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Free Enterprise: Profits as potential measure of failure

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The golden days are back, or so it seems. What not so long ago was a list of shame may once again become a roll of fame.

Goldman Sachs, JP Morgan, Bank of America, Citibank - all posted higher than expected quarterly profits this week, some even defying analysts' predictions that they would lose money.

Obviously, not all is gold that glitters. Some of the profits are the direct result of selling off valuable assets, a strategy that will diminish future earning power.

Also, a closer look reveals that spectacular successes in several areas conceal continuing losses in other business segments.

Furthermore, it is not easy to discern - money being fungible - to what extent the government's (very) generous decision to honor AIG's outstanding contracts with those financial institutions enabled these results.

The most interesting question, however, is a different one: Do billion-dollar profits in the financial services industry actually, as expected in a free-enterprise system, measure success or do they in fact highlight failure?

Profit opportunities are the driving force of free markets. Moreover, in competitive markets factors of production are supposed to earn their marginal revenue product or, in plain English, what they are worth to the firm.

In the case of Goldman Sachs, news reports have put that average at around $400,000 per employee. Naturally, if financial firms are increasing the efficiency of the economy by enabling investors and savers to interact effectively, there is no reason for howls of outrage regarding such remuneration.

However, the intuitive unease with which many have greeted this earnings bomb-shell may have a basis in fact.

Almost everybody in the U.S. and many more abroad have been impacted by the economic downturn that was caused by "systemic failures" in the financial markets.

This means many financial institutions had followed a "damn the consequences" approach. Almost all of them had found it impossible to forgo opportunities that were, at some point at least, clearly headed toward calamity.

In that sense, profits were not a true measure of the cost and benefits of their business models. In economics, that is called an externality - a scenario in which one's actions impact the livelihood of others, but one does not have to pay for those externally imposed costs.

Smart institutional constraints or outright government regulation are often introduced as a remedy.

It is now apparent that the billion-dollar business model of securitization and credit-default swaps had imposed negative externalities on other participants in the economy. When the bill came due, taxpayers were on the hook for protecting "too big to fail" firms, which led some to coin the bitter phrase of "Heads, they win; tails, we lose."

Consequently, it is important for proponents of free enterprise to also emphasize the responsibilities that come with the privilege to operate in a free (market) society.

Profits are only a measure of success if they reflect the true costs imposed and benefits created. If they do not, then profits could very well represent a measure of failure to protect the very system of free enterprise.

Seen in that light, proposals to better link (enormous) rewards to the long-term risk of certain investments by, perhaps, postponing the actual payday have great merit.

Otherwise, today's golden days for some may just signal once more tomorrow's doomsdays for many.

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