JUSTICE, RIGHTS, AND BAILOUTS

A Contractarian Approach to Corporate Bailouts

ANN E. CUDD*

INTRODUCTION

Social contract theory provided the foundation of early liberal theories of political legitimacy, and was conceived as in part grounded on what we now think of as capitalist property rights. Private property, however, poses its own normative puzzle, which is the question of how one can come to have some exclusive right over a thing, justifying coercive and even violent force to protect one's rights to that thing. Locke justified this right as an extension of the natural right divinely granted to exclusive control of one's body. Although many descendants of Locke accept the natural right of self-ownership without appeal to its divine origin, others have found the concept of self-ownership mysterious.[1] Furthermore, Locke's argument for private property differs from the general social contract approach, his own and others', which justifies the coercive power of government by appeal to consent.

The revival of social contract theory in the 20th century by Rawls led to development of several strands of contract theory, the most fundamental distinction among them being between the contractualist and the contractarian. Whereas contractarians seek to construct moral and political principles on the basis of rational agreement from a coercion-free starting point, contractualists begin with basic guiding principle of the moral equality of persons, and derive higher order moral and political principles from this moral starting point. Thus while

* Professor of Philosophy, University of Kansas. I gratefully acknowledge the comments of Jason Brennan and Neal Becker, as well as input from the audience at the Georgetown Institute for the Study of Markets and Ethics Symposium on the Morality of Corporate Bailouts, Nov. 30, 2012. All remaining errors are my own.

1. CAROL PATEMAN, THE SEXUAL CONTRACT (1988).

contractarians construct the foundation for morality and justice, contractualism offers a method of practical reason that builds on a given foundation.

The mutual advantage contractarian approach that I propose offers a justificatory method for defending capitalist property rights. Mutual advantage contract theories claim that the principles of morality and justice are the principles that can be justified to rational persons as rules to structure human life as a cooperative venture for mutual advantage. In this general conceptualization, both Rawlsian contractualist[2] and David Gauthier's contractarian[3] theories count as mutual advantage contract theories, though not Thomas Scanlon-type theories,[4] which argue from fairness and mutual acceptability of the rules alone.[5] I will use the term "mutual advantage contractarianism" in a stricter sense, however, to refer to theories that begin from no moral presuppositions and attempt to construct morality from the demands of rational prudence, thus ruling out Rawlsian contractualist theories as well.[6] According to mutual advantage contractarianism, a property rights scheme is justified if it fosters mutually advantageous interactions among persons.

Contractarianism offers a particularly useful approach to the question of whether corporate bailouts can be justified. Two quite diametrically opposed political philosophies, socialism and libertarianism, can be seen as agreeing that this question must be answered in the negative. Socialists object that the property rights that justify corporate capitalism are themselves unjustifiable from the perspective of justice.[7] Such property rights lead to unacceptable inequalities in wealth, and therefore must be rejected. Thus, corporate bailouts are unnecessary because corporations themselves are unjustified. Libertarians argue, very roughly, that the capitalist property rights that allow corporations to form are justifiable but that such rights do not permit the kind of government intrusion in economic matters that is necessary to bail-out corporations when they fail.[8] Thus, bailouts are unjustified. Contractarianism, I shall argue, endorses capitalist property rights, but constructs property rights in such a way that encourages the growth of corporations that may become "too big to fail." Thus, the question of whether corporate bailouts can be justified becomes for

2. JOHN RAWLS, A THEORY OF JUSTICE (1971).

3. DAVID GAUTHIER, MORALS BY AGREEMENT (1986).

4. THOMAS SCANLON, WHAT WE OWE TO EACH OTHER (1998).

5. MARTHA C. NUSSBAUM, FRONTIERS OF JUSTICE 54 (2006).

6. THOMAS DONALDSON & THOMAS DUNFEE, TIES THAT BIND: A SOCIAL CONTRACTS APPROACH TO BUSINESS ETHICS (1999), offers a contractualist approach to business ethics of the Rawlsian type. Despite its suitability for business ethics, I know of no such fully articulated contractarian version of business ethics.

7. *See* ANN E. CUDD & NANCY HOLMSTROM, CAPITALISM, FOR AND AGAINST: A FEMINIST DEBATE (2011).

8. Robert McGee, *An Ethical Analysis of Corporate Bailouts* (Florida Int'l Univ. Chapman Graduate Sch. of Bus., Working Paper, 2008), *available at* http://ssrn.com/abstract=1304754. Libertarians are also often opposed to fiat money, which they might argue causes the problems for the economy that are alleged to justify bailouts of banks. But even if there were no such massive bank failures, failures of large manufacturing firms that lead to massive unemployment would still be possible in a libertarian economy.

contractarianism a question about how best to construct capitalist property rights and whether such rights can include insurance against failure.

In this paper, I will begin by sketching out the basic political and economic principles that impinge on corporate bailouts as justified by mutual advantage contractarianism, but I do not intend to conclusively defend it as a moral or political theory here. Rather, this paper will investigate the implications of mutual advantage contractarianism for the question of whether and when corporate bailouts can be justified. Mutual advantage contractarianism holds that a governmental policy is legitimate if rational persons seeking their own interests would agree to it under conditions in which threats, violence, and fraud are absent. I argue that a policy of offering bailouts to corporations can be justified on this view, but only under certain conditions. First, the proposed bailouts must be necessary to prevent massive systemic failure. Second, measures must be in place to discourage rent-seeking on the part of the executives and owners of the corporations that are being bailed out. Third, bailouts should be filtered through consumers where possible in order to spread the benefits of the bailouts widely across the economy. Fourth, the bailout must be acceptable to global trading partners as a temporary, emergency measure to preserve the economy.

