Corporate Welfare Spending
vs. the Entrepreneurial Economy

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Mr. Chairman and members of the committee, thank you for the invitation to testify regarding corporate welfare, entrepreneurs, and economic growth. This testimony will address the problems caused by corporate welfare and discuss why spurring entrepreneurship is a better approach for generating economic growth.

Rising spending and huge deficits are pushing the nation toward an economic crisis. There is general agreement that policymakers need to find wasteful and damaging programs in the federal budget to terminate. One good place to find savings is spending on corporate welfare.

Some people claim that business subsidies are needed to help fix market failures in the economy. But corporate welfare is just as likely to create failures by misallocating resources and inducing businesses to spend time on lobbying rather than on making better products. Corporate welfare transfers wealth from average families to favored businesses, and it creates corrupting ties between government officials, politicians, and business leaders.

Policymakers are rightly concerned about the competitiveness of American businesses in the global economy. But the way to address that concern is not through subsidies, but through broad-based reforms such as permanent reductions to capital gains and corporate income tax rates.

The Taxpayer Cost of Corporate Welfare

A forthcoming Cato Institute study finds that federal business subsidies total almost $100 billion annually.[1] That is a fairly broad measure of subsidies to small businesses, large corporations, and industry organizations. The subsidies are handed out from programs in many federal departments including Agriculture, Commerce, Energy, and Housing and Urban Development.

However, there is no precise measure of "corporate welfare." As part of the national income accounts, the Bureau of Economic Analysis calculates that the federal government handed out $57 billion in business subsidies in 2010.[2] A 1995 Congressional Budget Office Study put the total at $30 billion in spending subsidies for businesses at that time.[3]

Ending business subsidies would be one step toward reducing the federal deficit, but there would be other benefits as well. The following sections discuss the unfairness of corporate welfare, how it harms the economy and generates corruption, and why entrepreneur-led growth is a better alternative.

Corporate Welfare Is Unfair

The Constitution empowers the federal government to take steps to ensure an open national economy. The Commerce Clause gives the government the authority to "regulate Commerce . . . among the several States," but the purpose was to remove barriers to trade, not to actively favor some businesses over other businesses and individuals.

People disagree on the meaning of "fairness," but surely it includes supporting the bedrock American value of equality under the law. The government's proper role should be that of a neutral referee in the economy facilitating the free exchange of goods and services. Yet corporate welfare advantages certain businesses at the expense of taxpayers, families, and other businesses, as some examples illustrate:

Farm Subsidies. Farm subsidies redistribute wealth from taxpayers to often well-off farm businesses and landowners. "Farm income stabilization" payments have recently fluctuated between about $13 billion and $33 billion annually.[4] This is a welfare hand-out like food stamps, yet it goes to higher-income households. In 2010, the average income of farm households was $84,400, or 25 percent above the $67,530 average of all U.S. households.[5] Moreover, the great bulk of farm subsidies go to the largest farms.[6]

Sugar Subsidies. The federal government also enriches certain businesses in an off-budget manner, as sugar subsidies illustrate. The government runs a Soviet-style system of price supports, quotas, and import barriers for sugar. The effect is to push up the domestic price of sugar to the benefit of U.S. sugar producers while imposing extra costs on consumers.[7] Artificially high sugar prices also hurt American businesses that use sugar, and numerous U.S. food companies have moved production to Canada and Mexico where sugar prices are lower.[8]

Economic Development. The government runs many so-called economic development programs that distribute corporate welfare. As one small example, the Community Development Block Grant program recently handed out $220,000 to a craft brewery in Michigan.[9] Meanwhile the Value Added Marketing program hands out money to selected wineries across the country.[10] These hand-outs are not fair to taxpayers or the breweries, wineries, and other businesses that don't receive such special favors.

Polls show that the public understands the unfairness of corporate welfare, and most people want it cut. Most people are against the federal government providing loan guarantees to small businesses; only 29 percent think that the government should help large corporations finance their export sales; and a plurality (46 percent) think farm subsidies should be abolished.[11] Polls have also found strong opposition to federal bailouts of financial institutions.[12]

Corporate Welfare Distorts the Economy

Some policymakers think that subsidies are needed to help U.S. businesses compete in the world economy. But the more we subsidize businesses, the more we weaken the market's profit-and-loss signals, and the more we undermine America's traditions of entrepreneurship and gutsy risk-taking by the private sector.

