

Market Perspectives

Working Paper: Subsidies limit our future.

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Introduction

Subsidies are payments from government to businesses for which the government receives no goods or services in return. Subsidies are typically used to support a specific group or industry that is perceived to need assistance. The form can be a fixed payment for every unit of something sold, a reduced tax rate, or some other form of support.

Often called “corporate welfare,” subsidies waste over \$100 billion of taxpayer money each year in the U.S. and carry a much higher opportunity cost to society. They distort essential market signals (prices, profits and losses), disrupt the discovery process, and limit our future by preventing the emergence of unforeseen products, services and solutions that might be more beneficial.

A subsidy is an attempt at picking a winner – what “should” happen. It reveals a central-planning approach to life that assumes one *can* know what should happen – what product, service or solution *should* result.

Subsidies hurt consumers, place industry rivals without political connections at a competitive disadvantage, foster corruption and result in many unintended consequences – all while depleting the private sector of strength. The greater the prevalence of subsidies, the more energy devoted to political rather than economic profit.

Some examples of subsidies

During the dust bowl of the 1930’s when agricultural families accounted for about 30% of the US population, Congress enacted price support programs for wheat, corn and other grains to help these families through some hard times. These price supports constitute a subsidy.

Although dust bowl conditions have long since ended and the percentage of the population that farms is now less than 5%, the U.S. Dept. of Agriculture continues to subsidize farms – the majority of which are highly mechanized – for crops such as corn, wheat, barley, oats, sorghum, cotton and rice in the form of a guaranteed price per unit (typically a bushel). The program has expanded to include Christmas trees and tropical fish.

If the farmer sells for above the guaranteed price, the USDA pays nothing. If he sells for below the guaranteed price, the USDA makes up the difference – called a “deficiency payment.” On average deficiency payments total about \$10 billion per year overall.

As you might imagine, guaranteed prices encourage farmers to produce as much as they possibly can, which creates oversupply and drives prices below the USDA guaranteed price – insuring a continued large transfer of wealth from taxpayers to these crop producers. It might shock you to discover that the USDA attempts to make up for this oversupply by subsidizing farmers to keep portions of their land idle.

The Conservation Reserve Program pays rent to farmers on land they keep idle for 10 years. The USDA web site states that as of October 2004 approximately 34 million acres are being “rented” from farmers at a cost of about \$1.6 billion. To give you some perspective – that’s roughly the equivalent of renting the state of Iowa. Thousands of “absentee farmers” who live in big cities receive millions in rent subsidies from the USDA.

There are rather negative consequences with this central planning approach. Among them: the waste of taxpayer money, fallowing land that has other potentially more productive uses, unnecessary surpluses, and politically motivated wealth transfers. Whether in agriculture, energy, transportation, banking – or any other industry of our economy – subsidy programs are insidious and costly. To drive this point a little deeper, let's consider another example.

The ethanol subsidy

Ethanol is a product made from corn (U.S.), sugar (Brazil) and other organic materials. You probably know it as distilled grain alcohol. It can be used to create liquors like gin and vodka or it can be blended with various amounts of gasoline to create "gasohol," which is a substitute for gasoline.

Ethanol has been controversial – as liquor or fuel – for centuries. In 1794, Pennsylvania farmers rioted in response to taxes on alcohol (which you might remember as the "Whisky Rebellion"). Passions regarding ethanol are just as strong today. Most people are not aware that the ethanol industry – and by extension, corn production – is subsidized by the US taxpayer.

Even those aware of the subsidy are often surprised to learn it is as much as .50 to 1.00 dollar per gallon depending on any additional state tax and production incentives beyond the federal excise tax and production incentives. Historically, it has amounted to a subsidy of about \$1 billion per year. In more recent years it's been closer to \$2 billion and going forward it will likely be between \$2 and \$4 billion (depending on production levels).

Ethanol is also supported in some locations by compelling its use as an oxygenate additive under the Clean Air Act. Oxygenates make gasoline burn cleaner (another chemical that competes with ethanol for this purpose is MTBE).

To prevent subsidization of non-U.S. producers, Congress enacted a tariff on imported ethanol that effectively eliminates the benefit to a foreign competitor, such as Brazil, the world's largest ethanol producer.

Is gasohol better than gasoline?

Ethanol subsidies were ostensibly created in the 1970's to encourage (1) investment in new markets for corn (to increase demand and drive prices above guaranteed subsidy levels); (2) improve the environment (through an alternative, cleaner burning fuel); (3) decrease dependence on gasoline and foreign oil.

So, is ethanol good or bad? It depends. On the positive side, it's non-toxic and its supply is renewable (you can always grow more corn or sugar cane). It is also an octane booster. But there are downsides: it has 20% less energy (BTU's or British Thermal Units) than the equivalent volume of gasoline. A gallon of gasoline and a gallon of gasoline mixed with 10% ethanol are not equivalent products – the ethanol product gets around 3-5% fewer miles to the gallon and blending ethanol into gasoline makes it difficult to meet vapor pressure specifications, especially in the summer.

There is also a controversy regarding ethanol's overall contribution to efficiency and the environment. Many scientists (such as Dr. Pimentel at Cornell University) argue that it takes 29% more energy to make ethanol than it eventually produces. Other scientists disagree and the USDA surprisingly states that corn-ethanol yields 34% more energy than it takes to produce it.

The Government Accounting Office reports that: (1) ethanol reduces gasoline consumption in the US by less than 1%; (2) if ethanol were no longer used as an oxygenate carbon dioxide emissions would increase slightly, but ozone depletion precursors would decrease; (3) its contribution to global warming – positive or negative – is minimal.

