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TESTIMONY

SUBSIDIES ARE THE PROBLEM, NOT THE SOLUTION, FOR INNOVATION IN ENERGY

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Good afternoon Chairman Weber, Ranking Member Grayson, and members of the subcommittee. Thank you for inviting me here to discuss the Department of Energy's energy efficiency and renewable energy programs. I appreciate the opportunity to testify.

My name is Veronique de Rugy, and I am a senior research fellow at the Mercatus Center at George Mason University, where my primary research interests include the US economy, the federal budget, federal programs, and tax policy.

The Obama administration's FY 2016 budget asks for a 42 percent increase in funding for the Department of Energy's Office of Energy Efficiency and Renewable Energy (EERE) and its portfolio of programs. Yet more than 40 years after President Richard Nixon announced "Project Independence"—to wishfully wean the American economy off oil and decades of federal involvement in efforts to develop "alternative" energies—we are once again discussing how many more taxpayer dollars should be thrown at the alternative energy wall in the hopes that something will finally stick.

Far from suggesting that alternative energies aren't welcome or desirable, I believe that it's time for policymakers to recognize that allowing the marketplace to determine winners and losers is preferable to a politicized, top-down approach that has produced more black eyes than benefits.

These black eyes belong to both parties and extend well beyond Solyndra and the ill-fated 1705 energy loan program, which has become a symbol of the problems with federal involvement in energy markets. Indeed, a short list of the federal missteps over the years would include so-called clean coal, the Synthetic Fuels Corporation, the Clinch River Breeder Reactor, National Ignition Facility, Superconducting Super Collider,

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FutureGen, Partnership for a New Generation of Vehicles, FreedomCAR, and the Yucca Mountain nuclear waste repository mess.[1]

I would argue that the most important consideration today should not be whether the Obama administration wishes to spend too much on EERE programs. (It does.) Nor should it be to figure out which special-interest squeaky wheels should get the most grease. What I believe we should be discussing is whether these subsidy programs should exist at all. I would argue that EERE programs should be abolished, along with all other energy subsidies—including those that benefit fossil-fuel production—because

1) government lacks the incentives to manage funds that private investors have;

2) giving subsidies to some businesses puts other businesses that do not receive such subsidies at a disadvantage, distorting investment and other economic activity; and

3) the existence of government subsidies increases the incentive to lobby and the power of special interests.

GOVERNMENT LACKS THE PROPER INCENTIVES

Even with the best of intentions, elected officials and bureaucrats simply do not possess the proper incentives to manage taxpayers' money prudently. They are not rewarded when they maximize consumer value; nor are they punished when they take unnecessary risks or fail to minimize costs. Government actors operate with limited knowledge. While individuals acting in markets are able to use price signals to guide their decisions. When a private company fails, the owners and its investors lose. Government decision makers have no such guide. They have no way of accounting for the value or costs of their decisions. And when the government fails, taxpayers lose.

Subsidies are justified as being necessary to encourage the development of alternative energies because the private sector is unwilling to undertake the risk necessary for their development. The truth is that private investors *should* avoid throwing scarce dollars at endeavors that do not make economic sense. Instances where the private sector will not invest signal that it would also be a bad idea for taxpayers to "invest."

Policymakers who believe that entrepreneurs and venture capitalists are investing insufficiently in new technologies should focus their efforts on reducing the federal tax burden on businesses and investment rather than attempting to subsidize specific firms, industries, or technologies. Lowering the tax burden is more likely to result in higher economic growth, innovation, and job creation—the same canned justification that policymakers often fall back on to justify subsidy programs.

It is amazing that many of the policymakers who believe that the private sector needs the government to fill this mythical investment gap are the same ones who want to further tax the rewards of investment, and support sending the money to agencies like EERE that fund the research and development of commercial products. Advanced research and development subsidies are a form of corporate welfare because the rewards end up going to private interests while the costs are borne by taxpayers. This cycle of "tax and subsidize" is just another example of the government robbing Peter to pay Paul. Policymakers like to tout Paul's "success stories" when defending energy subsidies, but somehow Peter escapes acknowledgement.

1. See Chris Edwards, "Energy Subsidies" (Downsizing the Federal Government, Cato Institute, Washington, DC, February 2009), http://www.downsizinggovernment.org/energy/energy-subsidies.