People argue that business subsidies are needed to fix market imperfections. But subsidies usually don't work as intended, and they often distort markets rather than fixing them. Robert Novak once said that "the mind-set underlying corporate welfare is that of the central planner," and yet we know that central planning does not work.[13]

Consider the energy industry, which Republicans and Democrats have been manipulating with subsidies for decades. An early subsidy effort was the Clinch River Breeder Reactor, which was an experimental nuclear fission power plant in Oak Ridge, Tennessee in the 1970s. This Republican-backed boondoggle cost taxpayers $1.7 billion and produced absolutely nothing in return.[14]

Then we had the Synthetic Fuels Corporation (SFC) approved by President Jimmy Carter in 1980, who called it a "keystone" of U.S. energy policy. The government sank $2 billion of taxpayer money into this scheme that funded coal gasification and other technologies before it was closed down as a failure. The SFC suffered from appalling mismanagement, huge cost overruns on its projects, political cronyism, and pork barrel politics in dishing out funding.[15]

Both parties have backed dubious "clean coal" projects for decades. The GAO found that many of these projects have "experienced delays, cost overruns, bankruptcies, and performance problems."[16] In a review of federal fossil fuel research, the Congressional Budget Office concluded: "Federal programs have had a long history of funding fossil-fuel technologies that, although interesting technically, had little chance of commercial implementation. As a result, much of the federal spending has not been productive."[17]

With the poor record of energy subsidies over the decades, it is no surprise that the Obama administration is having trouble with its green energy activities. The administration's failures keep piling up—Solyndra, Raser Technologies, Ecotality, Nevada Geothermal, Beacon Power, First Solar, Abound Solar, and Beacon Power.[18] These subsidy recipients have either gone bankrupt or appear to be headed in that direction.

Why don't business subsidies work very well? One reason is that political pressures undermine sound economic choices. The *Washington Post* found that "Obama's green-technology program was infused with politics at every level."[19] The decision to approve the Solyndra loan, for example, appears to have been rushed along by high-level politics.

Perhaps more importantly, subsidies change the behavior of businesses. An economist recently quipped to me: "I don't know whether the government is better at picking winners rather than losers, but I do know that losers are good at picking governments." When the government starts handing out money, businesses with weak ideas get in line because the businesses with the good ideas can get private funding. Enron, for example, was able to grab huge federal support for its disastrous foreign investment schemes.

At recent House hearings on green energy subsidies, most witnesses lined up in favor of Department of Energy loan programs, except for one witness who heads a solar power firm that does not receive federal subsidies.[20] James Nelson of Solar3D said that subsidizing green energy commercialization "is a wasteful mistake because it doesn't work."[21] Here are some of the problems he pointed to:

- *Firms that receive subsidies become spendthrift*. Nelson contrasted his firm's lean operations with Solyndra's wasteful ways, which included building a fancy factory in a high-cost location. Nelson noted that the "most powerful driver in our industry is the relentless reduction in cost." Yet government intervention rarely works to drive down costs in any activity.
- *Subsidies aren't driven by actual market demands*. Nelson noted that U.S. adoption of solar energy lags behind several other nations. But he said, "this should not bother us if it means that the other countries are investing in technology that is not economically viable." In other words, if other countries are misallocating resources, that won't hurt us. The good news, he said, is that America is the leader in market-driven private venture capital for "clean tech."
- *Subsidies distort business decisions*. Nelson noted that "giving companies money to set up manufacturing in the U.S. may doom them to failure by financing them into a strategically uncompetitive position." In other words, if subsidies induce U.S. firms to put more production in the United States than is efficient, it will disadvantage them in the marketplace.
- *Venture capitalists have already funded the best projects, leaving the dogs for the government*. If venture capitalists "reject a project, it is difficult to believe that the government could do a better job of picking a winner," argues Nelson.

