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Desert, Entrepreneurship, and Crony Capitalism

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Abstract
I argue that in free markets, profits gained and losses suffered by entrepreneurs are, in general, deserved, but that the degree of profits gained and losses suffered is not proportional to the degree to which entrepreneurs deserve them. This discrepancy appears to create a problem with arguing that entrepreneurial profits and losses are deserved in a free market; nevertheless, a free-market economy is superior to one of its main relevant alternatives: crony capitalism. The connection between desert and profits is closer in free markets than in crony capitalism, and free markets make it easier for outsiders to become entrepreneurs and thus become deserving.

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I. Introduction

I provide three main arguments in this paper. First, in a free-market system, profits gained and losses suffered by entrepreneurs are, *in general*, deserved. However, second, the degree of profits gained and losses suffered is not in proportion to the degree to which entrepreneurs deserve them. This discrepancy appears to create a problem with arguing that entrepreneurial profits and losses are deserved in a free market. Third, a free-market economy is nevertheless superior to one of its main relevant alternatives: crony capitalism.

Crony capitalism is a system wherein many entrepreneurs make profits to the extent that they receive protection and privilege from a system that favors politically well-connected firms and makes it

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difficult for outsiders to become entrepreneurs and compete with insiders. Free markets exist to the extent that these privileges are generally absent and to the extent that entrepreneurs generally compete with one another to satisfy consumer needs and wants. It is this satisfaction, I argue, that is the basis for deserved profits. The superiority of free markets to crony capitalism resides in the connection between desert and profits, which is closer in free markets than in crony capitalism, and in how free markets make it easier for outsiders to become entrepreneurs and thus become deserving of profits. My arguments build upon N. Scott Arnold's important article, "Why Profits Are Deserved" (1987).

II. Arnold's Argument

Arnold's paper is about the moral status of entrepreneurial profits and losses, so I begin by explaining what these are, by way of contrast with the income of capitalists. Entrepreneurship essentially involves organizing production: "deciding what to produce, when to produce it, and how much to produce at what price" (Arnold 1987, p. 388). Entrepreneurial profit occurs by discovering ways to rearrange the structure of production so that it more successfully meets consumers' previously unrecognized wants and needs; it is most visible in great innovators who envision new products and services and bring together the needed factors of production.[1] A capitalist's income, on the other hand, is a return on investment in capital goods. While entrepreneurs are often capitalists, they need not be. Their functional roles are different. Even if a market system could exist without a capitalist class,[2] entrepreneurs would still exist since markets change continuously, creating an ongoing need to uncover opportunities for reorganizing production in more profitable ways.

Entrepreneurship is central to markets, but why are entrepreneurial profits and losses deserved in a free market? The place of desert in a theory of justice is controversial, but it is plausible that if I deserve something, there is a morally significant reason why I

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[1] Arnold's analysis of entrepreneurship relies on the work of Israel Kirzner (1973). He also cites Joseph Schumpeter (1976).

[2] Imagine a market system where the only businesses are worker cooperatives—that is, worker-controlled and -owned firms. The workers clearly must act as entrepreneurs. But there may be no capitalist class, no group of persons who obtain their income solely from returns on their investment in capital goods.

should get it.[3] It's a prima facie reason, because there are other elements of justice than desert that could override desert considerations. Desert is typically analyzed as a three-part predicate: A deserves X in virtue of Y. Y is the desert base, or the "basal reason" for desert.[4] X is the object of desert, or what is deserved. Typical basal reasons for desert are conscientious effort, admirable character traits, and achievements.[5]

Desert concerns what is fitting, what is appropriate, what should occur. Desert claims are not claims about rights or entitlements. One reason for this is that entitlement need not be a normative notion, if, for example, the issue is purely a matter of a legal or conventional right. The more important reason is that one can have a right to something one doesn't deserve, and one can deserve something to which one has no right. The fastest runner in a footrace deserves to win, but if she unluckily trips and comes in second, she isn't entitled to win, and an official who rules otherwise is robbing a slower runner who crossed the finish line first of a victory to which the slower runner was entitled. The slower runner didn't deserve to win; he just got lucky. However, though desert and entitlement are different moral notions, I will note shortly that considerations of desert may be used to criticize entitlement rules.