So what's your point?

The point is this: whether or not ethanol is a “good” gasoline blending component or outright substitute is still up for grabs. Like all fuels, it has complex and overlapping environmental, social, and economic questions. The only way to fundamentally determine if all the benefits outweigh all the costs is to allow the scientific discovery (peer review research / challenge process) and market processes to work free of governmental mandates and subsidies.

Using a political process to choose among these tradeoffs will favor a small group of people who stand to gain large concentrated benefits while the costs are dispersed across a much larger population. Each person's incremental cost is so small that their opportunity cost of fighting it is much too high versus any alternative use of their time and energy. Sometimes the cost to any given individual amounts to less than the postage stamp required to send a letter to their senator.

This feature of a political process creates some rather perverse incentives. Ethanol and corn producers have a lot of good reasons to pour their money and time into influencing government to provide a subsidy – the rest of us, individually, don't have much reason to get all worked up about it and try to stop them. This hardly drives us to resolution regarding its economic competitiveness versus alternative fuels.

If you try to predict the future, you're almost certainly going to be wrong.

Choosing a technology today as the solution for tomorrow's needs has at least two big problems: first, you don't know the problems you'll be facing until you are there and facing them. Second, you don't know what technological alternatives will be available at that point in time.

In this sense, by attempting to forecast the right alternative fuel technology to invest in on a wholesale level – rather than allowing multiple diverse experiments whose risks are born by entrepreneurs within a market process – we are limiting our future by closing off a lot of potential options we don't even know will exist.

The transfer of taxpayer-financed investment to an industry (chosen by political influence) by the fiat of government officials means we all invest in ethanol whether we want to or not. And those dollars we pay as taxes that go to that effort are not put towards uses we might have determined more valuable to us individually.

Doesn't Koch benefits from subsidies, too?

Koch Industries always strives to create long-term value by the economic means. Nevertheless, we also benefit from political profit due to existing tax credits and subsidies – and are very engaged in the political process. How can this be consistent with our vision and principles?

The tax code and regulatory framework is full of subsidies and other politically motivated incentives. On a practical level, we would have to go out of business if we chose not to participate in markets where these are present. We also have a responsibility to our shareholders to minimize the tax burden by taking advantage of all legitimate means available, acting lawfully, with integrity and in full compliance with all applicable regulations.

We utilize the political process in an attempt to *remove* unnecessary taxes and regulations that prevent us from creating value for customers and the communities we live in – and this often benefits our competitors as well. We continue to lobby for fundamental reform to the tax system in the hopes of eliminating costly complexity and market-distorting subsidies, credits and other forms of “corporate welfare.”

We do *not* lobby for subsidies or attempt to create political barriers to competition. We do *not* build business models around such things. Our focus is on *creating real, long-term value* for our customers in the hopes that we will be rewarded by being allowed to retain a portion of that value for ourselves as profit.

Participating in markets where political incentives exist and our earnest attempt to keep more of our hard-earned money is consistent with our philosophy, vision and principles. We believe taxpayers – corporate *and* individual – have the right to keep more of their own money. That is not a subsidy.

Conclusion

Government steps outside its role when it attempts to pick winners and losers in the marketplace. This destroys wealth and creates unforeseen consequences. As economists like to say, there's no such thing as a free lunch. Money transferred by a political process to one chosen use is money that cannot be utilized by the market for other unforeseen, but likely more profitable uses.

In the case of ethanol subsidies, one set of producers is arbitrarily rewarded at the cost of taking resources away from all other possible producers – removing capital and incentives to invest in finding possibly better alternative fuels (or to continue finding more efficient ways to extract, deliver and utilize existing fuels). This is the nature of subsidies.

The choosing of winners and losers in the marketplace is best left to consumers, who are brutally honest in their spending patterns. This aligns the incentives of all market participants to do the right things for our current and future needs. The U.S. government would do far less harm and much more good by focusing its efforts on eliminating all subsidies for all industries and allowing the free market process to work.

Products and technologies with economic merit need no subsidies. It is entrepreneurial effort and risk coupled with the evolutionary, experimental processes of the free market that transforms economic ducklings into market swans – not public subsidies.

Talking Points, Thoughts for Discussion

- Economists are unanimous in the view that arbitrary tax policy, which plays favorites, has a substantial negative drag on any economy. In the last three decades, U.S. tax policy has become a jumbled maze of subsidies, incentives, and loopholes. Through the tax code, government promotes industrial policy that rewards the inefficient and penalizes the efficient. During substantial periods, it has put real-estate investment at an advantage over investments in corporate equities. You would think businesses would lobby passionately to fight such policies. In fact, the historical record from the 60's shows that not only didn't they fight it, *the were some of the biggest proponents!* Why do you think this is the case?
- What about subsidies inside the firm? Can you think of any examples? What are the tradeoffs?
- Sometimes corporate support functions are effectively “subsidized” when their true cost to provide service is not born by the consuming customer. How does this happen? What kinds of behavior does it drive?
- Once subsidies are granted, taking them away is difficult if not impossible – why?

Connection to Key MBM Mental Models and Guiding Principles

- Challenge Process
- Comparative Advantage
- Consequences of Regulation, Controls and Budgets
- Discovery
- Economic v. Political Profit
- Entrepreneurship

- Incentives
- Role of Prices, Profits and Losses
- Value Creation
- Subjective Value
- Opportunity Cost

Suggested Reading

Economics in One Lesson by Henry Hazlitt;

Basic Economics: A Citizen's Guide to the Economy by Thomas Sowell

The Suicidal Corporation: How Big Business Fails America by Paul H. Weaver