Subsidies: When Free Comes at a High Cost

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Few things are more popular than free stuff, and many politicians have built a career on handing out generous subsidies to preferred businesses and groups. This has been the case since the first cities in Mesopotamia, when a class of rulers and priests began to demand tribute and redistributed parts of it to the subjects.

Most people view a subsidy as a welcome gift from benevolent governments. But as Ludwig von Mises pointed out: "The government has no more ability than individuals to create something out of nothing. What the government spends more, the public spends less."

Every dollar spent by governments on subsidies is withdrawn from the public, either directly by raising taxes, or indirectly, by increasing government debt. As von Mises went on to say:

> "Public works are not accomplished by the miraculous power of a magic wand. They are paid for by funds taken away from the citizens. If the government had not interfered, the citizens would have employed them for the realization of profit-promising projects the realization of which they must omit because their means have been curtailed by the government. For every unprofitable project that is realized by the aid of the government there is a corresponding project the realization of which is neglected merely on account of the government's intervention.[1]

The problem is that this alternative use of resources is not seen, precisely because it stays unrealised, so the public only sees the effect of the subsidies and the jobs it creates, and not the ones that it destroys. Therefore it looks like the government has done something impressive.

People overlook that these gifts are paid for by themselves, via taxes, so their real effect is to distort the behavior and resource allocation that would have been the natural result on a free market.

The price system is the way to integrate all our dispersed knowledge and preferences into a system of signals that also function as an incentive to act on them. The effect of subsidies is to disturb the signaling function of the price system, by artificially reducing some prices and increasing others.

It distorts the market by penalizing the most efficient firms, to support the less efficient. Even if the subsidies are paid to a firm that would be efficient even without it this remains the case, since it is now encouraged to expand beyond the point that is economically efficient. This means that subsidies result in resources being used in more inefficient ways, so more subsidies means less wealth for society as a whole.

A traditional argument for government intervention is market failure. If the market miss long-term potential for a particular business model or technology, the government has to step in as a venture capitalist. But if it were obvious which

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[1] Ludwig von Mises, *Human action: A treatise on economics*. Chicago: Contemporary Books, 1966 (1949), p. 659

companies would be future winners, they would get plenty capital on the free market anyway. If it is not, why do we think that the government can do it? Of course it is easy to make the theoretical case that markets can miss potential, but the fact that an omniscient being could find those cases does not mean that Angela Merkel or Donald Trump would.

Giving public funds to particular projects is a way of replacing the knowledge, evaluations and market discipline supplied by millions of actors with the guesses of a small group of politicians and bureaucrats. It is a way of losing local knowledge that is necessary to employ the scarce means of production in accordance with the needs of consumers.

It also replaces the pressure from constantly changing consumer demand, with the pressure from politicians who have their own interests and from lobbyists who are more interested in benefiting their companies than the consumers.

As the Swedish economic historian Eli Heckscher pointed out: Either a company is viable, and then it needs no government support, or it is not viable, and then it deserves no government support.

How not to spend it

When the economist Josh Lerner sat down to write a book on how the government can support businesses he had to give it the title "Boulevard of Broken Dreams", since he found that it rarely works.

Governments rarely find profitable ventures that are neglected by the market, on the contrary they find the most popular firms – the ones that can provide them with the best headlines. They do not support those with the greatest potential, but those with the greatest clout and run the most in corridors of power. And the subsidies make them slower, since they are not exposed to market discipline any more.

Authorities poured money over IT companies when the dot-com bubble was at its biggest, when anyone with a website drowned in capital no matter what the government did. France burned money on the fatal idea of creating a Silicon Valley in Brittany, and so did many other countries. When it failed, everyone wanted to support biotechnology instead. 49 of the 50 states of the United States paid subsidies to get biotech companies to move there instead of to other states.

Malaysia's government tried to create an "Entertainment Village" to challenge Hollywood with the help of generous subsidies. When that failed, it tried to create a "Bio Valley" in the same place. It is now known as the "Valley of Bio-ghosts". And now of course, everybody wants to support green technology.