The House hearing included testimony from green energy firms that had received subsidies. Their comments revealed how subsidies were eroding their focus on the bottom line. The firms stressed how many jobs they were creating and how their supplier chains covered many states—and thus many congressional districts. One solar firm bragged that it is "creating and maintaining jobs locally and across the nation," while it is "procur(ing) from a supply chain that stretches across 17 states."[22] Another solar firm bragged that it "spent more than $1 billion with U.S. suppliers in 35 states."[23]

Subsidy supporters at the hearing stressed the "nonfinancial objectives" of green subsidies, such as jobs.[24] But as Nelson noted, "businesses are not made more successful by more jobs."[25] If businesses want to succeed in tough global competition, they need to minimize their labor and supplier costs, and subsidies erode that lean focus. Nelson concluded that success in the marketplace "requires brains, discipline, and grit. It is rarely aided, and often impeded by government involvement."[26]

Another problem with business subsidies is that they can encourage investing in very dubious projects. That is the story of Enron's international investments, which played an important role in the implosion of the firm. By one estimate, Enron received $2.4 billion in federal aid through the Export-Import Bank and the Overseas Private Investment Company between 1992 and 2000.[27] Another study puts total federal government subsidies to Enron for its foreign schemes at $3.7 billion, plus Enron received subsidies from international agencies such as the World Bank.[28] All these subsidies made possible Enron's excessively risky foreign investments, which came crashing down at the same time that the firm's accounting frauds were being revealed.[29]

Suppose that the government was capable of channeling subsidies only to well-managed companies with sensible ideas. Then the subsidies wouldn't be needed because they would simply crowd out private investment. That seems to be the case with much of the $7 billion in subsidies for rural broadband in the 2009 stimulus bill, as one detailed study in 2011 found.[30]

Or consider the Department of Energy's Advanced Technology Vehicles Manufacturing Loan Program, which provides subsidies to companies to develop green cars. A former executive with Tesla Motors, which received subsidies, concluded that "private fundraising is complicated by investor expectations of government support."[31] Subsidies distort the venture capital market, having "a stifling effect on innovation, as private capital chases fewer deals and companies that do not have government backing have a harder time attracting private capital."[32]

A final problem with corporate welfare is that it can create broader distortions in the economy. For more than a century, the federal Bureau of Reclamation has subsidized irrigation in the 17 western states. About four-fifths of the water supplied by the bureau goes to farm businesses, and this water is greatly underpriced.[33] Because farmers are receiving water at a fraction of the market price, they are overconsuming it, which threatens to create water shortages in many areas in the West. Subsidized irrigation also causes environmental damage.

Corporate Welfare Generates Corruption

The creation of corporate welfare programs has spawned an expanding web of lobby groups that demand ever more favors from policymakers. The more that the government intervenes in the economy, the more lobbying activity is generated, and the more new subsidy programs get created. It's a vicious cycle.

Corporate welfare doesn't just create direct economic harm, it also erodes support for America's free enterprise system. Businesses that become hooked on subsidies become tools of the state. They lose their independence, and they may focus more on gaining special benefits from Washington than on making good products. The more special breaks that businesses receive, the less willing they are to speak out against the expansion of big government.

While some people think that corporations lobby to slash government, they mainly do the opposite. Businesses often lobby in favor of federal intervention if it will benefit them and hurt their competitors. The major airlines, for example, were against airline deregulation in the 1970s because existing rules protected them from competition.[34]

Business subsidy programs attract corruption like garbage dumps attracts rats, and that has always been the case in Washington. For example, federal subsidies for the first transcontinental railroad, the Union Pacific, led to the Credit Mobilier scandal of the 1870s, which involved payoffs to dozens of members of Congress. In recent decades, scandals stemming from corporate welfare have been a bipartisan problem, as these examples illustrate:

HUD Subsidies under Reagan. President Ronald Reagan's Department of Housing and Urban Development overflowed with corruption in the 1980s under Secretary Sam Pierce.[35] Pierce routinely dished out grants, loans, and other sorts of subsidies to friends and business associates. And HUD created programs that involved large subsidies to mortgage lenders, developers, and other businesses, with Republican Party contributors as frequent beneficiaries.