Arnold offers an institutional theory of desert: the basal reasons that ground desert claims are determined by the goal or point of an institution. (By contrast, in a noninstitutional or preinstitutional account of desert, the basal reasons that warrant desert claims stand outside of the institution and can be used to criticize it.[6]) For example, in the World Series, the basal reason—being the best team—warrants a desert claim because the essential goal of the World Series is to discover and recognize the best team in baseball. The institution's goals also determine what is deserved. In a contest, one of the things deserved is victory. Some of the entitlement rules—

[3] This is plausible only if one doesn't want to excise desert from a theory of justice, which seems to occur in Rawls (1971, sections 12, 17). Rawls's argument has been subject to a variety of criticisms, the most compelling of which I find to be in Schmidtz (2006, pp. 34–39).

[4] The phrase comes from Feinberg (1999, p. 72). As I shall discuss later, some philosophers think we should add a fourth predicate: A deserves X in virtue of Y from B.

[5] Built into these basal reasons is a claim that the deserving person was responsible, at least to some extent, for what she deserved—that her achievement, effort, or character traits were not matters of pure luck. I will return to the issue of luck later.

[6] I shall return to preinstitutional concerns in subsequent sections.

Arnold calls them achievement rules—specify what is needed to claim victory relative to the institution's essential goal. As already noted, entitlement rules can't guarantee that the entitled person deserves the achievement, given the role of luck. However, the rules are designed to bring desert and entitlement together.[7] If the point of a contest is to determine who has the greatest skill, the achievement rules are designed to reveal that. More importantly, the entitlement rules can be criticized as defective (and can be changed) if the rules do not have a significant relationship with desert.

The same kind of criticism can be made with other things deserved, such as entitlement rules setting out rewards and punishments. If part of the goal of an institution is to positively or negatively recognize certain characteristics, the reward rules are defective and should be changed if they conflict with that goal.

Rewards or punishments can be out of sync with desert if they fail what Arnold calls "the proportionality principle," that there should be a fit between the basal reasons and the things deserved. Consider grading, whose purpose is to reflect students' mastery of knowledge and skills. If a student who demonstrates excellent mastery of the subject gets a *C* and a student who has mediocre mastery gets an *A*, then the proportionality principle is violated and these students are not getting what they deserve.

Now we can explain Arnold's argument that entrepreneurial profits are deserved. The market's essential goal is to meet and anticipate consumer needs and wants, and in a free market,[8] entrepreneurs make profits to the extent that consumers reward their innovations and their discovery of new ways to satisfy previously unmet needs. Arnold argues that to the extent that the market's institutional entitlement rules prevent or interfere with entrepreneurs making profits or suffering losses,[9] the feedback loop between anticipating and meeting consumers' needs and wants and

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[7] Except, of course, in games of pure chance.

[8] Arnold does not explicitly say a *free* market, but I think it is clear from the context that this is what he has in mind. See also note 9.

[9] I say "to the extent" because I think this language better fits the intent of Arnold's argument. Arnold (1987) says that the market's goal would not be served if entrepreneurs were not allowed to keep profits or suffer losses (see pp. 394, 397–98). But he also says that an implication of his argument is that capital gains taxes are prima facie immoral (p. 399), and, of course, such taxes can exist without being confiscatory. I think the best way to accommodate all these remarks is to say that to the extent that entrepreneurs are interfered with in making profits or are not allowed to suffer losses, these interferences are incompatible with the market's goal.

entrepreneurial success or failure is significantly weakened.[10] Since entrepreneurs are responsible for changes in the production process, the connection between that process and meeting consumer needs and wants—which is markets' essential goal—would be far more adventitious. He also argues that his account is in accordance with the proportionality principle, since the larger the profits, the more resources were misallocated, and the more entrepreneurs were alert to and discovered this misallocation.