The American government's favorable loan of $580 million dollars to the now defunct California solar company Solyndra illustrates all the different distortions and unintended consequences that result from government attempts to pick winners.[2]

First of all, it replaces the taxpayer's preferences with the politicians', who want to be seen to do something in a popular industry. "While that is good for us, I can't imagine

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[2] The following description is based on Johan Norberg, *Power to the People*. Hermosa Beach: Sumner Books, 2015.

it’s a good way for the government to use taxpayer money,” as one of the investors in Solyndra put it privately at the time.

It also changes companies’ priorities in a destructive way, from making customers happy to making politicians happy, and they don’t restructure in the way that would be a healthy response to market demand. One board member claimed that the hopeless company founder survived in his position despite all his mistakes only because of his close relationship with the administration. Within a week of getting the first loan, Solyndra applied for another, worth $400 million. The always had their sights on Washington, not on the market.

Since the politicians and bureaucrats don’t risk their own money, they don’t devote the same time and energy to make sure that the investment pays off. One Management and Budget official complained that the Department of Energy’s loan process had “barely any review of materials submitted, no synthesis for program management and inherent conflicts in origination team members monitoring the deals they structured.”

Another temptation for picking winners is that politicians want to be seen doing something about problems. Just creating the right incentives and standing back might result in researchers and entrepreneurs coming up with better solutions, but it is not something for which politicians can take credit. If you have planned for something and subsidized something, you create particular jobs and photo-ops that wouldn’t have been there otherwise.

Documents show that the White House wanted bureaucrats to rush their decision to grant Solyndra the huge loan so it could be announced on Vice President Biden’s planned visit to California. As Biden put it when he announced the loan guarantee: “these jobs are going to be permanent jobs. These are the jobs of the future.”

Suddenly it is more about political appearance, than results. Before president Obama’s visit to Solyndra in May 2010, the administration asked an executive to lose the suit, another one to wear a hard hat and white smock and the workers to dress so that they created “the construction-worker feel.”

And later on, when Solyndra had to lay off workers, a Solyndra adviser noted that the White House “did push very hard for us to hold our announcement of the consolidation to employees and vendors to Nov. 3rd — oddly they didn’t give a reason for that date.” November 2nd was the midterm elections of 2010. The day after, Solyndra could announce that it would close its first factory, and that the jobs weren’t so permanent as the vice president has suggested.

The subsidies often become so important for businesses that they devote resources to lobbying for more preferences. Instead of using money to satisfy consumers’ needs, they are used to try to change politicians’ preferences. That a wealthy Democratic fundraiser (through his family foundation) owned a third of Solyndra is not necessarily the reason for the subsidy, but it probably didn’t hurt.

Even if none of these complicating circumstances had been present, even for a disinterested, rational, knowledgeable person, picking winners in the energy sector is at least as difficult as it is in other areas of the economy. It has often stuck us with the wrong solution at the cost of alternative solutions that could have worked better. “Government is a crappy venture capitalist” as Lawrence Summers, then Obama’s chief economic advisor, put it in relation to the Solyndra guarantee.

Shifting the goal post

Subsidies and the interest groups they build have a tendency to pervert any goal they might originally have had, from promoting a future technology into promoting a certain interest. Everybody knows that solar power has fantastic potential and with the right technology it might supply us with unlimited power, but does government subsidies help to realise that?

Instead of just generally supporting research and development, many European governments started supporting solar power companies. In ten years, Germany spent around 45 billion dollar on the relatively inefficient and expensive solar technology of the day. So the companies realised that they made money just by producing as many square meters of present model panels as possible in as short a time as possible – before the support dried up.

Instead of becoming super modern pioneers and innovators, as politicians had promised, they slashed research to get more people on the factory floor in the short run, to produce as much as possible that could give them subsidies. The share of the turnover spent on research and development fell to 2 to 3 percent, below engineering industry, and far below then innovative industries like telecom, where companies like Ericsson spent around 15 percent on research and development.