Commerce Subsidies under Clinton. President Bill Clinton's Commerce Secretary, Ron Brown, used federal business subsidies as a fund-raising tool for the Democratic Party in the 1990s. Corporate executives who played the game were given access to export promotion trips and loans from OPIC.[36] In subsequent investigations, U.S. District Judge Royce Lamberth found that Commerce officials concealed and destroyed documents relating to the scandal, and he compared the officials to "con artists" and "scofflaws.[37]

Enron Subsidies under Clinton and Bush. Enron Corporation is a poster child for the harm of business subsidies, particularly with regard to its disastrous foreign investments. Enron lobbied government officials to expand export subsidy programs, and it received billions of dollars in aid for its foreign projects from the Ex-Im Bank, OPIC, the U.S. Trade and Development Agency, the U.S. Maritime Administration, the Commerce Department, and the U.S.-backed World Bank. As noted, Enron received about $3.7 billion in financing through federal government agencies.[38] These subsidies induced Enron to make exceptionally risky foreign investments, and the resulting losses were an important factor in the company's implosion.[39]

During the Clinton and early Bush administrations, high-level officials went to great lengths to aid Enron on an Indian power plant deal.[40] The *Washington Post* noted, "President Bush's National Security Council led a 'working group' with officials from various Cabinet agencies to resolve Enron's troubles over a power plant venture."[41] We saw similar high-level involvement in the failed Solyndra investment by the Obama administration. Top government officials should be spending their time on policies in the general interest of all Americans, not on helping individual companies earn higher profits.

Green Subsidies under Obama. The *Washington Post* found, "Obama's green-technology program was infused with politics at every level."[42] The $535 million loan guarantee for Solyndra, is a prime example. The DOE approved the loan after receiving pressure from White House officials to move ahead so that the vice president could announce it at a groundbreaking for the company's factory.[43] President Obama visited Solyndra and called the firm an "engine of economic growth" just months before it collapsed.[44]

President Obama's green energy programs illustrate how corporate welfare creates corrupting relationships between businesses and politicians. The *Washington Post* found that "$3.9 billion in federal [energy] grants and financing flowed to 21 companies backed by firms with connections to five Obama administration staffers and advisers."[45] It also noted that the "main players in the Solyndra saga were interconnected in many ways, as investors enjoyed access to the White House and the Energy Department."[46] According to the *New York Times,* Solyndra "spent nearly $1.8 million on Washington lobbyists, employing six firms with ties to members of Congress and officials of the Obama White House."[47]

American businesses, of course, have a right to lobby the federal government. But given that reality, Congress throws fuel onto the corruption fire by creating business subsidy programs. When subsidy money flows out the door from Washington to businesses at the same time that money flows back from businesses to Washington for lobbying, it's no surprise that we get influence-peddling. Corporate welfare undermines honest and transparent governance, and Americans are sick and tired of the inevitable scandals.

Long-Term Growth Depends on Entrepreneurs

Most of America's technological and industrial advances have come from innovative private businesses in competitive markets. Indeed, it is probably true that most of our long-term economic growth has come not from existing large corporations or governments, but from entrepreneurs creating new businesses and pioneering new industries. Such entrepreneurs have often had to overcome barriers put in place by dominant businesses and governments.

Economic historians Nathan Rosenberg and L.E. Birdzell found that "new enterprises, specializing in new technologies, were instrumental in the introduction of electricity, the internal-combustion engine, automobiles, aircraft, electronics, aluminum, petroleum, plastic materials, and many other advances."[48] We can update that list to include cell phones, personal computers, biotechnology, and all kinds of Internet businesses.

