air, lifting our thoughts and spirits, are today so hidden by smog that a child may grow up almost at their feet with only occasional glimpses of them. That same smog of industrial-age emissions into the atmosphere has in recent years become so extensive that it has now invaded wildernesses high in the mountains and is killing forests.

There is no need to go on with the by now well-worn list of degradations of the environment that are robbing us not only of economic resources, but, perhaps far more fundamentally important, of the many higher qualities of life available only from nature. And California is only one poignant case that I am sure natives of many other places could duplicate. The point is that for all of us--with rapidly fewer exceptions--there has been a severe decline in the quality of the environment that involves a sharp drop in the quality of our lives.

The causes of pollution are of course complex. But at bottom one finds the processes of production of goods and services attempting to

fulfill the needs and desires of a growing population. This, in itself, is an immensely complex fact, and the results are not simple. But we can ask: although we are worse off than might have been foreseen 30 years ago, are we worse off than we should have been able to foresee 20 years ago, or, to be as generous as possible, 10 years ago? And for most of this period, when we have been in retreat in what we now know is a battle for survival, where was the leadership we should have expected from the business community? In the most part, it was absent. It seemed simpler, when the subject was raised of damage to the environment by industrial processes and products--such as the gasoline fueled automobile--to point elsewhere, and hope to be left alone.

Now, with the processes of environmental decay pressing upon us, it becomes harder day by day to argue that a firm's responsibilities end with making a good product and a good profit. The know-how possessed by industry is needed not only to solve industry's pollution problems, but also to help solve the problem in its general aspects. To go back to what I said earlier, those who impose negative externalities on the public must recognize the impact of their actions, and assist in establishing joint standards suitable for the future. If this is not done, if the solving of our public problems becomes a battle rather than a cooperative effort, we shall all suffer.

### Conclusion

The lesson to be drawn from these examples, I think, is that myopic attention to short-run maximization of profits may lead to serious misallocation of resources. If banks do not lengthen their investment

focus, they stand to lose as businesses and institutionally. This is true for business as a whole, and across the spectrum of our social problems. Within the large-scale social problem, often lurks an economic cancer. It is true that business has no mandate to attempt to solve these problems on its own. But business has the mandate of very much broadened expectations of what business can do to help--talk to your children if you do not believe me.

I, for one, do not think the prized ingenuity of the American entrepreneur has so degenerated that solutions preserving adequate business incentives cannot be found. This may involve acceptance of taxation, and changes in costing and pricing that will affect business deeply. It may involve a closer partnership between business and government than has ever been the case in our land.

But I think businessmen, and particularly bankers, must be expected to pay more attention to their function of shaping a more desirable industrial environment and community in the future. The idea that bankers and businessmen perform this proper function by seeking maximum profits in their firm is not a correct or sufficient rule to follow.

I believe that it is critical for business to take the lead in searching for the answer to what its social responsibilities may be, because if business does not do so, the risk arises of unacceptable answers being thrust upon the business community. And, quite beyond this, lies the more pervasive fact that viable businesses cannot be operated in a society that is not viable, or one that is hostile to private enterprise as an institution.

It was a great feat for the classical economists to show that freeing individual initiative, with each seeking to maximize profits, would increase the general well being. I do not think our present experience overthrows this finding. Our specific task now is to identify those additional goals of the entrepreneur in the free enterprise society that will properly enable him to meet the broadening of our social expectations of a higher quality of life while properly accounting for all the costs of his operations, including the cost to society.

This will involve what could be termed a heightened sense of brotherhood between business and the society business serves. In terms of classical economic analysis it involves something else of great interest and hopefulness. If we approach the problem of the social responsibilities of business on a cooperative plane, with a sense of shared responsibilities, I believe we shall find that the gain of all will become as well the gain of each. That is to say, I am certain that, if we try, we shall see that Adam Smith's "unseen hand" is capable of moving not only to the general good from individual benefits, but also from the general good to individual benefits.