

# Entrepreneurial luck and the problem of just and efficient reward<sup>1</sup>

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In this paper, I apply the concepts of moral and epistemic luck to entrepreneurship. I analyze the luck egalitarian response to entrepreneurial luck and elaborate a Hayekian consequentialist libertarian critique of such responses.

In ethics, the ‘*moral luck*’ question is about whether we should morally praise or blame somebody for something which is just a matter of good or bad luck (Nagel 1979). Something is a matter of luck for somebody when he or she has not freely and autonomously chosen it. In epistemology, moral luck has been compared with the issue of ‘*epistemic luck*’, where a belief, its truth or its justification is just a matter of luck, which urges the question whether this belief really is ‘knowledge’ (Pritchard 2004). Likewise, since risk and genuine uncertainty are at the heart of entrepreneurship, entrepreneurial ‘knowledge’ seems to be tainted with a kind of epistemic luck I will call ‘*entrepreneurial*’ or ‘*economic luck*’.

So-called ‘*luck egalitarians*’ have argued that, when a rise or decline in welfare is due to luck rather than free, autonomous choice, we are not responsible for it and we cannot be said to deserve it: justice demands that inequalities due to luck are neutralized (Arneson 2004). Accordingly, some have defended monetary reward and ‘punishment’ according to freely chosen *effort*, regardless of the accidental results of this effort.

Hayek (1944; 1960; 1976) has spent a lot of time criticizing such views, which nevertheless seem to reemerge time and again. Freedom, according to Hayek, means freedom from coercion by others, and responsibility refers to the convention that the individual should reap the benefits and bear the costs of the *results* of his or her own behavior. Freedom from coercion and responsibility for result give us the ability and the incentives to use our own knowledge to pursue good results. By contrast, reward according to effort creates perverse incentives: it will incite much effort with little result. When the market rewards according to the value of the result of action, it promotes much result for little effort. Hayek’s focus on the good consequences of freedom and responsibility make him a *consequentialist libertarian*.

Perhaps the luck egalitarian might defend that the state should reward only *useful* effort, maybe even conceding that we should reward not only physical but also mental effort, if useful. However, the state faces a knowledge problem in the sense that it does not *know* which effort is useful – focusing on knowledge problems makes Hayek’s economics typically *Austrian*. What people in fact prefer and how we can effectively and

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economically satisfy these preferences can only be discovered through entrepreneurial trial and error and communicated through prices.

Moreover, the entrepreneur has an incentive problem in the sense that he has no incentive to show his personal knowledge when this contrasts with the state's official knowledge on what effort is useful: even if his effort based on unofficial knowledge has great results, the state will consider this to be a matter of epistemic luck and leave it unrewarded. All of this would render the use and communication of personal entrepreneurial knowledge and the growth of common knowledge impossible. Furthermore, epistemic luck is not accidental but really essential to the entrepreneurial discovery procedure. Entrepreneurship and innovation are all about discovering *new* ways of making old products, *new* products to satisfy old preferences or even about discovering entirely *new* possible preferences opening up new markets. In as far as something really new is discovered and real progress is made, this must go beyond what is already foreseen and beyond what the state can control.

Finally, I will show that luck egalitarianism cannot be saved by saying that entrepreneurial trial and error behavior is useful *on average*, so that the effort must be rewarded while spreading the profits and the losses. I will show that in addition to some new incentive problems, the same incentive and knowledge problems as the ones discussed occur, but on another level.

## I. The Austrian concept of entrepreneurship

Austrian economists have studied the central role of entrepreneurs in the acquisition, aggregation, communication and use of knowledge in society. Kirzner (1973: 35) chooses to label “that element of alertness to possibly newly worthwhile goals and to possibly newly available resources – which ... is absent from the notion of economizing but very much present in that of human action – the *entrepreneurial* element in human decision-making. It is this entrepreneurial element that is responsible for our understanding of human action as active, creative, and human rather than as passive, automatic, and mechanical”. Kirzner distinguishes the ‘Misesian entrepreneur’ from the ‘Robbinsian economizer’. Entrepreneurship is not mere calculating, maximizing or economizing within a framework of given means and ends, allocating scarce means in the pursuit of multiple ends but rather ‘alertness’ to new potential goals and means.

I would like to interpret alertness in the widest sense possible, so as to include not only alertness for local differences in prices or qualities of a certain type of good, but also for potential utilization of resources and potential consumer wants. You can look for local differences in prices of a certain type of good in the real world and make some profit out of this, or you could look into your mind whether there are potential opportunities for profit. An entrepreneur can perceive a certain willingness to pay for a certain good, but he might also *conceive of* such willingness. Both perception and conception can be very profitable. In this sense, there is alertness in the real world but also in the fantasy world of the mind.

Entrepreneurship is in general being alert to ‘buy-low-sell-high opportunities’: the entrepreneur spots opportunities to buy some things (or some services) at a relatively low price, to do something with them (or combine them in a certain way), and to sell this at a relatively high price. ‘To do something with them’ can vary from doing nothing, or transporting, to completely transforming them into something unrecognizable.