III. Criticisms and Some Alternative Accounts

Arnold's argument has three apparent problems. First, markets as such do not have goals, so they don't have essential goals. However, we can reinterpret Arnold's point about essential goals in terms of functions of markets and basic reasons to value or endorse them. If we value or endorse markets because they meet consumer needs and wants, then entrepreneurs, who are key to anticipating and meeting those needs and wants, deserve recognition for doing so. Allowing entrepreneurs to profit from discovering and correcting misallocations of productive resources is the best way, the most fitting way, to accord that recognition because it gives responsibility for the results to those who reorganize production.

Second, Olsaretti (2004, pp. 19–21) would argue that even with my revision, Arnold's account is mistaken because institutional accounts of desert give us no reason to believe that what is deserved institutionally is thereby just. That markets are valuable because they serve consumer well-being, and that entrepreneurs who play the key role in bringing this value about (or frustrating it) deserve profits (or losses) isn't a sufficient link with justice. For that, we need some prior argument about the justice of the market, or at least some claim that our valuing or endorsing markets because they serve consumer well-being is an issue of justice.

Olsaretti is correct in the sense that there are evil or morally unimportant institutions where the move from "*X* is deserved" to "*X*

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[10] In addition, winning big profits provides a signal for competitors to follow or emulate those that obtained the big profits—or suffer consequences. In a free market, entrepreneurial profits tend to be competed away; in that sense, entrepreneurial profits are temporary. But to the extent that entrepreneurs are blocked from or interfered with in their pursuit of profits, it's not clear how well this signaling function would operate or how likely it would be that competitors would need to adopt the changes in production or innovations that serve consumer well-being. (Again, as in footnote 9, I have altered Arnold's language so that the problem is one of degree.)

is prima facie just" is false or at least suspect. But if the basic reasons we have to value or endorse markets are that they serve consumer well-being, and if it is fitting that those who exercise entrepreneurial creativity and satisfy consumer needs deserve profits, then it's hard to see why this fittingness would have nothing to do with justice. It seems to be a bedrock principle of justice that a failure to reward those who perform such a valuable service for so large a group of people shows disrespect for those persons.[11]

A third problem that is not so easily addressed is that Arnold's account of desert doesn't satisfy the proportionality principle. The basal reason that entrepreneurs deserve profits is because they are alert to or discover resource misallocation, and in this way anticipate or meet consumers' needs or wants. But the degree of profits made doesn't correspond with the degree of alertness or the extent to which one *discovered* these misallocations because of the role of luck. That entrepreneurs in general are alert to or discover misallocations of productive resources doesn't show that those who are *more* alert make greater profits than those who are less alert. Arnold mistakenly inferred from the general connection between the amount of profits and previously misallocated resources that the same general connection holds between the praiseworthy feature of entrepreneurship and the amount of profits.

Perhaps one could reply that even if Arnold made a mistaken inference here, still it is reasonable that the relationship does hold, because entrepreneurs are continually testing their ideas in the market. It is therefore unlikely that those who generally excel in this test and make larger profits than competitors are doing so to a significant extent by luck.[12] But even if that analysis is correct, there is a deeper problem. While one can measure the degree of profits, it is unclear that entrepreneurship is measurable in the same way.

Consider two scenarios. Entrepreneur A stumbles on a good idea about how to rearrange productive resources and immediately acts on that discovery, making a substantial profit. Entrepreneur B is alert to profit-generating ideas about rearranging productive resources;

[11] If this reply is not satisfying, note that I argue in section 3 that Arnold's approach can be applied to the preinstitutional question of which system gives more opportunities to become deserving. This argument would presumably satisfy Olsaretti, who thinks desert, to be linked with justice, must be a preinstitutional notion. See also note 20.