I. MUTUAL ADVANTAGE CONTRACTARIANISM

Contractarian theory has two fundamental elements from which it derives its moral and political principles: a characterization of the initial situation, and a characterization of the parties to the contract, particularly in terms of their rationality and motivation to come to agreement.[9] The initial situation posits what in bargaining theory is called the "no agreement position," the situation to which the individuals return in case of failure to make an agreement or contract. This situation is what would obtain in the absence of rules of justice, and it is the starting point for making agreements. The second element of a contractarian theory characterizes the potential contractors' practical rationality. There are two parts to this. First, contractarian (as opposed to contractualist) theories take persons to be self-interested in order to justify rules of justice as rational self-interest, and avoid assuming that persons have preferences for moral behavior as such in order to derive morality from prudence. Persons are assumed to have given preferences and interests that do not necessarily include the well-being of others, because interests in the well-being of others are taken to be moral preferences and as such not prior to morality. Self-interest need not be selfish or self-centered, but it may be; self-interest simply entails that the motivation to act is one's own.[10] Secondly, persons are presumed to understand and desire the instrumental benefits of social interaction if they can be had

9. Ann Cudd, *Contractarianism*, THE STANFORD ENCY. OF PHIL., http://plato.stanford.edu/archives/fall2012/entries/contractarianism (last updated 2012).

10. *See* Donald C. Hubin, *Non-tuism*, 21 CAN. J. PHIL. 441 (1991). For a contrary view, see Susan Dimock, *Defending Non-tuism*, 29 CAN. J. PHIL. 251 (1999).

without sacrificing individual self-interest. Contractarians characterize practical rationality instrumentally, subjectively, and preferentially: acting rationally entails maximizing satisfaction of one's own subjective preferences. Contractarian argument relies on the crucial fact about humans that we are able to cooperate to produce more than each working or acting alone, thus making it rational to cooperate under at least some terms. The desire to benefit from cooperation in turn makes persons rationally concerned about their reputations for adhering to the moral norms that make cooperation possible and rational. The basic principle of action for mutual advantage contractarianism is thus: *seek mutually beneficial interactions and seek to make interactions mutually beneficial.*

Contractarians argue that without rules of justice for cooperation, persons are worse off by their own lights. Hence it is rational to adopt some rules for morality and justice. These two aspects of the contractarian individual—self-interest and the ability to benefit from interaction with others—along with the conditions of moderate scarcity imply what Rawls, following Hume, called the "circumstances of justice:" the conditions under which rules for justice could be both possible and necessary.[11] Justice, and so a social contract, is only possible where there is some possibility of benefit to each individual from cooperation, but where there is such a possibility, rational individuals will agree to cooperate.

Agreements require some rules to guide the formation of agreement, however, and on pain of regress, these rules cannot themselves require prior agreement. Mutual advantage contractarianism attempts to minimize the moral presuppositions of the contract by asking what conditions of initial agreement would make possible a stable agreement, where stability means that the agreement will be voluntarily adhered to after it is made. The answer, and the first rule of contract, is that there must be no force or fraud in the making of the agreement; no one is to be coerced into agreement by the threat of physical violence or by intentional misrepresentation of the terms. The reasoning for this is quite straightforwardly prudential: if one is allowed to use violence or lie about what is being exchanged, then there is no real difference between the "contract" arrived at and the state of nature for the threatened or defrauded party, and hence no security in the agreement.[12] Contracts must be significantly better for each party than the initial situation of no established rules of justice.

The second rule of contract is that each individual who is a party to the contract must comply with the rules of justice, which are the outcomes of the contract. This raises the familiar compliance problem for contractarian theories, which is the objection that rational contractors will comply with rules of justice only when it is to their advantage to do so; when they can get away with it and it is to their advantage, they will cheat. Mutual advantage contractarianism must

11. RAWLS, *supra* note 2, at 126.

12. There is a fine line between being coerced by the threat of violence into giving up one's rights and being convinced by the threat of penury to make an unfavorable agreement. Where is the line? Again, prudential reason suggests that a fair and impartial starting point for bargaining that will lead to secure and stable agreements.

show that it is rational to expect that most persons will comply most of the time, which requires a combination of trust building and enforcement. For contractarianism to be viable, and for my purposes here I will assume that it is, persons who are part of a broadly compliant, just society will have to be able to develop dispositions of trusting and trustworthiness, but also skills of detecting those who are not trustworthy. These dispositions make most persons less likely to look for situations that they can exploit by cheating others, and cause them to resent and punish those who are found to be cheating. Cheaters will be excluded from future interactions, at least until they can regain the trust of others, who have now been put on notice of potential future cheating. At the same time, persons will seek out others who can be relied on to cooperate with them for mutually advantageous interactions and projects. In an environment of mostly trusting, trustworthy persons who resent and punish cheaters, compliance is likely enough for the rules of justice to be stable even given occasional non-compliance by some.[13] Much more must be said about the compliance problem in a full defense of mutual advantage contractarianism, but this is not the occasion for that defense.