Entrepreneurship presupposes imperfect knowledge of the other market agents (Kirzner 1973: 37-38). The entrepreneur tries to outsmart other people: suppliers who sell too cheaply, consumers who buy too expensively, and entrepreneurs who have missed the profit opportunity. In this sense, the entrepreneur goes beyond common market knowledge, beyond accepted means-ends frameworks. According to Mises (1996: 293), “an entrepreneur can make a profit only if he anticipates future conditions more correctly than other entrepreneurs”.

It is debatable whether the knowledge of the entrepreneur him- or herself must also necessarily be imperfect or fallible. According to Mises (1996: 290; 293), uncertainty is at the heart of entrepreneurship. However, Kirzner (1973: 86) is somewhat reluctant to stress the speculation and gamble aspect of entrepreneurship. An alert entrepreneur might notice such clear and simple facts as certain products being sold at very different prices in certain places with transportation costs being relatively low. Profit here would be as certain as it gets.<sup>2</sup>

However, even in the case where entrepreneurs spot real world divergence of prices, there is *antecedent* uncertainty. Entrepreneurs possess two types of knowledge, and uncertainty can vary over these types. Kirzner distinguishes between “the substantive knowledge of market data” and “the *‘knowledge’ of where to find market data*” (Kirzner 1973: 67), which is a kind of procedural knowledge. While the substantive knowledge of market data, of willingness to pay, of willingness to receive in payment, of technological possibilities, of organizational possibilities, etc. can approximate certainty, I would like to stress that the entrepreneurial procedural ‘knowledge’ of how to increase one’s substantial knowledge is always fallible. Entrepreneurs can never be sure to find profit opportunities where they look for them. Some entrepreneurs stumble upon a gold mine, while others find nothing but misery. If profit were guaranteed, entrepreneurs would compete for it until the profit would be eroded away. Moreover, entrepreneurs can outsmart others in the ways to find interesting market data. In conclusion, very often the new enterprise will be a gamble in itself, but the activity of looking for potentially profitable market data is always a gamble. Luck seems to be a necessary part of entrepreneurial activities.<sup>3</sup>

## II. Moral, epistemic and entrepreneurial luck

People do not like luck: they hate bad luck when it happens to them and even good luck when it happens only to others. Philosophers, since ages on the lookout for unshakable certainty, have joined the people in these intuitions. In ethics, the *‘moral luck’* debate is about the possibility of situations where we morally praise or blame somebody for something which is just a matter of good or bad luck (cf. Williams 1981; Nagel 1979). Williams believed that there could indeed exist such a phenomenon of ‘moral luck’, while others have been quite skeptical. Something is a matter of luck for somebody when

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<sup>2</sup> Note that real world alertness results in entrepreneurial knowledge that is much more secure than the knowledge resulting from mental world alertness.

<sup>3</sup> Entrepreneurship has more characteristics that have caused some concerns: entrepreneurship is an *intellectual* (epistemic), non-physical endeavor, totally aimed at gaining *profits*, which it does by *exploiting ignorance*, and very much dependent on *luck*. I will concentrate on the issue of luck, but indirectly, all these despised features will be discussed.

it is not the intended result of his or her free, autonomous and rational choice, which is the case when he or she has not or could not have foreseen or controlled it.

The moral luck literature distinguishes three types of moral luck: resultant, circumstantial and constitutional luck, which might be contrasted with resultant, circumstantial and constitutional *choice*. First, the specific result of action might be not intended but caused by interfering external factors beyond one's foresight or control. An example of bad resultant luck is shooting an arrow at an innocent inanimate target when the wind redirects it towards a friend.

Second, very unlikely circumstances can push you to act in a certain way. For example, being born in a ghetto where gang membership is quasi-universal might be bad circumstantial luck. In contrast with resultant luck, the result is intended in the case of circumstantial luck, but the fact that the result is intended is in some sense due to accidental circumstances.

Third, actions can be determined by your physical or psychological constitution. Having had a good moral education might be an example of good constitutional luck. The problem with constitutional luck seems to be that it is inescapable. This is not to deny that sometimes elements of our physical or psychological constitution might be the result of freely and autonomously chosen effort, for instance when we choose to go to a sport club or to school. However, even this preliminary choice seems to be based on some personal characteristics, and while these characteristics might also have been deliberately cultivated, the chain must stop somewhere. Hence, we are stuck with constitutional luck.

In epistemology, moral luck has been compared with the issue of '*epistemic luck*', where a belief, its truth or its justification is just a matter of luck, which urges the question whether this belief really is 'knowledge' (cf. Gettier 1963). In general, one can distinguish between physical luck and epistemic luck. While having a good body can be constitutional physical luck might, having a good brain might be constitutional epistemic luck. However, this distinction only partially overlaps with the distinction between moral and epistemic luck. Moral luck is concerned with the moral justification of *acts*, while epistemic luck is concerned with the epistemological justification of *beliefs*. But since believing is also an act, and acts are always based on certain beliefs, both issues intertwine.