If policymakers want to get U.S. economic growth back on track, they should put entrepreneurs front-and-center in their thinking about policy. Here are some of the ways that entrepreneurs generate growth:

Entrepreneurs are Radical Innovators. Their advances are usually unexpected and disruptive to existing businesses.[49] Personal computers were pioneered in the 1970s by new companies such as Apple. The opportunity was missed both by leading computer firms and by government planning agencies such as Japan's MITI.[50] Big corporations were focused on mini and mainframe computers, while the U.S. government was subsidizing supercomputers. Governments and big companies often overlook niche products that later become revolutionary. In the 1970s, microcomputers were an obscure hobbyist activity, and software for microcomputers—which Bill Gates helped pioneer—was a niche within a niche. The small-scale innovations of entrepreneurs in niches often create huge, unforeseen changes.

Entrepreneurs Generate Competition. Another crucial role of entrepreneurs is that they challenge dominant firms and governments. One great story is the rise of MCI Corporation in the 1970s and 1980s. MCI helped destroy the AT&T monopoly, which paved the way for the modern telecommunications revolution. Another innovator was Fred Smith of Federal Express. Today we take overnight letter delivery for granted, but it was Smith who battled federal regulatory roadblocks in the 1970s and provided new competition for the U.S. Postal Service by proving that there was an untapped demand for rapid delivery.

Entrepreneurs Turn Inventions into Innovations. America's long-run growth is often portrayed as a steady process of accumulating new *inventions*. Many people seem to think that the government can simply pump money into research and the economy will grow. But that "science push" theory of growth is incorrect. Economies grow because of *innovations*, which are inventions that are packaged and tested in the marketplace by entrepreneurs.

The modern economy is steeped in uncertainty. No one can predict the future, not even the best scientists, engineers, and economists in big companies and the government. Many experts have made hugely off-base prognostications about the economy.[51] Two decades ago, many pundits and policymakers were convinced that Japan was taking over the global economy. Professor and pundit Robert Reich thought that "chronic entrepreneurialism" was undermining the U.S. economy. And past predictions about the computer industry have been laughable, such as this comment in 1977 by the founder of Digital Equipment Corporation: "There is no reason for any individual to have a computer in his home."

Luckily, expert predictions don't drive the economy. Rather, successful market economies work by having swarms of entrepreneurs freely testing new ideas. Entrepreneurs are the economy's guinea pigs. They have the guts to act in the face of uncertainty, and they learn from their mistakes and keep trying until they find ideas that work and generate profits.

By contrast, government plans to stimulate the economy are often based on ideologies and rigid ideas. Some policymakers believe that particular energy technologies are THE solution to America's problems, and they support ongoing subsidies year after year regardless of marketplace realities. By contrast, in competitive and unsubsidized markets, mistakes are usually quickly exposed and businesses cut their losses short and change direction.

It appears that the unexpected fall in solar panel prices helped to sink Solyndra. Perhaps businesses that are tethered to governments are slower to make the changes needed to survive. The government tends to work at a turtle's pace, which doesn't sync well with the fast-paced modern economy. We saw a comparison of the government turtle with the private-sector gazelle during the first sequencing of the human genome in the late 1990s. The government's lavishly funded Human Genome Project was a lengthy multi-year research project, but it was upstaged when entrepreneur Craig Venter launched Celera Genomics to complete the job at a fraction of the time and cost.

What are the policy lessons from America's great entrepreneurial history? One lesson is that because markets have high levels of uncertainty, government agencies and dominant companies cannot be relied upon to secure our economic future. Instead, we should remove hurdles to entrepreneurship every way we can—by tax reforms, by repealing barriers to entry into industries, and by reducing financial industry barriers to private risk financing.

While it has become fashionable to criticize Wall Street, the financial industry has been crucial to funding waves of innovation in the U.S. economy. Risk capital was integral to the railroad and telegraph booms of the 1800s, and the radio, electricity, and automobile booms of the early 20th century. J.P. Morgan Chase has garnered negative headlines in recent weeks, but J.P. Morgan was the company that provided seed capital for Thomas Edison's Edison Electric Illuminating Company, which became General Electric.[52]

In recent decades, high-yield bonds, venture capital, and angel investment have played key roles in growing new industries. Today, U.S. venture capital and angel investors pump more than $50 billion annually into young companies.[53] Tax policy influences investment flows, and funding for high-growth ventures is affected by the tax treatment of capital gains in particular. One step for policymakers would be to create investment certainty by permanently extending the 15 percent federal capital gains tax rate. Also, the corporate tax rate should be cut to spur greater capital investment—new capital equipment usually embodies technological advances.