Cooperative interactions are beneficial when there is something for each participant to gain from the interaction. Interactions that have potential to be beneficial are those in which a surplus is created over and above the sum of the potential that each individual could create alone. Individual gains or losses are determined by the way that the surplus value created by interaction is split. Thus a principle for sharing the surplus under mutual advantage contractarianism must allocate to each an amount that is greater than they could achieve on their own. But note that the words "sharing the surplus" and "allocate" are not to be read as if the whole social product is gathered together and then divided up and distributed back out to the individuals. In fact, that would be a wasteful way to organize society and so mutual advantage contractarianism is unlikely to recommend it. The point is that the distributive outcome of the rules of trade, taxation, and government provision of services, whether they are centralized or decentralized or some combination of such mechanisms, has to allow each to obtain a greater share than they could on their own. An individual can (to some degree) determine how much she will contribute to the social surplus, and which interaction she will choose to contribute to. When individuals can choose to contribute to various social interactions, the next best opportunity for sharing surplus from interaction is the opportunity cost of this interaction. Thus, ideally rational individuals will benefit from an interaction only when they are compensated with a share of the surplus that is greater than their opportunity cost.

However, non-ideal individuals with incomplete information and limited calculating capacities who spend much of their time and efforts on calculating exact costs and advantages will lose a lot of opportunities for mutually advantageous interactions in doing so. Furthermore, non-ideal individuals live in real

13. GAUTHIER, *supra* note 3, at 174–77.

time and have to respond to offers as they come, without prefect knowledge of what future offers will come. Thus, cooperating with others who offer smaller benefits can be rational. Also, taking small losses in opportunity cost terms may be a good investment for future interactions if by doing so they build trusting relationships, and prevent others from becoming predators. Furthermore, calculating individuals are not highly prized by others as companions. So it will be to each person's advantage to use a rule of thumb to live by that affords them overall satisfactory benefits, but does not require them to obsessively focus on advantage-seeking. That is, it will be rational to be merely satisfiers, not optimizers, when it comes to sharing the benefits of interaction.

Rational individuals consider how they should behave in order to be able to interact beneficially, which means they need to be disposed to interact cooperatively and to detect those who are not disposed to cooperate, but also to make manifest that disposition in order to not be supposed a cheater. To be seen as cooperative, they need to be able to recognize when they are not contributing as much to an interaction as another and be willing to settle for less of the cooperative surplus. But such recognition is difficult, and each is likely to think that he is contributing more than he actually is. Since cheaters would likely not have strong relationships with others, manifesting an ability to build and maintain relationships would be a good way to signal one's cooperativeness. A good rule for sharing benefits would be for each in the interaction to gain proportionally to their contribution, with some hedge toward more equal shares in order to preserve the good will of all those in the interaction and build trust through focusing on relationships rather than advantage.

One further thought about differential contributions mitigates the degree of inequality of shares. Since we live in a dynamic environment in which persons' abilities, interests, and assets change, it is in persons' interest to expansively project how interactions will lead to future advantage. For each of us, some of our abilities will improve and some will decline. We want to make future interactions more likely with those whose abilities will improve or become better than ours as our abilities decline. As a kind of insurance against our own decline and as an investment for future interactions with more able cooperators, it is rational to de-emphasize differences in abilities to contribute. By sharing the surplus this way, mutually advantageous interactions are beneficial, even if not maximally so, for all and likely to be repeated. We can call this general idea of sharing social surplus from interaction among individuals so that interaction is beneficial to each the *principle of reciprocity for mutual advantage*.

II. PROPERTY RIGHTS AND CORPORATE CAPITALISM

Mutual advantage contractarianism constructs the rules of justice on the foundation of hypothetical rational agreement for mutually beneficial interactions. Mutual advantage contractarianism, as an approach that minimizes moral assumptions, takes property rights to be conventional, not natural. Since secure possession and exchange of goods are among the most beneficial interactions, property rights must be designed to ensure that trade in goods is mutually beneficial and that opportunities for such mutually beneficial interactions are maximized. To be secure as rights, property rights must be secured by social enforcement and regulation against violence, coercion, theft, and fraud. Therefore, the exact contours of property in a society are molded by the ways it chooses to enforce, restrict, tax, and distribute the gains from trade. Furthermore, since societies interact globally, there will be external constraints imposed as well. There are many different bundles of possible property rights, and according to contractarianism the choices of what and how to enforce and regulate are to be made so that the overall scheme is to the mutual advantage of all potential contributors to society.

Property rights (along with persons' differential abilities to make use of them) partly determine the distribution of goods in a society. Socialist property rights distribute goods equally, while capitalist property rights result in a distribution of goods that is highly unequal. Rawls argued that the distribution of goods even in welfare state capitalism was too unequal to be just,[14] and hence he argued for a property owning democracy, in which land and capital would have to be continually redistributed by the state to equalize shares. Rights to own capital in his system are thus quite weak or non-existent, and therefore, there would be little ability or incentive to start a company or invest in a long-term venture. Rawls's contract is not, in my terms, a mutual advantage contract, and clearly there will be many who are disadvantaged by his system relative to other possible property rights regimes. More importantly, many opportunities for mutually advantageous interactions will be sacrificed. On the other hand, a highly unequal property rights regime that does not do anything to equalize educational and welfare opportunity will miss out on many opportunities for economically disadvantaged but naturally talented individuals to contribute to the social product.