Just like moral luck, epistemic luck seems to be inescapable. First, if one accepts that all knowledge is fallible, as Popperian fallibilists have convincingly argued, then the fact that a belief, no matter how justified it is, is indeed true is to a certain extent a matter of circumstantial epistemic luck. Indeed, there are always possible circumstances imaginable in which your maximally justified beliefs are in fact false; conjecturing such circumstances has been the hobby of generations of sceptics.

Second, if progress in knowledge cannot be planned or foreseen, it is a matter of luck too. The problem of scientific progress<sup>4</sup> has been nicely described by Donald Campbell (1987: 57), the psychologist from whom Karl Popper borrowed the term 'evolutionary

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<sup>4</sup> This is related to Meno's paradox and the problem of induction (Nickles 2003). In Plato's *Meno*, learning or discovering something new is said to suffer from a dilemma: either we do not know what we are looking for and we will have a problem ever recognizing it when we find it, or we do know what we are looking for but then we already know it and should not be looking for it. The problem of induction, which originated from Hume's (2005) *Treatise*, refers to the problem of inferring from a limited number of experiences a universal statement about certain phenomena. Both Meno's paradox and the problem of induction seem to imply that we do not have intelligent means to go beyond the known.

epistemology': "In going beyond what is already known, one cannot go but blindly. If one can go wisely, this indicates already achieved wisdom of some general sort." When we go beyond the boundaries of the known and yet succeed, we are just lucky with our methods. In this sense, we might call it 'methodological luck'. A method is just (procedural) knowledge on how to acquire (substantive) knowledge. Beliefs on how to acquire knowledge are only justified if we know that certain steps result in certain knowledge; but then we already possess this substantial knowledge. You just cannot know how to build a car before you know about cars.

Both substantive and procedural entrepreneurial 'knowledge', or should we say 'gambles', seem to be tainted with epistemic luck. I distinguish between resultant, circumstantial and constitutional entrepreneurial luck. First, an entrepreneur that starts producing Twin Towers salt cellars and pepper mills has bad *resultant luck* when airplanes unexpectedly crash into the Twin Towers. Second, when an alert entrepreneur stumbles upon an unnoticed but extremely great local divergence in price of certain goods while hundreds of thousands of others have missed this opportunity because they were simply not there on the right spot, he has good *circumstantial luck*. Among alert entrepreneurs, some find interesting exploitable market data, others do not. Sometimes the difference might be attributed to differential alertness, but sometimes not. Moreover, among seemingly worthwhile entrepreneurial endeavors, some turn out to be a success, others do not; some entrepreneurial expectations turn out right, others turn out completely wrong. Again, sometimes the difference might be attributed to differential intellectual merit – some ideas are just stupid – but sometimes this is not the case. Finally, the entrepreneur has good *constitutional luck* when he happens to have excellent entrepreneurial skills due to social, cultural or biological factors.

All these types of entrepreneurial luck are common in the market, and they are responsible for a great amount of the differences in income. Moreover, as my discussion of epistemic luck has suggested, entrepreneurial luck is ineradicable. In going beyond what other entrepreneurs already know, the entrepreneur cannot go but blindly. Entrepreneurial gambles are therefore highly fallible. Even when gambling is minimized, entrepreneurial expectations are about the future, and the future is always uncertain. When entrepreneurial expectations turn out to be right, when his or her subjective beliefs turn out to be objectively true, there is always an element of luck. Risk and genuine, 'Knightian' uncertainty are at the heart of entrepreneurship. Both substantive knowledge of economic means and ends and procedural knowledge of how to acquire such substantive knowledge are fallible. For example, if you know where to look for divergent prices, you already know what you are looking for. It would be silly to say that you should look for divergent prices at certain locations  $l$  and  $m$ , because at  $l$  the price is lower than at  $m$ . Alertness is necessary but not enough for success. You need a portion of luck. And this portion of luck can yield a great portion of money.

### **III. Luck egalitarianism**

Political philosophers have discussed how society, or the state, should react to inequalities that are due to good or bad luck. So-called '*luck egalitarians*' have argued that, when a rise or decline in welfare is due to luck rather than free, autonomous choice, we are not responsible for it and we cannot be said to deserve it. Therefore, justice

demands that inequalities due to luck are neutralized (e.g., John Rawls 1999; Ronald Dworkin 1981; Gerald Cohen 1989; John Roemer 1996).

Accordingly, luck egalitarians have suggested pecuniary reward and ‘punishment’ according to freely chosen *effort*, or freely chosen abstinence from effort, regardless of the accidental results of this effort. Rewarding effort is a good way to approach rewarding choice: we can only choose to make an effort; the rest is beyond our control.<sup>5</sup> Whether we have the capabilities to transform effort into results, whether we are in the right circumstances in which effort can be useful or whether external factors rendering effort useless are absent, are conditions which can be beyond our control. The state should thus reward the entrepreneurial effort of starting and running a business, notwithstanding the actual success of the business as this is due to entrepreneurial resultant, circumstantial or constitutional luck.