Policymakers should put aside the idea that some sort of big intervention can permanently "win the race" for some particular goal, such as energy independence, solar power dominance, or beating China. In the recent House testimony, an energy consultant said, "clean energy has been targeted by our major international competitors (including China and Germany) as a critical, and perhaps the critical, future growth and export industry … whether the U.S. wins or loses in this race matters because the outcome will have a large impact on future U.S. employment and economic strength."[54]At the same hearing, a solar company executive said that America could "win in the long run" with a particular solar technology.[55]

However, those sorts of prognostications are refuted by U.S. economic history. There is never any final "win" in the marketplace. Look at how leadership in cell phones and smart phones has shifted from firm to firm and country to country, from Nokia, to RIM Blackberry, to Apple and others. Technologies and markets are always changing, so the only way for America to permanently "win" in the struggle for economic growth is to have the best climate for investing, innovating, and building entrepreneurial companies.

We've mainly focused on subsidies to new industries such as green energy. But withdrawing corporate welfare from older, established industries could spur innovation as well. Consider farm subsidies. New Zealand ended virtually all its farm subsidies in 1984, which was a bold stroke because that country is much more dependent on farming than is the United States. The changes were initially resisted, but New Zealand farm productivity, profitability, and output have soared since the reforms.[56] Faced with new financial realities, New Zealand's farmers innovated—they cut costs, diversified their land use, sought nonfarm income, and developed new markets.

Thus rather than looking for new ways to subsidize businesses, policymakers should be looking for places to withdraw subsidies and deregulate in order to spur innovation. For example, just as the break-up of the AT&T monopoly in the 1980s helped to generate growth in the telecommunications industry, ending the U.S. Postal Service monopoly today would spur innovation in that industry. Europe is moving in that direction, with Germany and the Netherlands already privatizing their postal systems.[57]

The transportation sector is another area where innovation could be spurred by the reduction of federal subsidies. For example, Amtrak is doomed to inefficiency as a government-run business pumped full of subsidies and shackled with regulations. It should be privatized.[58] Other countries are ahead of the United States in privatizing transportation infrastructure, or at least in bringing private investment into infrastructure.[59]

The United States subsidizes its air traffic control system, but it doesn't need to. Canada privatized its air traffic control system in 1996, and it operates as a self-funded nonprofit corporation. It has been a big success.[60] Another ripe area to cut subsidies and bring the private sector in is space flight. The recent success of the SpaceX flight and the 2004 success of SpaceShipOne indicate that the private sector is entirely capable of bold and risky technological ventures.

To sum up, the way to spur economic growth is not through business subsidies, but through breaking down barriers to entrepreneurs. Let's give entrepreneurs a crack at postal services, air traffic control, passenger trains, and other monopoly industries. Let's pursue tax and regulatory reforms to maximize the flow of financing to new and growing businesses. And let's stop demonizing entrepreneurs who succeed and the financial system that allows them to grow. If we want to exorcize some demons, we should end the corporate welfare system that is corrupting our government and the American economy.

Thank you for holding these important hearings.

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[54] Gregory Kats, Capital E, testimony to the House Committee on Oversight and Government Reform, Subcommittee on Regulatory Affairs, Stimulus Oversight, and Government Spending, May 16, 2012.
[55] Craig Witsoe, Abound Solar, testimony to the House Committee on Oversight and Government Reform, Subcommittee on Regulatory Affairs, Stimulus Oversight, and Government Spending, May 16, 2012.
[56] Vaudine England, "Shorn of Subsidies, New Zealand Farmers Thrive," *International Herald Tribune*, July 2, 2005.
[57] www.downsizinggovernment.org/usps.
[58] www.downsizinggovernment.org/transportation/amtrak/privatize.
[59] Chris Edwards, "Federal Infrastructure Investment," testimony to the Joint Economic Committee, November 16, 2011.
[60] www.downsizinggovernment.org/transportation/airports-atc.