Laissez-faire capitalism is a system of property rights that provides the strongest rights to property consistent with others' rights. There are no taxes for collective projects nor for any kind of social safety net or redistribution of wealth. Inheritance rights are absolute. Government provides only a police force and a judiciary to protect full capitalist property rights and enforce contracts. Mutual advantage contractarianism rejects this scheme of property rights because it fails to provide adequate opportunities for the economically disadvantaged and fails to counteract market failures of various kinds.

Between these extremes, there is a set of property rights regimes that each meet the standard of mutual advantage, all of which are some form of capitalism. First, only capitalism allows private property in the means of production,

14. JOHN RAWLS, JUSTICE AS FAIRNESS: A RESTATEMENT 137–40 (Erin Kelly ed., 2d ed. 2001). Note that Rawls does not say that they are distributed unequally, but that the distribution inevitably becomes unequal and so has to be rearranged ex ante. The distributive outcome is not what he objects to but rather the need to continually redistribute in order to reach that outcome.

which is necessary for incentivizing mutually advantageous commercial interactions. Furthermore, without the right to own capital there would need to be continual taking of excess property to prevent anyone from beginning to use that excess as capital. It is hard to see how anyone who is able to produce more than they consume (that is, most of us) would agree to this or comply with such an agreement. So some amounts of private property in capital must be allowed by a mutual advantage social contract. A mutually advantageous capitalism must provide universal primary and secondary education (though perhaps through issuing vouchers for privately contracting schools), assistance for higher education, and a social safety net that provides health care, nutrition and other basic needs for children. These things are justified on the grounds that children provide the future of mutually advantageous interactions, and investments in their human capital will pay off in future valuable social contributions. Furthermore, it must counter-balance information asymmetries through safety regulation on food, medicine, and to some extent, working conditions. Anti-discrimination laws are justified by appeal to mutual advantage, as well.

Taxation by government, along with the purposes to which the taxes are put, are to be considered part of the property rights regime of the society, and thus tax policy is a part of the basic agreement in a mutual advantage contractarian society. Taxes limit the ownership of property (even if they buy goods that we collectively want) because they are not part of voluntary exchanges. Taxes are by definition mandatory. Furthermore, the purchases made by government with tax revenues differentially benefit persons in our society. If we are taxed to provide a bridge, then the people who drive over that bridge are advantaged more than those who do not. There may of course be secondary benefits to many who do not drive over the bridge, for example, if it enables cheaper transportation of goods they consume or sell.

Likewise, regulatory schemes that restrict voluntary transactions between individuals or firms are to be considered part of the property rights regime, since they also constrain the use of property.[15] Like taxes, regulations differentially affect persons. A regulation on banking that requires security deposits from banks and prohibits them from loaning out all their money protects customers who have savings accounts but may cost the owners of the banks opportunities for advantageous investments. Just as some taxation is mutually advantageous, some regulations will be mutually advantageous. Regulations can help control negative externalities and informational asymmetries, each of which tends to decrease the number of mutually advantageous transactions in society. More to the point of this paper, regulations allow a society to control the size of corporations, preventing them from becoming so large that they dampen competition or create a hazard for the system. However, it must be noted that regulation provides an opportunity for rent-seeking, that is, for lobbying government to create regulations that simply reduce the market compe-

15. JOHN BRAITHWAITE, REGULATORY CAPITALISM (2008).

tition, allowing a few firms to corner the market and drive up prices. The extra profits that result are called "rent," as opposed to the normal profits that accrue to capital in a competitive market. Rents are wasteful and not mutually advantageous, and rent-seeking itself is wasteful. Thus, mutual advantage contractarianism is opposed to rent-seeking and so sets a high bar for instituting new regulations. Thus, even within the set of mutually advantageous systems, there are many different possible property rights regimes determined by combinations of tax and regulatory schemes, and these different regimes differentially advantage persons.

Under the right taxation and regulatory rules, capitalist property rights regimes provide opportunities for everyone to gain. Socialist regimes, by preventing persons from owning productive capital, prevent some opportunities for interaction, and laissez-faire capitalism, by failing to provide education for poor children or a safety net for unemployed workers, disadvantages them and others who might have productively interacted with them. Mutual advantage contractarianism supports those property rights regimes that are mutually advantageous, but among these, individuals may gain in some of these regimes relative to other possible regimes within the set of mutually advantageous ones. Thus, parties who are disadvantaged by one property rights system within this set relative to another system in the set need to be compensated to secure agreement and compliance.