For a long time, egalitarians have criticized market outcomes for installing unjustifiable inequalities, while libertarians have criticized egalitarianism for dismissing responsibility and efficiency (welfare). Between strict egalitarians and libertarians, luck egalitarians try to reconcile equality with freedom and responsibility, since they accept unequal wealth when this is due to the choice of the individual. Cohen (1989: 933) said that “Dworkin has, in effect, performed for egalitarianism the considerable service of incorporating within it the most powerful idea in the arsenal of the anti-egalitarian right: the idea of choice and responsibility”. I will show that matters are not so simple. I will consider different possible redistribution schemes, embodied in ‘income formulas’. Different formulas will entail different problems, which will necessitate different adaptations of the formula. I start by contrasting the libertarian with the egalitarian formula.

Where  $I_x$  is the income in Euros of individual  $x$ ,  $O_x$  the output in Euros produced by an individual  $x$  of a total of  $n$  individuals, libertarians defend the following formula for individual income calculation:

$$I_x = O_x .$$

Everybody gets what he produces. The old egalitarian formula for individual income was this one:

$$I_x = \frac{\sum_{i=1}^n O_i}{n} .$$

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<sup>5</sup> Notice that there are some clever forms of luck egalitarianism that allow for ‘gambling’. It is argued that when people consciously choose to gamble, the results, whether good or bad, are just. This is called ‘option luck’ in contrast with ‘brute luck’. According to Dworkin (1981: 293) “[o]ption luck is a matter of how deliberate and calculated gambles turn out—whether someone gains or loses through accepting an isolated risk he or she should have anticipated and might have declined. Brute luck is a matter of how risks fall out that are not in that sense calculated gambles”. Still it is arguable whether a loser has really chosen to lose. He chose to take the chance of losing, but did he choose the outcome of losing? My guess is that the more coherent luck egalitarian should say *no*. Actually losing was unforeseeable, in contrast with the possibility of losing.

Everybody gets a fraction of the total output of the society. Luck egalitarians substitute it for a new formula, with  $E_x$  being the effort spent by individual  $x$ , measured in hours of labor<sup>6</sup>:

$$I_x = \frac{E_x}{\sum_{i=1}^n E_i} \cdot \sum_{i=1}^n O_i .$$

#### IV. Hayek on luck, results and merit

Friedrich Hayek (1944; 1960; 1976) has criticized such ‘reward according to effort’ theories of justice for a long time. However, Hayek, who has always stressed the limits to reason, agrees with luck egalitarians that market income is to a great extent due to luck rather than skill and talent, and that skill and talent are often due to luck rather than effort<sup>7</sup>. He is even prepared to consider that our behavior and our talents might be completely determined by the laws of nature, although this is something we could never know for certain. Moreover, he agrees that this means that we cannot be said completely to deserve our market income in a moral way.

Hayek (1960: 94) defines ‘merit’ as “the attributes of conduct that makes it deserving of praise, that is, the moral character of the action and not the value of the achievement”. In footnote, he quotes Hume:

“‘T is evident, that when we praise any actions, we regard only the *motives* that produc’d them, and consider the actions as signs or indications of *certain principles in the mind and temper*. The external performance has no merit. We must look within to find the moral quality. This we cannot do directly; and therefore fix our attention on actions, as on external signs. But these actions are still consider’d as signs; and the ultimate object of our praise and approbation is the motive, that produc’d them” (Hume 2005: 307, emphasis added).

Merit, just like responsibility, is a relational concept of the form ‘ $X$  merits credit for  $Y$ ’, where  $X$  is a motive, internal principle or ‘disposition’ and  $Y$  an action, belief or any result. If good behavior (or behavior resulting in good consequences) springs from a good disposition, we say that it deserves praise. Resultant and circumstantial luck suggest the absence of such a good disposition.

However, even when good behavior is the result of a good disposition, and praise is appropriate, we can still ask whether the good disposition itself deserves praise. This would only be the case when the good disposition is in its turn the result of good behavior

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<sup>6</sup> I measure  $I$  in Euros or some other monetary value,  $E$  in hours of labor and  $O$  again in Euros: all more or less *objective* measures. Ideally, some might argue,  $I$ ,  $E$  as well as  $O$  should be measured in *units of subjective welfare*.  $I_x$  would then be the pleasure that individual  $x$  derives from his income,  $E_x$  would be the pain that labor costs him or her and the aggregate  $O$  would be the sum of the ‘pleasures’ that all the individuals in a society derive from their incomes based upon a distribution of the social output.

<sup>7</sup> “The inborn as well as the acquired gifts of a person clearly have a value to his fellows which does not depend on any credit due to him for possessing them. There is little a man can do to alter the fact that his special talents are very common or exceedingly rare. A good mind or a fine voice, a beautiful face or a skilful hand, a ready wit or an attractive personality are in a large measure as independent of a person's efforts as the opportunities or experiences he has had. In all these instances the value which a person's capacities or services have for us and for which he is recompensed has little relation to anything that we can call moral merit or desert” (Hayek 1976: 94).

resulting from another good disposition. If this is not so, and ultimately it seems to be inescapable that it is not so, we have a case of constitutional luck.