[12] If this occurred occasionally or erratically, we would have greater confidence that the greater profit was due to luck.

however, she hesitates to act on these ideas, but eventually does act and generates a substantial profit. Even if A makes more profit than B or vice versa, it's unclear whether more alertness was involved in A's or B's activities, unless one defines the degree of alertness as simply being the amount of profit made, which is implausible. But what Arnold needed, to apply the proportionality principle, is to link the degree of profits with the *degree* to which one was alert to and discovered misallocations, and these examples suggest that this endeavor is misguided. Both entrepreneurs were alert to and discovered misallocations, but we can't fix a sense in which one entrepreneur displayed this alertness more than another.

A way to fix the problem with Arnold's argument occurs in Narveson's (1995) argument for the deservedness of profits. Whereas Arnold says entrepreneurs deserve profits because they serve consumer well-being by being alert to or discovering misallocations of resources, Narveson says one deserves profits because one creates value for consumers. A virtue of Narveson's account is that there is an obvious relationship between the degree of one's profits and the value created for consumers.[13]

Narveson's account depends on a revision in the analysis of desert. Instead of analyzing desert as a three-place predicate—*A* deserves *X* in virtue of *Y*—Narveson says desert is a four-place predicate: *A* deserves *X* from person *B* in virtue of *Y*.[14] For Narveson, the interests of the rewarder, not the rewardee, are central: "We only go up blind alleys if we myopically fix our gaze only on desert factors in abstract from what cause them *to be* desert factors, namely the interests of agents—in this case, ultimately the consumers—who hold the purse strings, the loosening of which is the source of the relevant rewards in this area. What is done that deserves reward is the marshaling of resources in the direction that elicits the purchasing response from consumers. No further justification of grounds of high moral character, or whatever, are required here" (1995, pp. 84–85). Narveson makes clear that the "whatever" can be anything that meets the rewarders' criteria, so long as it is not pure luck—for then we would not have anything that would be recognizable as a case of desert.

[13] Narveson's account isn't limited to the profits of entrepreneurs, but to anyone who provides value to consumers. That is not a matter I will pursue here, though.

[14] Strictly speaking, Narveson doesn't say desert is a four-place predicate. But it seems natural to describe it that way, given the revision Narveson makes.

This is a neat account. If we value markets because they serve consumer well-being, then shouldn't the consumers' criteria for rewarding those who benefit them be all that matters? If the consumers don't care about the causal story that explains why they benefit, isn't that the end of the matter?

However, Narveson's account is *too* neat. He asks us to focus on the rewarders' criteria and to virtually ignore the significance of the rewardees' characteristics. But his analysis blunts the moral significance of desert claims. Desert claims are significant because if A deserves X (from B), then there is a prima facie reason why A ought to get X (from B). But this reason is quite weak if the basis for why A deserves X is of little moral significance. By asking us to ignore the causal story of how entrepreneurs come to produce value for consumers, Narveson's account makes us wonder why we should *care* that entrepreneurs deserve their profits. I suspect the force of Narveson's account derives from an awareness that the process by which entrepreneurs create value for consumers *is* of moral significance—it is no easy task to have your ideas about how to reorganize production constantly tested in competitive markets that are always changing. But if that's right, then the idea that entrepreneurs deserve profits because entrepreneurs create value has force because we understand that the process by which that value is created is morally significant.