So these companies, with their relatively primitive technology didn't add anything unique. It meant that they were no match for Chinese companies that started large-scale production of similar panels, which reduced them in price substantially. Suddenly, the German companies that politicians wanted to be seen with, stumbled and began to fall, and they spent even more on lobbying to protect themselves from the Chinese.

This resulted in a dramatic turnaround from European governments. At first they said that they spent these billions of euros to create a green future, with better access to cheaper solar panels. Soon we got these cheaper panels – from China. Then, in 2013, the European Union responded by imposing 47 percent tariffs against Chinese panels, and delay the green transition. In the end, it was more important to protect the companies than to protect the climate.

Capitalism without bankruptcies

Many would say that you can avoid some of those problems by supporting every business in a particular industry, rather than picking and choosing, but in that case you only put the problem on a higher level. Then it gives particular support to a particular sector, to the disadvantage of all other sectors.

One example is the guarantees given to the financial industry, both by the monetary policy of central banks and the implicit promise of bailouts in case of trouble. This has given investors the impression that it's safe to hand money over to the biggest players, so they don't have to pay as much for their loans as other businesses.

This has also taught the major financial players to take hair-raising risks in the knowledge that they can privatize gains and socialize potential losses because they are far too big to fail. The dilemma is that they would never have grown that big if they had not had that safety net.

Present-day capitalism is sometimes attacked for being nothing but a "casino economy." But I know of no casino where the head of the central bank and the finance minister accompany customers to the roulette table, kindly offering to cover any losses. If there were such casinos, I am convinced that we would all be gambling much more, and much more wildly, than we do today. But that is how things are in our financial markets, especially now that government support and deposit insurance have become more extensive than ever before.

The problem is that we do *not* have a casino economy. To borrow a metaphor from child-rearing, we have a *helicopter economy*. Helicopter parents constantly hover over their kids, preventing them from falling and hurting themselves. This means that their children never grow up and learn to see dangers for themselves. And for this very reason, such children will eventually fall in more serious and dangerous contexts instead, because risk is part of the human condition.

The helicopter economy works in a similar way. The government hovers over banks and investors, making sure they do not get hurt too badly (and cleaning up any messes they leave behind). Whenever there is an accident, the benchmark rate is lowered, the central bank extends credit, and taxpayers' money is pumped in. The players never learn to look out for risks; they just continue their reckless behavior, and sooner or later they will fall off a ledge that they were not watching out for and pull us all down with them.

As has been pointed out repeatedly, capitalism without bankruptcy is like Christianity without hell – it loses its ability to motivate humans through their prudence and fears.

In all sectors there is a tendency for subsidies to support struggling incumbents. It keeps alive companies that would otherwise have failed, and the subsidies are often diverted to the companies that already has a long past, since they have political clout, and can easily convince politicians that jobs would be lost without them.

This is a serious problem for the economy as a whole, not just because the subsidies are taken from taxpayers who might have spent them on new and more value-creating companies instead, but also because it keeps labour and capital locked in, in old technologies and business models, rather than smoothly transferring them to more efficient uses, which is the creative destruction that creates continuous progress.

This creates a category of zombie firms, old firms that have persistent problems meeting their interest payments. A study from the OECD shows that a 3.5% rise in the share of such zombie firms in a country reduces labour productivity in that country by 1.2%.[3]

Be careful what you pay for

Subsidies in the form of welfare benefits have the same function, of replacing our preferences with the politician's preferences. Every single thing the government gives you has been paid for by yourself, but you only get it if you behave in the way the

[3] Müge Adalet McGowan, Dan Andrews and Valentine Millot, "The walking dead? Zombie firms and productivity performance in OECD countries". OECD, Economics Department Working Papers, No. 1372, 10 Jan 2017.

government prefers. For example, the Swedish government taxes and spends and to get back your own money, we must do what is expected. For example, as I learned when I got my first child, the government is very generous to families with children – of you adjust to its schedule.