In conclusion, a disposition to act in a certain way in certain circumstances is activated when the relevant circumstances occur, and the intended result is obtained through the act when no external elements interfere. Luck with the disposition is constitutional luck; luck with the circumstances is circumstantial luck; and luck with interfering elements is resultant luck.

However, the omnipresence of luck does not imply, according to Hayek, that people cannot be said to be free and responsible, nor does it imply that we should redistribute to neutralize the effects of luck. Freedom, according to Hayek, is not metaphysical freedom or 'free will', which refers to "the extent to which a person is guided in his actions by his own considered will, by his reason or lasting conviction, rather than by momentary impulse or circumstance" (Hayek 1960: 15). The 'voluntarists' and 'determinists' (Hayek 1960: 73) wrongly use the concept of metaphysical freedom in their arguments about responsibility: voluntarists argue that the fact that we are free makes us responsible, while determinists, or better: 'hard determinists', say that, because we are *not* free, we cannot be held responsible<sup>8</sup>.

However, individual freedom, on which the political doctrine of classical liberalism is based, is freedom from *coercion* by others, so that one is able to use one's own knowledge to pursue one's own plans. Hence, constitutional luck does not necessarily undermine freedom, nor do the other types of luck. Moreover, according to Hayek, metaphysical determinism and individual responsibility are perfectly compatible. Responsibility is not the description of a metaphysical fact, according to Hayek, but refers to the convention that the individual should reap the benefits and bear the costs of the *results* of his or her own behavior, so that one would be incited to use one's own knowledge to pursue good results.<sup>9</sup> Hayek (1960: 75) says that "[w]e assign responsibility to a man, not in order to say that as he was he might have acted differently, but in order to make him different". The legal fiction '*nemo censetur ignorare legem*', 'nobody is supposed not to know the law', generalizes to '*nemo censetur ignorare*', 'nobody is supposed not to know', period.

By contrast, reward according to the merit of the action, i.e. according to effort, creates perverse incentives: it will incite *much effort with little result*. Hayek (1960: 96) contends that "we do not wish people to earn a maximum of merit but to achieve a maximum of usefulness at a minimum of pain and sacrifice and therefore a minimum of merit". If efficiency is to be saved, central control of the economy by the government is

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<sup>8</sup> "Few beliefs have done more to discredit the ideal of freedom than the erroneous one that scientific determinism has destroyed the basis for individual responsibility" (Hayek 1960: 15-16).

<sup>9</sup> "Liberty not only means that the individual has both the opportunity and the burden of choice; it also means that he must bear the consequences of his actions and will receive praise or blame for them. Liberty and responsibility are inseparable. ... Though it can offer to the individual only chances and *though the outcome of his efforts will depend on innumerable accidents*, it forcefully directs his attention to those circumstances that he can control as if they were the only ones that mattered. Since the individual is to be given the opportunity to make use of circumstances that may be known only to him and since, as a rule, *nobody else can know whether he has made the best use of them* or not, the presumption is that the outcome of his actions is determined by them, unless the contrary is quite obvious" (Hayek 1960: 71, emphasis added).

inescapable, says Hayek.<sup>10</sup> When the market rewards according to the value of the result of action, it promotes *much result for little effort*.<sup>11</sup> Note that the value of the result is decided through the willingness to pay, the preparedness to sacrifice something of consumers, or even better: through the actual paying and sacrificing of consumers, and not through value-judgments of the government or experts appointed by the government.

But maybe the belief in metaphysical freedom, free will and unlimited rationality can still have a function. Hayek believes that “[t]hough a man's conviction that all he achieves is due solely to his exertions, skill, and intelligence may be largely false, it is apt to have the most beneficial effects on his energy and circumspection” (Hayek: 1960a: 82-83)<sup>12</sup>. The question is then whether we should correct such false beliefs or not, or even if we should encourage them:

“It is therefore a real dilemma to what extent we ought to encourage in the young the belief that when they really try they will succeed, or should rather emphasize that inevitably some unworthy will succeed and some worthy fail – whether we ought to allow the views of those groups to prevail with whom the over-confidence in the appropriate reward of the able and industrious is strong and who in consequence will do much that benefits the rest, and whether without such partly erroneous beliefs the large numbers will tolerate actual differences in rewards which will be based only partly on achievement and partly on mere chance” (Hayek 1976: 74).

*Bad philosophy, bad science can make good politics.* Hayek (1967: 121) quotes Hume who said that “it appears somewhat strange, that a maxim should be true in politics which is false in fact”. And the opposite can also be true: *good science sometimes makes bad politics*. Determinism, in a sense, might be good science, but it is bad politics, while the free will doctrine is bad science, but good politics. The doctrines of metaphysical freedom and unlimited rationality are useful on the one hand from the perspective of the entrepreneur, who will believe in his unlimited powers and on the other hand from the perspective of the voters and politicians who, since they do not understand how markets work, will be more likely to accept differences in income if they believe they are due to merit. Hayek seems to suggest that *in fact* we are determined and irrational beings, but perhaps we *should* treat each other *as if* we were free and rational.<sup>13</sup> Because Hayek justifies freedom from coercion and responsibility for result, and even the belief, though false, in unlimited rationality and metaphysical freedom and responsibility, on the basis

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<sup>10</sup> “Once the rewards the individual can expect are no longer an appropriate indication of how to direct their efforts to where they are most needed, because these rewards correspond not to the value which their services have to their fellows, but to the moral merit or desert the persons are deemed to have earned, they lose the guiding function they have in the market and would have to be replaced by the commands of the directing authority” (Hayek 1976: 82; cf. 2007: 150-51).