It will be impossible to know precisely which individuals gain or lose from a particular property rights regime. For one thing it is difficult enough to assess the counterfactual of how an individual's behavior would be altered were she living in a different regime but with the same preferences and abilities. However, the property rights regime presumably affects persons' preferences and abilities, and thus changing regimes changes how one would behave. But it is possible to be able to say which economically identifiable groups of persons are systematically advantaged or disadvantaged. For example, suppose that there are two ways a tax can be raised for public education. One is a progressive state income tax that is then allocated back to school districts on a per pupil basis, and the other is a local property tax that is directly allocated to local schools. The progressive income tax benefits lower income earners more, particularly those with children who attend schools that would be less well funded with local taxes alone. The local property tax benefits families with children who live in wealthy communities, but disadvantages those who live in less well off communities relative to the other scheme. Other economically identifiable groups include any who are differentially affected by tax and regulatory schemes, such as consumers, urban/suburban/rural dwellers (e.g., if there are taxes to provide urban mass transit), and gender groups (e.g., if insurance companies are mandated to provide or not provide insurance for abortion or contraceptive services). Economic policies should not systematically advantage any one economic interest group relative to other mutually advantageous schemes, but should instead attempt to even out the advantages in a mutually advantageous, reciprocal way.[16]

Corporations are a type of capitalist property right, which should be structured to bring about mutual advantage. Corporate capitalism is a property rights system that encourages private investment in large firms that privately (that is, without government) internalize costs and benefits of research and development, management, and information. Corporate capitalism arguably serves mutual advantage by providing returns to scale, economic stability, incentives for innovation, and entrepreneurial freedom. Corporations undertake large-scale commercial activities, which provide returns to scale. Because they are large, they are able to withstand short-term fluctuations in the economy or in the profits that they make from their products. Also because they are large, they offer larger profits for innovative products and thus incentivize the development of such products. In addition to these social benefits of corporations, they provide benefits to individuals in addition to the wealth that they enable persons to accrue. Many prize the ability to develop a product and bring it to the market as a kind of freedom that is not possible for products that require a great deal of investment in research and development without the ability to incorporate. All of these advantages create more opportunities for interactions that are mutually advantageous to producers, but also for consumers who are able to choose more desirable, more innovative, and more readily available goods.

In entrepreneurial capitalism there are a large number of persons—entrepreneurs—who are seeking to innovate and commercialize their innovations. Innovation is the primary way that societies make material progress. This is because with a fixed set of technologies, there can be only so much improvement of the productivity of labor, and resources become ever scarcer as they are exploited in production. Innovations allow new techniques and resources to be exploited; successful innovations are those that bring about great changes in the way things are made, information is transmitted and managed, people are transported, and generally in how life is lived. Successful innovation offers the possibility of mega-prizes of great wealth, as well as the psychic gains of being one's own boss and of trying for the prize, which accrue even to those who do not win a mega-prize. These instrumental and intrinsic rewards make entrepreneurs the low cost innovators; they are people who are willing to take the risks of having their investment in time and materials go to waste if their innovation does not succeed either technically or commercially, in return for the possibility of enormous payoffs. More significantly, the innovator is likely to be in the best position to judge how good her idea is, and so a better judge of how much to invest in it.

Large firms and the possibility of mega-prizes can increase the possibilities

16. Some groups should not be considered for this rule of reciprocity. For example, if a group decides to designate a day as its weekly Sabbath, it ought not therefore have any consideration in the regulatory scheme. Purely voluntary groups that are not created by the economic system are ignored by the property rights regime; neither established nor impeded.

for innovation, and make its spirit contagious. As an example of this, William Baumol, Robert Litan, and Carl Schramm point to IBM computers, which, once they were introduced and made well known and available to a large number of consumers, created an ever-increasing market for computers.[17] This led to new firms like Apple and Dell that made innovations that enabled them to capture a larger and larger share of an increasing market for computers. While Apple competed with technical innovations in the capabilities and aesthetic appeal of the personal computer, Dell competed by its ability to customize the components of the computer to each consumer for a low price. The introduction of the iPhone, which in turn spawned many less expensive mobile smart phones, which has created seemingly endless demand for and supply of new apps is another example of this innovation contagion.

Capitalism should not aim simply to encourage the creation of big firms, however, since this could discourage innovation and create its own stability problems. Baumol, et. al. distinguish between what they call big firm capitalism, in which big firms dominate the economy, and entrepreneurial capitalism, in which new firms with innovative products are continually entering the market.[18] In big firm capitalism, firms tend to be large and to include research and development programs in house, ensuring that there are incremental, intentional improvements of their products from the perspective of the paying consumers. However, these firms introduce so-called principal-agent problems: the investors in the firms—the principals—have to rely on the advice of their agents, the managers of the firms, to make decisions on future research and investment. Yet what will be profit maximizing for individual managers may not maximize overall firm profits, which is the primary interest of the investors. Similar information problems arise for consumers, who have to rely on the promises of the firms about the future performance of durable goods. Firms have an incentive to build in a degree of planned obsolescence in such goods in order to assure future sales.

Capitalism should therefore make rules that permit large firms and incentivize innovation in terms of new products and lower cost production. Innovation inevitably leads to some firms' obsolescence, however. This is, as Schumpeter observed, the creative destructive power of capitalism.[19] The labor and capital that has been deployed in the manufacture of goods that are no longer wanted are freed up to be redeployed creating new goods that are wanted. When a corporation is destroyed, management, workers, and investors suffer losses. While such destruction is temporarily painful, with the proper regulation and social safety nets for retraining and redeploying displaced workers, it is to the long-term benefit of the whole economy. Corporate capitalism should also make

17. WILLIAM J. BAUMOL ET AL., GOOD CAPITALISM, BAD CAPITALISM, AND THE ECONOMICS OF GROWTH AND PROSPERITY (2007).

18. *Id.*

19. JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY (1975).

the demise of firms that no longer innovate and fulfil customers' needs possible to free up capital for new firms that offer more innovative, less expensive products.

