Is This Really “How to Make Wealth”?

Stuart Wray 21 November 2006
www.stuartwray.net

Paul Graham's essay “How to Make Wealth” (http://paulgraham.com/wealth.html) is about two different but related ideas: how to make yourself wealthier and how to make society wealthier. By way of an introduction, it first explains how it is possible to make wealth without depriving others of anything. For example, by fixing up a car in your spare time you get an extra working car without other people having fewer cars. Through your work you have genuinely increased not only your own wealth but the wealth of society as a whole. Of course, there are second order effects, such as what happens to your waste, and it’s possible that the price you pay for your materials doesn’t reflect the long-term costs to society. But the idea that building things creates wealth is basically correct.

So what is the best way to create wealth for yourself? If the genetic lottery has given you an above average start in the brains department, then joining a start-up does seem like a plausible bet. If instead you have come out ahead in height and hand-eye coordination, you might be better trying out for a basketball team. Of course, some people don’t come out ahead in anything; they are never going to be wealthy, short of literally winning the lottery. The best they can hope for is that those who did come out ahead show sufficient compassion, and remember to help those who drew life’s short straws.

If you have the prerequisites, being part of a start-up has another advantage, namely that it has a certain moral appeal. Just like repairing the old car in your summer holidays, you are not depriving others of anything to make yourself wealthier: you are quite literally creating something from nothing. Whether the start-up succeeds or fails, you can look yourself in the eye and be happy that you didn’t hurt other people. Even if the startup fails, at least you left the world with more than it had before. You’re practically a philanthropist.

Of course, the question of failure is the fly in the start-up ointment. As “How to Make Wealth” points out, very many more start-ups fail than succeed. The ratio of failure to success is perhaps thirty to one. Although the average returns are pretty good, the only people who see those average returns are the venture capitalists, the money-men bankrolling the whole thing. As an individual developer it is much more like buying a lottery ticket. Even if you have a great idea, great talent and work hard, that isn’t enough. You also need a huge amount of luck.

So in the end I am ambivalent about the conclusion that joining a start-up is a good way to make wealth for yourself. You will certainly learn some valuable things, and make yourself into a more desirable employee. But joining a start-up is basically a bet, and not at very good odds. As the winner of such a bet the author of “How to Make Wealth” has perhaps a rosier view of things than the average developer.

Now let’s have a look at the second, confusingly interleaved aspect of “How to Make

Wealth": how to make society as a whole wealthier. It's here that I start to part company more seriously with the author's conclusions. We live in a capitalist society, which is to say that we use money rather than central planning to ensure that resources are distributed efficiently. You might think that central planning would be best, that a central authority could gather information and make the best global decisions. After all, we know that global optimisation can achieve more than local optimisation.

However, it turns out that the failure modes of central planning are worse than the failure modes of capitalism. Central planning fares much worse under the influence of laziness and greed, whereas capitalism can thrive in the presence of these two vices. (Sometimes we need to adopt central planning, to avoid a "Tragedy of the Commons", and in any case we still need to maintain constant vigilance against corruption.) Using capitalism is thus a pragmatic decision, a relatively reliable way to organise resource distribution. It is neither more nor less morally correct than the alternatives, but merely the choice which is usually best.

Given this background, are start-ups a good way to increase the wealth of society? They are high-risk enterprises, which if they succeed will deliver things that society values, so they fit well within the capitalist scheme. People certainly are motivated by a prize at the end of a struggle, so it is appropriate that the winners be rewarded. But perhaps the way the rewards are allocated is inefficient: the winners get very much more than was needed to motivate them, while the also-rans get very little.

It's well known that offering a prize for a technological feat encourages a disproportionate effort. Think of Lindbergh, of Rutan's non-stop flight around the world, of the X-Prize. Small groups, like start-ups, beg and borrow, take risks and short-cuts that mature enterprises never could. Many fail but some succeed, and the relatively small prizes are sufficient to motivate all of them.

From the point of view of a whole society, the question about both capitalism in general and start-ups in particular has to be "are they an efficient way to distribute resources?" Efficiency is the key issue. Paying more for something than necessary is foolish, if a lower price would bring the same result. Are the disproportionately large rewards for successful start-ups really necessary to motivate them? It's clear that less money would still be very motivating. As the author says, "If there had been some way just to work super hard and get paid for it, without having a lottery mixed in, we would have been delighted." It appears that society is paying more to the winners than really necessary in order to gain the extra wealth that they bring. Or to put it another way, if society decides to take some money back from the winners, they won't be particularly discouraged.

This is the point where I disagree with the author, who believes in "allowing those who made a lot of money to keep it." The argument being that otherwise they won't be sufficiently motivated to generate the wealth in the first place. But as we've seen above, getting somewhat less money is unlikely to significantly dampen the geeks' enthusiasm for making things.

And let's remember, it's geeks that the author is talking about. It's clear that he doesn't think that those who get their money by “chance, speculation, marriage, inheritance, theft, extortion, fraud, monopoly, graft, lobbying, counterfeiting, and prospecting” are equally worthy of keeping all their money. Even if we were to concede that geeks deserved to keep all their money, how would we make a law which allowed them to do so and not all these other less deserving rich people?

It’s not realistic to imagine such a law, and in saying that society should allow “those who made a lot of money to keep it”, the author runs the risk of being misinterpreted as an apologist for the rich. I’m sure the author doesn’t mean that those who have a lot of money should keep it all, regardless of how they came by it, as though they had no moral obligations. But the essay can easily be read as supporting that position, that the wealthy should be left in peace to enjoy their riches, and that no part of their wealth should ever be taken to support the less fortunate in society.

As the author notes early in his essay, Bill Gates is a statistical outlier. This is true of what he has chosen to do with his wealth, as well as the wealth itself. He is arguably the greatest philanthropist of the age. Presumably he appreciates the role of luck in his wealth, and he seems to be doing things to deserve it. Perhaps we should all ask ourselves: what am I doing to deserve my wealth? At least by paying taxes we know that we are directly supporting our own society, even if we are not defeating AIDS like Bill Gates.