<sup>11</sup> Reward according to merit might be suitable for *the employed*, for whom it is more difficult to discern how much he contributed to the product, in contrast with *the independent*, who must always be rewarded according to the value of the result (Hayek 1960: Chapter 8). Moreover, Hayek accepts that we should *praise or blame morally* the ones with good dispositions and intentions. But we should *reward economically or pecuniary* the ones who get good results.

<sup>12</sup> But he specifies that “it leads no doubt also to an exaggerated confidence in the truth of this generalization which to those who regard themselves (and perhaps are) equally able but have failed must appear as a bitter and severe provocation” (Hayek 1976: 74; see also Hayek 1960: 98).

<sup>13</sup> The situation is like that of the surgeon who doubts whether to tell his patient the sad truth that she is dying. The surgeon's dilemma is about choosing between truth and utility. Should you always opt for the truth when illusion is more useful? Note that if Hayek would choose to encourage in the young false beliefs about freedom and rationality, this would be like spreading a Platonic ‘noble lie’, a notorious totalitarian strategy and something to which Hayek has objected in the past.

of its beneficial consequences, he can be called a *consequentialist libertarian*. The sacrifice of certain people, here the ones who undeservingly fail without being compensated, and the possibility of noble lies are typical features of consequentialist or utilitarian political philosophies.

## V. A consequentialist libertarian approach to entrepreneurial luck

Because of considerations of justice, the luck egalitarian could never accept such consequentialist arguments. However, he or she might well try to take some of these consequentialist reasons into account and contend that the state should reward only *useful* effort, effort that results in a social contribution. This would be a mix of reward according to effort and reward according to social contribution. I mentioned that Hayek thinks that central direction of the economy is necessary to safeguard efficiency in an economy based on rewarding merit. However, instead of ‘rewarding prescribed behavior according to merit’, the state could indeed choose to ‘reward behavior according to prescribed merit’. It could codify substantive knowledge of economic means and ends, teach this in schools, publish it in official papers and proclaim that it will only reward effort in these areas. With  $EU(E_x)$  being the expected utility of individual  $x$ ’s effort, measured in Euros, this gives us the following formula:

$$I_x = \frac{EU(E_x)}{\sum_{i=1}^n EU(E_i)} \sum_{i=1}^n O_i. {}^{14}$$

However, in addition to incentive problems, the state copes with serious knowledge problems – this consideration is typically *Austrian*. For the state should decide which efforts are useful, which presupposes that it *already knows* what effort is useful. But the answer to the question, first, what a contribution is (what people prefer) and, second, what results in a contribution (how we can effectively and economically satisfy these preferences) can only be discovered in the market through entrepreneurial efforts and communicated through prices.

But maybe the luck egalitarian could suggest looking for answers in the present market, before abolishing it. We know what consumers want and what the technological possibilities are to satisfy these wants. However, reward according to effort which the state judges to be useful would incite effort to be spent only on what is *already known* to be useful (thanks to the present market). This would imply never going beyond what is already known, so that there could be no progress in the knowledge of what is useful.

This would mean the end of real innovation, creativity and progress. Entrepreneurship and innovation are all about discovering *new* ways of making old goods, *new* goods to satisfy old preferences or entirely *new* possible preferences opening new markets. And in as far as something really new is discovered, in as far as real progress is made, this must go beyond what is already foreseen, it must go beyond our control; epistemic luck is thus

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<sup>14</sup> Note that  $EU(E_x)$  is equal to  $E_x$ , measured in hours, multiplied by the expected utility of one unit of effort, measured in Euros per hour. So we have just weighted expended effort in the old luck egalitarian formula on the basis of the expected utility of one unit of effort.

essential to this entrepreneurial discovery procedure.<sup>15</sup> Hayek (1960: 40) says that “[a]s progress consists in the discovery of the not yet known, its consequences must be unpredictable. It always leads into the unknown, and the most we can expect is to gain an understanding of the kind of forces that bring it about”.<sup>16</sup> Hayek’s comments on equilibrium theory also convey the message clearly:

"The real problem in all this is not whether we will get *given* commodities and services at *given* marginal costs but mainly by what commodities and services the needs of the people can be satisfied most cheaply. The solution of the economic problem of society is in this respect always a voyage of exploration into the unknown, an attempt to discover new ways of doing things better than they have been done before" (Hayek 1969: 100).