However, corporate capitalism, as we know too well from the 2008 crisis, can lead to companies that are "too big to fail," or TBTF. That is, the failure of some corporations can lead to system-wide recession or depression. This can happen in different forms. A large industrial firm or several of them, like the auto industry, may, by going into bankruptcy or suspending production, unemploy thousands of workers, which makes them at least temporarily unable to make ends meet, pay their bills, buy their groceries, or pay their mortgages. When this happens to a large group in a community, other businesses that depend on these workers as their consumers will also become troubled and some may fail. Unemployment may spread, lowering the prices of goods, and further worsening the situation systemwide.

The financial crisis of 2008 was caused in part by the repeal of the Glass-Steagall Act, which allowed investment banks and commercial banks to be merged into very large banks.[20] The banks, which had been more conservative before they merged with the more risk-loving investment firms, then took aggressive risks on, and enticed with confusing, predatory terms, mortgage holders who would be very unlikely to be able to pay back their loans. The inability of massive numbers of mortgage holders to pay their mortgages led to an enormous devaluing of housing prices, which in turn led many of the mortgage holders to abandon their homes and mortgages, creating huge sums of "toxic assets" owned by financial firms that traded in mortgage backed securities. This led to the failure of some investment firms and banks, the personal financial ruin of millions of homeowners and small investors in banks, and a government expenditure of $245.2 billion to bail out banks and another $187.5 billion to bail out Fannie Mae and Freddie Mac,[21] government chartered enterprises that buy and sell mortgages and mortgage backed securities in the secondary market. Although the repeal of the Glass-Steagall Act seemed (to some) like a good way to stimulate innovation in the economy,[22] it turned out to be nearly disastrous for the economy by allowing the creation of financial firms that were TBTF.

Summarizing this section, then, I have argued that corporate capitalism as a form of property rights regime can be justified by appeal to mutual advantage. However, there are problems endemic to corporate capitalism that need to be

20. JOSEPH STIGLITZ, FREEFALL 15 (2010).

21. *Bailout Tracker*, PROPUBLICA http://projects.propublica.org/bailout/main/summary (last visited Nov. 18, 2012).

22. There were critics, however: Gary Stern, *Thoughts on Designing Credible Policies after Financial Modernization: Addressing too big to fail and moral hazard*, THE REGION: THE FED. RESERVE BANK OF MINNEAPOLIS, Sept. 2000, at 2–4, 24–29; Arthur E. Wilmarth, Jr., *The Expansion of State Bank Powers, the Federal Response, and the Case for Preserving the Dual Banking System*, 58 FORDHAM L. REV. 1133, 1155 (2001).

attended to and controlled by proper regulation and taxation. Corporations can become too large, which can discourage innovation, and they can become TBTF, which creates a hazard for the entire system. Furthermore, economic interest groups will be differentially affected by the taxation and regulation scheme that is chosen, and this can violate the principle of reciprocity for mutual advantage, unless individuals in those groups are compensated. The actual history of capitalism shows that economic disasters affecting all economic interest groups have occurred when very large corporations have suddenly failed, throwing the system into deep recession or depression.[23] Arguably, when such disasters loom, emergency measures must be taken to prevent the failure of these very large firms in order to prevent economic disaster system-wide. However, such emergency measures can themselves be harmful over the longer term and can destroy the mutually advantageous nature of the capitalist system.

III. ARE BAILOUTS JUSTIFIABLE?

In this section I will argue that if "bailing out" a corporation is necessary to preserve market stability (avoid mass unemployment, failure of financial system, large government loss of tax revenue), then it is to mutual advantage to do so under some conditions. By failure of a corporation, I mean bankruptcy of the Chapter 7-type, where the company's assets are sold off, some or all creditors are paid off, and the company is out of business.[24] These are the types of bankruptcy that bailouts are designed to prevent, because in the case of Chapter 7, both investors and workers lose all their interests in the firm. By systemic failure I mean widespread and serious losses of wealth across many economic interest groups and sectors of the economy. With the failure of a firm, investors lose their entire investment. Workers can contract with other firms for wages, but the loss of the employment opportunities with the bankrupt firm means that they lose their best opportunity, and since the loss of those jobs contributes to the number of workers seeking employment, wages will be reduced. Reductions in wages can have snowballing effects that lead to losses across other sectors of the economy: demand for consumer goods goes down, other firms may go bankrupt causing further loss in employment. Furthermore tax revenues are reduced and government may be tempted to reduce spending, which further reduces the demand for goods, and so on. Unemployed workers may be unable to pay their mortgages, which in turn may cause housing prices to fall. Mortgages that have been secured by higher housing prices then may

23. The Great Depression was preceded by the stock market crash of 1929 and the subsequent failure of many US firms and banks. Nick Taylor, *The Great Depression*, N.Y. TIMES, http://topics.nytimes.com/top/reference/timestopics/subjects/g/great_depression_1930s/index.html (last visited Mar. 21, 2013).