So we have a problem if we want desert-based justification of entrepreneurial profits to be morally significant and to satisfy the proportionality principle. That the justification should be morally significant is easy to see, but what is the importance of the proportionality principle? To answer that question, recall our earlier discussion about the relationship between entitlement and desert. If the relationship between A having a right to X and A deserving X is too distant, then we have grounds for revising the entitlement rules so they are more congruent with what people deserve. If the extent to which entrepreneurs make profits is not tracking their alertness to misallocated resources, then a desert-based defense of these profits appears to be defective,[15] and a natural suggestion is to revise the entitlement rules that allow them to make profits and suffer losses so that entitlement and desert are more in sync. So, for example, rather than Arnold's argument showing that capital gains taxes are prima

[15] In the next section, I argue that this appearance is mistaken when one considers the relevant institutional alternatives.

facie immoral, as he suggested (1987, p. 399), his argument might open the door to supporting such taxes so that entrepreneurs' profits do not exceed the extent to which they are deserved.[16]

Before concluding this section, it is worth examining another desert-based defense of profits, that of Kershar (2005). Kershar argues that profits are deserved because they track the productive contributions to the general welfare that result from correcting misallocated resources. To some extent, this argument is like Arnold's argument regarding the entrepreneur's role,[17] but for Kershar, it is good that people get what they deserve, not a matter of justice that they do so. Kershar's argument is that entrepreneurs' innovations, by lowering costs, increase aggregate preference satisfaction by enabling consumers to buy the same or better goods for less money. Furthermore, aggregate preference satisfaction tracks improvement in the general welfare, since people generally prefer things that increase their welfare.

At first glance, this approach meets the two conditions we have been looking for: it explains why we would care about desert, since productive contribution to the general welfare seems significant, and it seems to meet the proportionality principle. Unfortunately, Kershar disconnects desert-based arguments from considerations of justice; he would need to provide a strong argument for this disconnection, which he does not. He says that (a) the distinction between desert and entitlement (or desert and rights) is a reason to maintain that desert has nothing to with justice or what is owed to others and only concerns what is good, and (b) making desert part of the good explains why we think the world is a better place when people get what they deserve. Regarding (a), since considerations of desert can be used to criticize entitlements and vice versa, it is unclear why desert should not be considered part of justice. As for (b), talking about the world being a better place doesn't commit one to only focusing on the good; it can be a better place because one requirement of justice is satisfied.[18]

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[16] Or perhaps it would open the door to subsidizing firms whose profits (or losses) do not adequately reflect their desert.

[17] Kershar's argument is about capitalists, not entrepreneurs per se, but that is not relevant for my discussion here.

[18] It would be an interesting project to make entrepreneurs' productive contributions to the general welfare a matter of justice and see how this view of the entrepreneurial role would differ from my reconstruction of Arnold, but I will not pursue that matter here.

So at this point, we appear not to have a satisfactory desert-based defense of entrepreneurial profits. Arnold's argument fails to satisfy the proportionality principle, Narveson's argument doesn't show us why we should care about desert, and Kershar's argument disconnects entrepreneurial contribution from justice. The problems with Narveson's and Kershar's arguments are more serious, since a desert-based argument for entrepreneurial profits must explain why we should care about desert and that caring must have something to do with justice. But what should we do about the problem with Arnold's argument?

IV. Solving the Problem: Comparing Free Markets with Crony Capitalism

We can gain traction on the question of a satisfactory desert-based defense of entrepreneurial profits by reflecting on an interesting quote by Arnold that, from the point of view of institutional desert, "a particular market system can be justly criticized only if those who are responsible for changing the structure of production to capture profits are systematically prevented from getting those profits (or suffering those losses, as the case may be)" (1987, p. 401).[19] However, it's also relevant whether the rules of a market system allow people sufficient opportunity to become entrepreneurs in the first place. If successful entrepreneurs deserve their profits in a free market, then blocking them from becoming entrepreneurs is blocking them from a significant way to become deserving—and that interest is preinstitutional. As Miller (2002) observes, most people "want to use the resources they have actively, to get ahead on their own steam" (p. 286). Schmidtz (2006) adds that "people don't want just to be given stuff; they want to be successful and they want their success to be deserved" (p. 56). If a market's entitlement rules should not block successful entrepreneurs from obtaining profits, then we also have grounds for revising those rules if they do not afford a fair chance to become deserving through entrepreneurship.[20]

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[19] For reasons that I will discuss shortly, Arnold is wrong that this is the *only* way a market system can be justly criticized from the point of view of institutional desert, since markets can be cronyist, where the issue need not be that those in charge of production decisions are prevented or significantly interfered with in their ability to make profits, but that their profits are not serving consumer well-being.