We get a tax-funded family leave, and since the level of the benefit it is based on our most recent job, we learn to stay a bit longer on that well-paid job that we happen to hate. And the father should use three of those months, since it's earmarked for the father. The second child should come no later than 21 months after the first one, because then the mother can keep the benefits based on the last job without having another one inbetween. And in fact, the average time families take between the first and second child in Sweden has in an uncanny way been reduced exactly according to the way the benefit requirements have changed.

Then daycare for the kids is so heavily subsidized that it is an offer we can't refuse. If you stay home, or want another form of childcare you have to pay for the others' care, but you don't get anything yourself. If you have working times that do not fit the normal pattern daycare is closed, but you have to pay for it via the tax bill anyway.

Basically, you get what you pay for, which creates a terrible paradox at the heart of modern welfare states. We want to help people who face problems in their life, like unemployment or disability, and when we do by giving people in those circumstances generous subsidies, we in fact subsidize these conditions.

We penalize work and encourage staying away from it. Once again, Sweden is a case in point. In the early 2000s, Sweden had a very generous sick-leave benefit, where people could get up to 80 percent of their wage if they were off sick.

This undermined traditional attitudes to benefits in Sweden and people began to exploit the system. Fascinatingly, when there is a European or World Championship in Soccer, Swedes are "sick" 65 percent more often, compared to the same weeks when there is no championship. Until the rules were changed, Swedes – who objectively are one of the healthiest populations on the planet – were off sick from work more than any other population.

This is a serious problem in the west right now. Restructuring of the economy used to mean that people moved to new jobs and upgraded their skills, but this has slowed down dramatically. From the end of the Second World War through the 1980s, about 20 percent of Americans moved annually and 3 percent moved to another state. 2015, just 11.2 percent moved and just 1.5 percent to another state.

One reason is that people now receive more generous benefits if they stay behind, and many declining regions also receive bailouts. 57 percent of white American men who have dropped out of the workforce now get some sort of government disability benefit.

This is a way of subsidizing communities that do not function and where children grow up without seeing many adults work. As J. D. Vance notes in his celebrated work *Hillbilly Elegy*:

> "Growing up around a lot of single moms and dads and living in a place where most of your neighbors are poor really narrows the realm of possibilities. It means that you don't have people to show you by example what happens when

> you work hard and get an education."[4]

The motives for these policies are good, but unfortunately the subsidies result in retaining those who are the least able to adapt to market forces. The Iowa State University economists David Kraybill and Maureen Kilkenny points out:

> "It does no good to retain (or attract) people in places that are too costly for most businesses, which cannot sustain economic activity. That turns the place into a poverty trap."[5]

When the writer Ron Bailey visited his old Appalachian county McDowell, one of the poorest in the US, to understand why people don't move to places with more opportunity, the answer he got from social workers, drug abuse counselors and others was that "many folks in McDowell are being bribed by government handouts to stay put and to stay poor. Drug use is the result of the demoralization that follows."[6]

As the executive director of Families, Agencies, Children Enhancing Services, put it to Bailey when he asks why so many young unmarried women becomes pregnant early:

> "There are no consequences to pregnancy – they get immediate access to a medical card, food stamps, a check, WIC, and home visits"

Conclusion

To sum up: the biggest problem with subsidies is not what they cost, but what they *buy* – a change in behavior, investment and consumption, from what people would have done according to their own local knowledge, and according to the supply of and demand for the work they can contribute to, to what politicians are willing to pay for.

And often the result is an unwelcome surprise for the politicians as well, in business because they can't pick winners, and in people's behavior because there are unintended consequences when you start pulling apart the social fabric and the market's incentive structure.

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[4] J. D. Vance, *Hillbilly Elegy*, 2015, chap. 15.

[5] Maureen Kilkenny & David Kraybill, "Economic rationales for and against place-based policy." Rural Sociological Society, 2003. http://ruralsociology.org/annual-meeting/2003/proceedings.html

[6] Ronald Bailey, "Stuck", *Reason Magazine*, 10 December 2016.