24. *Corporate Bankruptcy*, U.S. Sec. & Exch. Comm'n, http://www.sec.gov/investor/pubs/bankrupt.htm (last visited Mar. 21, 2013).

become underwater, causing mortgage holders in some cases to walk away from their homes. Banks with many unpaid mortgages have relatively worthless homes to foreclose on, which they cannot sell, other firms holding mortgage backed securities suffer losses, and so on. Thus, it is possible for the failure of firms to cause system-wide failure, which can be catastrophic.

Mutual advantage contractarianism is a fundamentally liberal theory in that each individual is taken to be the fundamental unit of moral concern. Each person counts as a veto player for the construction of moral and political principles. It is, however, a hypothetical consent theory, and persons are assumed to consent to what brings about for them the best consequences in terms of their subjective well-being. Thus, the consequences of institutional and policy choices for subjective well-being matter. Among the most important guarantors of individual well-being is a peaceful, secure economic system in which commercial activity can flourish, in which individuals can own personal property, obtain secure employment, invest in entrepreneurial enterprises, and run their households without hassles from creditors.

The experience of individuals during the Great Depression was among the most traumatic economic times in the history of American capitalism. This systemic failure was so catastrophic that government financial regulatory institutions such as the FDIC were developed to avoid future depressions. There is no perfect science of regulation, which would tell us how to optimally regulate in order to create the right set of and sizes of corporations without the possibility of growing TBTF, however. The advantages of having a property rights scheme that allows large corporations to form are great, as we have seen, but this raises the risk of having firms that are TBTF. Thus, government needs to have policies to limit the damages when regulations fail to protect the economy and the threat of a severe recession or depression becomes real. US government agencies can pursue bailouts according to their "systemic risk exception,"[25] which allows them to loan money to failing banks and securities, among other things, to keep the economy from suffering a severe recession or depression. Such conditions are the economic equivalent of the Hobbesian condition of war, in which no one is secure against financial failure. This fact justifies constructing regulations to avoid these conditions, but also drastic, exogenous action to curtail collapse as it is occurring.

Since system-wide failure is catastrophic and unacceptable to all, there must be some conditions under which bailouts are justified. However, bailouts create many epistemic, economic, political, and moral problems that need to be examined and addressed. While the epistemic problems of determining when bailouts are needed and how best to pursue them to forestall collapse are very significant, I concentrate primarily on the ethical and political issues in this paper. I see four main problems with corporate bailouts. First, bailouts, as a kind of insurance policy for corporate risk-taking, create the conditions for moral

25. SHEILA BAIR, BULL BY THE HORNS 75 (2012).

hazard. Second, they create the conditions under which rent-seeking and corruption is profitable. Third, bailouts tie-up government funds in failing companies rather than investing in other more productive activities. And fourth, bailouts redistribute wealth in the economy and therefore raise questions of fairness and justice. In light of these problems, the key question is this: is it to the mutual advantage of those in society to violate principles of private property ownership and limited intervention by government into corporations in order to stabilize an economy? Or is it rather mutually advantageous to preserve those principles regardless of specific consequences in order to preserve impartiality, fairness, predictability of government, and prevent moral hazard, corruption, and rent-seeking that is consequent on such intervention?

Pursuing a bailout creates the expectation for future bailouts if trouble should arise, and thus bailout policies act as a kind of free insurance program for very large firms. Simply by becoming so large that their failure is catastrophic for the economy, such firms incur the potential to be saved from bankruptcy by the government. Insurance creates the well-known problem of moral hazard, where the insured has reduced incentive to avoid the problem that is insured against, in this case, bankruptcy. Thus, banks will take larger risks than they would if their managers and shareholders had all their assets at risk; auto firms may invest less in innovative new designs. Such behavior brings negative externalities for the entire economy, in the form of added risk or reduced innovation. Moral hazards are controlled by ensuring that agents have more to lose by allowing the bad event to occur, that is, by ensuring that agents have some "skin in the game." For example, if the managers of companies lose their jobs if the company is bailed out, the managers would have greater incentives to avoid them. The shareholders should also be made to lose something if a bailout is necessary; at the very least their company should be made to pay back the full amount of the loan with interest. This gives the government a stake in the company as long as the loan is outstanding, and therefore also at least partial control.

When the government signals a willingness to pursue bailouts, it creates the conditions under which rent-seeking and corruption are profitable. Very large firms will seek both to reduce any regulations designed to prevent collapse by restricting the risks they can take, and to increase the willingness to bail them out in the event of near collapse. Thus, there will be wasted efforts on lobbying politicians for these things. Politicians are likely to hear much more from those in favor of bailouts than those against them. People against them have little to gain individually by expressing their opposition, and even less chance of persuading their elected representatives not to do them, so they ignore it; meanwhile those corporations or sectors that want to be bailed out have a lot at stake.[26] Furthermore, there will be an incentive to unduly influence politicians or regulators to hedge in these directions (against strict regulation, in favor of lenient bailouts). Perhaps then government should declare that it will not pursue

26. McGee, *supra* note 8.

bailouts? Such a pronouncement is unlikely to work because it is not a credible threat. When a firm is TBTF and already on the brink of systemic collapse, not bailing it out is too costly, and thus government is likely to jump in to save the system. Thus, bailout policies cannot be avoided; the best thing to do is therefore to craft a bailout policy that is as moral hazard-proof as possible, limits rent-seeking, and is as just as possible.