[20] I argued in section 2 that market entitlement rules that fail to give successful entrepreneurs what they deserve manifests disrespect for persons. Preinstitutionally, the unfairness in blocking opportunities to become an

We can now use Arnold's essay to compare free-market capitalism with crony capitalism. As noted earlier, under crony capitalism, it is difficult for outsiders to become entrepreneurs and compete with protected firms; many firms make profits to the extent that their production decisions are driven by protection and privileges that they or others have sought from a political system. This kind of protection and privilege can take many forms, such as bailouts, subsidies, differential tax treatment, regulations, and licensing rules that significantly raise the cost of entering a certain profession. We move away from crony capitalism and get closer to free-market capitalism to the extent that these privileges are absent and most entrepreneurs compete with one another to serve consumer well-being. Note also that there can be cronyist sectors or industries within a generally free(ish) market system, and relatively free-market sectors or industries within a cronyist system.

What does Arnold's argument about institutional desert imply about the entrepreneurial profits of crony capitalist firms? The general answer is straightforward: they are not deserved because they are more driven by the incentives of the political process than by anticipating or meeting consumer demand or by creating value for consumers.[21] (Applying that answer to particular cases may be tricky, as there will be cases where it is unclear to what extent a firm or sector is profitable because it is responsive to consumer demand and to what extent it is profitable because of cronyist restrictions.[22]) In a deeper, preinstitutional sense, his analysis also implies that these firms don't deserve their profits because the rules that enable them to profit have unduly blocked others from becoming entrepreneurs. Not only don't they deserve their profits, but if we want desert and entitlement to be aligned, justice weighs in on the side of getting rid

entrepreneur and to become deserving also seems to manifest disrespect. Here we see another way to connect institutional and preinstitutional questions about desert.

[21] The point here is not just about active lobbying for restrictions on outsiders. Lobbying for the restrictions makes a cronyist firm or industry more culpable for the harm it causes to outsiders, but lobbying doesn't change the evaluation that neither crony capitalist responders nor lobbyers deserve their profits.

[22] An example might be some green-energy firms that have received subsidies. There is clearly a market demand for green energy, but it's unclear at what point the subsidies get sizeable enough to say that a firm would not have survived without them.

of cronyist restrictions.[23] Even though in free-market capitalism the extent of firms' profits does not track desert, the system overall tracks desert by creating value in a morally significant way, and it does not throw out the raft of subsidies, licensing requirements, favoritism, bailouts, regulations, and so on that prevent outsiders from being entrepreneurs.

Notice, also, that attempts by the state to engage in redistribution to help profits track desert more closely are likely to produce crony capitalism or something like it. That is because the state's power to redistribute is the power to pick winners and losers in the market, and that power is likely to be captured by or organized by those who are well-versed in using the political process to limit competition or challenges to their politically derived market positions.[24]

For political philosophers and economists, the question is not whether free-market capitalism has flaws, but how it compares to the relevant alternatives. On the institutional question of whether entrepreneurs deserve their profits, and the preinstitutional question of whether the system allows people a fair chance to become deserving, free-market capitalism is superior to crony capitalism.

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[23] Note, also, that crony capitalist restrictions are particularly harmful to the vulnerable or worst off who wish to become entrepreneurs, so prioritarian considerations point in the same direction.

[24] This point is well traversed in public choice economics. See, for example, Randy Simmons, *Beyond Politics: The Roots of Government Failure* (Oakland, CA: Independent Institute, 2011).