This shows that the entrepreneur, the motor behind this dynamics, simultaneously has an *incentive* problem in the sense that he has no incentive to show his knowledge on what effort is useful, thus making the use and communication of this knowledge impossible, aggravating the state’s knowledge problem. Rewarding effort which is already known to be useful would discourage entrepreneurs to use their personal knowledge to bet against common knowledge. If the state does not recognize your knowledge as official, it will not reward effort based on it. If your effort based on unofficial knowledge has great results, the state will consider this to be a matter of epistemic luck and leave it unrewarded. Luck becomes relative to an official standard: it is merely what was not foreseen by the state and its specialists.

Moreover, luck and foresight are indistinguishable in entrepreneurial activity. Remember that, if one is a fallibilist, when what was subjectively foreseen becomes actualized reality, this is a matter of luck. But how can we measure the luck in expectations turning out right? The entrepreneur would say that he was 100% sure that his enterprise would succeed, while the state might oppose that, notwithstanding his subjective belief being 100% certain, the *a priori* objective probability of success was much lower.

So maybe  $EU(E_i)$  should not be interpreted as the ‘objective’ expected utility of the effort *judged by the government*, the social scientist hired by the government, or by the community, but rather as the expected utility ‘subjectively’ *judged by the individual him- or herself*. Perhaps the state could recognize all personal knowledge as official. However, this will result in overly optimistic judgments of  $EU(E_i)$  by individuals, just to maximize  $I_i$ . Again, this would incite *much personal knowledge with little result*, much expected but little actual utility, the reason why it was decided earlier only to reward useful effort in the first place.

The luck egalitarian might retort that only *justified* expectations of the utility of a certain effort should be taken into account:  $EU$  should thus be interpreted as ‘justly

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<sup>15</sup> It might be noticed that I have a Schumpeterian rather than a Kirznerian (or Misesian) concept of entrepreneurship. The Schumpeterian entrepreneur is the original innovator, while for Kirzner imitators of the innovator are also entrepreneurs when by imitating they can earn a profit (Kirzner 1973: 79-81). However, one must bear in mind that the imitator also outsmarts others in the sense of perceiving that it is profitable to imitate. After a while imitation will cease to be profitable in the strict sense; this is when the market is in equilibrium again, and imitators are no longer Kirznerian entrepreneurs.

<sup>16</sup> Taleb describes how *a priori* unpredictable but often *a posteriori* rationalized events with great impact, which he calls ‘black swans’, can revolutionize individual lives and world history. He refers to Hayek as one of the few economists who have recognized the importance of black swans (2008: 79-83).

expected utility'.<sup>17</sup> The state could first evaluate the process of how individuals obtain certain expectations.

Normally, individuals form expectations through 'mental labor'. Therefore, the state might want to reward this mental effort  $ME$  in addition to the physical effort  $PE$ , and eliminate factors of luck<sup>18</sup>:

$$I_x = \frac{EU(ME_x) + EU(PE_x)}{\sum_{i=1}^n [EU(ME_i) + EU(PE_i)]} \sum_{i=1}^n O_i$$

This formula presupposes that we can distinguish between the (expected) contributions of mental or epistemic factors and the 'physical', executive factors to a certain output. The terms 'mental' and 'physical' should not be taken too literally. From a Kirznerian framework, it might be useful to interpret  $EU(ME_x)$  as expected entrepreneurial profit and  $EU(PE_x)$  as expected managerial income. The knowledge necessary to judge  $EU(ME_x)$  is the procedural knowledge on how to discover new economic means and ends, while the knowledge necessary to judge  $EU(PE_x)$  is substantive knowledge of economic means and ends.

Note that Kirzner argues that the costs of alertness are zero, while nevertheless this can result in a justified expectation of utility. This is, for instance, the case when one accidentally stumbles upon a divergence in prices. Can  $EU(PE_x)$  then be very high, while the justification itself is the result not of great mental efforts but rather of luck? The answer is *no*. Entrepreneurial profits are categorized under  $EU(ME_x)$ , which will be zero when  $ME_x$  is zero. But not rewarding costless mental 'efforts' will destroy all incentives to exploit accidentally discovered profit opportunities. Moreover, the less mental effort, the more efficient and the better; so we should encourage it.

On the other hand,  $EU(ME_x)$  should again refer to the *justified* expectation of the utility of mental labor. Again we have the same dilemma: either  $EU(ME_x)$  is the objective expected utility of the effort as judged by the government, or it should be interpreted as the expected utility as subjectively judged by the individual. If it is the expectations of the government that should be taken into account, we have again the problem that government does not know which mental effort will result in the greatest contribution. In as far as it knows it, first, it is just taking for granted what has been discovered in the market and, second, it is not going beyond what it already knows.

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<sup>17</sup> Note that the individual's justified expectation of the utility of effort is not the same as the government's expectation of the utility of effort. The whole point was allowing for individuals to outsmart government.