Corporate bailouts raise two kinds of distributive justice concerns. When the government spends its funds on bailouts, the funds cannot be spent on other projects, either by the government or the taxpayers, which other groups and individuals in the economy would prefer. For example, instead of saving the auto-industry the money could have been spent on creating a new industry in Detroit or reinvesting in the declining airplane industry in Wichita. These are the opportunity cost concerns. There are also redistributive concerns that tax dollars are taken from one group in society and paid out to another. For example, there may be other sectors of society that are also in crisis and need bailouts, such as the many working class individuals who held subprime mortgages in the 2008 crisis. As Robert McGee objects, "corporate bailouts . . . are a form of corporate welfare, a transfer of wealth from the lower and middle economic classes to the middle and upper economic classes."[27] This was particularly true in the bailouts of the banks in 2008 and the Savings and Loans in 1989, which saved the owners of banks from losing their assets rather than homeowners from losing their homes or large groups of employees from losing their jobs (as was the case in bailouts of the auto industry in 2009 and the airline industry in 2001).

The principle of reciprocity for mutual advantage requires that the policy be constructed so that all can be expected to obtain some benefit from the bailout policy. Although all benefit from economic stability brought about by the bailout, the wealthy gain more by preserving a system that already benefits them more. Thus, the benefit of stability alone may not be enough to compensate for the losses that less well off groups suffer. In addition to suffering from the moral hazard behavior of the bailed out firms and the opportunity costs of the taxes they have paid for the government bailouts, they also suffer from the costly preservation of the status quo that does not benefit them as much as it does the wealthy owners. Private citizens who have suffered significant losses from poor business practices that led to bailouts are owed some consideration if an alternative to saving the system would be to bail them out.

In order to benefit more of the economy through the multiplier effect of a government stimulus plan, bailouts should be filtered through consumers where possible. This will not only spread the benefits of the bailouts widely across the economy but will also limit the moral hazard problem. In the subprime mortgage crisis, this would mean using funds to restructure mortgages and perhaps pay down some of the accumulated debt. In the case of bailouts of manufactur-

27. *Id.* at 9.

ing industries, this could mean subsidizing purchases of the industry's product. This is not a perfect solution, but it addresses the redistribution concern, spreading out the benefit to at least more classes in the economy. It also limits moral hazard by not directly benefiting the companies that are failing and forcing them still to compete for consumers' business in order to survive. In this way bailout policies can limit the damage that they cause through their very existence, while acknowledging the need for a social insurance policy for capitalism against catastrophic collapse.

IV. INTERNATIONAL TRADE CONSIDERATIONS FOR BAILOUTS

One final consideration I want to briefly raise concerning the ethics of corporate bailouts has to do with fairness in international trade. Mutual advantage contractarianism should not be confined to a single national boundary, since international interactions provide the possibility of mutually advantageous interactions. Just as the property rights within the national system are defined by the enforcement, taxation and regulation schemes that structure ownership and trade, so property rights to things that may be traded internationally are structured by international treaties, guarantees, and agreements about restrictions on enforcement of property, subsidies, and trade barriers. Corporate bailouts constitute a subsidy to the corporation, and in some cases to an entire domestic industry. International trading partners may have legitimate grounds for restitution or retaliation if a company that competes with one of theirs is bailed-out by the US government.[28] However, just as a domestic economic system may be at risk by failure of a very large corporation, economic systems of other nations may also be put at risk by the failure of the US economy. Mutual advantage contractarianism thus could justify some bailouts, provided that they are necessary for economic stability and temporary. Something like the systemic risk exception would apply to the international case.

These international trade considerations give us even more reason to support bailouts that can be funnelled through consumers, since subsidies to consumption could lead to greater demand for imports. However, that also reveals a leakage in the consumer led bailout scheme: to the degree that imports substitute for domestic consumption, the injection of funds to consumers will not benefit the very companies that need bailouts. This is an important economic consideration in designing bailouts that will forestall a crisis in a mutually advantageous way.

CONCLUSION

In this paper I have argued that a capitalist property rights scheme in which large corporations can flourish contributes to the cooperative venture for mutual

28. CLAIRE BRUNEL & GARY HUFBAUER, PETERSON INST. FOR INTN'L ECON. POL'Y, POL'Y BRIEF 09-04, MONEY FOR THE AUTO INDUSTRY: CONSISTENT WITH WTO RULES (2009).

advantage, and hence is legitimate. However, such a scheme should also include regulations that prevent corporations from becoming so large that they stifle competition and innovation or pose a threat to the economy in the case of failure. Despite such a regulatory scheme, the existence of large corporations, particularly as we have seen, large financial and banking firms, will still pose the danger of systemic collapse, and thus a policy of corporate bailouts is needed to insure against such an outcome. Corporate bailouts can meet the contractarian legitimacy test, but only under certain conditions where system-wide recession or depression is at stake. Measures must be put in place to discourage rent-seeking on the part of the executives and owners of the corporations that are being bailed-out. Bailouts should be filtered through consumers, where possible, in order to spread the benefits of the bailouts widely across the economy. Finally, the bailout must be acceptable to global trading partners as an emergency measure to preserve the economy. The contractarian justification of bailouts requires reciprocity both within society and beyond, and demands sharing the benefits along with the costs of bailouts.