<sup>18</sup> In addition to the expected utility of effort, some have argued that *luck or choice in the disposition towards effort* should be taken into account in rewarding effort. Some effort is the result of constitutional luck – some people have a genetically or culturally transmitted disposition towards effort: they luckily inherited a good work ethics through their genes or through education – while other effort is the result of genuine choice (cf. Roemer). Hence, some people should be rewarded for less than their actual effort. Only the individually chosen and cultivated disposition towards effort (constitutional choice) should be rewarded, or the individually chosen actual effort. The question is of course where the effort comes from which is necessary for the cultivating of the disposition for effort. The chain of meta-effort, meta-meta-effort, etc. not only drowns in an infinite regress but is psychological nonsense.

So maybe we should look at the individuals' expectations on utilities. However, for expectations on the utility of mental effort to be justified, preceding mental effort is usually necessary. The state should also reward this effort, and all the preceding mental efforts necessary to justify subsequent efforts. With  $EU(ME_{x,t})$  being the mental effort spent by individual  $x$  at time  $t$ , this gives us the extended formula:

$$I_x = \frac{EU(ME_{x,t-m}) + \dots + EU(ME_{x,t-1}) + EU(ME_{x,t}) + EU(PE_x)}{\sum_{i=1}^n [EU(ME_{i,t-p}) + \dots + EU(ME_{i,t-1}) + EU(ME_{i,t}) + EU(PE_i)]^{i-1}} \sum_{i=1}^n O_i .$$

Eventually this justificatory chain must stop, at time  $t - m$ , and luck is inescapable. The corresponding ultimate mental effort will be zero, and it is not clear how much utility is attributable to it. It seems to me that all entrepreneurial profit will in this way be a matter of luck, in the sense of lack of some mental meta-effort.

Individual entrepreneurs suffer from the same knowledge problem as the state. In going beyond common knowledge, it is essential that entrepreneurship cannot be a secure road to success. Entrepreneurship is a process of trial and error, gambling and hoping, conjectures and refutations (cf. Popper). Moreover, randomly trying can be more useful than 'justified' courses. If the benefits from luck minus the costs from luck, which are zero, are higher than the benefits from effort minus the costs from efforts, which are often quite high, then it pays to leave it up to chance. Then gambling and guessing is the rational and deserving strategy.

However, the luck egalitarian might accept that trial and error, and random search are useful *on average*, that the expected utility of certain speculative activities that require only a little bit of effort is relatively high. But he or she might insist that we should pool the gains from luckily successful speculative market behavior and distribute them among all speculative agents.

However, if the state would judge that certain entrepreneurial trial and error behavior has a certain expected utility, first, this presupposes that it has knowledge on this (while there is genuine, Knightian uncertainty), and second, it would confine entrepreneurial trial and error behavior to a specific type. We have the same knowledge and incentives problems as before. The state does not know, first, whether (quasi-)randomly trial is more profitable than routinal behavior or imitation and, second, what trial heuristics are more profitable. Maybe the path of certainty has a higher average utility in certain situations. We do not know. The only way to know it is to try. The knowledge problem moves from the level of the substantive knowledge of market data to the level of the procedural knowledge of where and how to find market data. The concept of utility can be applied to increasingly higher levels, but the same knowledge problems will reoccur.

Rewarding useful gambling would also preclude entrepreneurs using their personal knowledge that would contradict the state's knowledge to improve their chances. Maybe another type of gambling has a higher average utility. Rewarding useful gambles would incite *much entrepreneurial effort, much trial with little result*, much trial with much more error.

Hayek (1976: 95) contends that "[i]n those speculative efforts which we call 'research' or 'exploration,' or in economic activities which we commonly describe as 'speculation,' we cannot expect to attract those best qualified for them unless we give the

successful ones all the credit or gain, though many others may have striven meritoriously”. The only solution is to substitute *actual utility*,  $AU$ , for expected utility in the income formula:

$$I_x = \frac{AU(ME_{x,t-m}) + \dots + AU(ME_{x,t-1}) + AU(ME_{x,t}) + AU(PE_x)}{\sum_{i=1}^n [AU(ME_{i,t-p}) + \dots + AU(ME_{i,t-1}) + AU(ME_{i,t}) + AU(PE_i)]} \sum_{i=1}^n O_i$$

How can we measure actual utility? Since there is no way for the state to measure the relative utility of something for people, we must let people pay for it.

But  $\sum_{i=1}^n [AU(ME_{i,t-p}) + \dots + AU(ME_{i,t-1}) + AU(ME_{i,t}) + AU(PE_i)] = \sum_{i=1}^n O_i$ . Therefore:

$$I_x = AU(ME_{x,t-m}) + \dots + AU(ME_{x,t-1}) + AU(ME_{x,t}) + AU(PE_x) = O_x$$

And we are back to where we started: the simple libertarian formula. As if it were magic. If you refine your (socialist) principles of distributive justice to accommodate for consequentialist inconveniences, you will end in libertarianism. How frustrating it might be for our intuitions of justice and merit, there is no other way but rewarding the value of the results of behavior, in the sense of individuals freely paying for what they judge to be worth buying. According to Hayek, the tradition of liberty and that abstract, extended order it produces conflict with our instincts of equality and justice, inherited from times when people lived in small, closed communities. But if we want progress, and, according to Hayek, we even *need* it in order to survive, we should allow tradition, backed up by economic reason, to suppress these instincts.

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