SUBSIDIES DISTORT ECONOMIC ACTIVITY

Policymakers justify energy subsidies by arguing that they are needed to fix alleged imperfections in the marketplace. The imperfections, however, are typically short-term issues (e.g., oil price spikes) that the marketplace will address—if allowed. Policymakers often rush to address short-term concerns with government interventions, including subsidies, which end up distorting economic activity and generating failures of their own.[2] The problem is compounded by the reality that policymakers usually have political and parochial interests in mind when creating and sustaining subsidy programs. When government intervenes,

1) subsidized firms get an unfair competitive advantage over firms that do not receive a government subsidy, and

2) policymakers, instead of the market, pick winners and losers.

Unseen Losses of Unsubsidized Competitors

By aiding particular businesses and industries, subsidies put other businesses and industries at a disadvantage. This market distortion generates losses to the economy that are not easily seen and thus generally aren't considered by policymakers. For example, energy companies that don't receive a government subsidy are disadvantaged when they compete against companies that do receive government backing. A company or entrepreneur with a superior product or technology might never reach the market because they didn't have access to government handouts. The result is a diversion of resources from businesses preferred by the market to those preferred by policymakers, which leads to losses for the overall economy.

The Cost of Policymakers Picking Winners and Losers

When the government starts choosing industries and technologies to subsidize, it often makes bad decisions at taxpayer expense, because policymakers possess no special knowledge that allows them to allocate capital more efficiently than markets. Businesses and venture capital firms make many mistakes as well, but they bear the consequences of those mistakes. When the government picks losers, the costs are involuntarily borne by taxpayers.

Even the supposed "success stories" that government officials and the direct beneficiaries of subsidies like to tout at congressional hearings do not come without cost. In addition to the taxpayer money that's spent when policymakers try to steer the market in certain directions, government intervention can also delay the development of superior alternatives by companies and entrepreneurs who didn't receive government backing. Worse, young companies and entrepreneurs can have a harder time acquiring capital because private investors usually prefer to provide capital to projects that are subsidized over ones that are not.

In a 2009 article in *Wired* magazine, Darryl Siry, a former executive with Tesla Motors, which has benefitted from government handouts, wrote that startup companies applying for energy subsidies "have admitted that private fundraising is complicated by investor expectations of government support."[3] He noted that the government trying to pick winners distorts the market for private capital, which "will have 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."[4]

2. See Jerry Taylor and Peter Van Doren, "Energy Interventions" (Downsizing the Federal Government, Cato Institute, Washington, DC, February 2009), http://www.downsizinggovernment.org/energy/intervention.
3. Darryl Siry, "In Role as Kingmaker, Energy Department Stifles Innovation," *Wired*, December 1, 2009.
4. Ibid.

CORRUPTING INFLUENCE OF SPECIAL INTERESTS

Numerous economists have demonstrated that government officials benefit by acting on behalf of special interests under the guise of working on behalf of the public good.[5] Policymakers aren't driven by the profit motive as is the case in the marketplace; rather, concerns about reelection and other self-rewarding benefits drive the decision-making process. Thus, interest groups who gain, or stand to gain, from government subsidies are willing and able to exploit the natural self-interest of policymakers.

When "free" government money is up for grabs, interests that stand to benefit have a strong incentive to organize and lobby for a slice of the pie. Policymakers face little or no cost for conferring benefits on particular interests who return the favor by delivering votes and campaign funds. Adding in the lack of incentive for policymakers to be good stewards of taxpayers' money results in government programs that exist to pick winners and losers in the marketplace—the "winner" being a politically predetermined outcome. Unfortunately, when the government tries to pick winners and losers, it often picks the wrong horse at the expense of taxpayers and the broader economy.

Government subsidies create an unhealthy—and sometimes corrupt—relationship between commercial interests and the government. The more the government has intervened in energy markets, the more lobbying activity has been generated. The more subsidies that it hands out to businesses, the more pressure policymakers face to keep the federal spigot flowing. As the number of lobbyists grow, more economic decisions are made on the basis of politics, and more resources are misallocated. And the door opens to cronyism and corruption.

Solyndra has become emblematic of these issues, even as policies expanding subsidies for alternative energy companies have been pursued enthusiastically over the past several years. 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" during the period of time that its subsidized loan request was under review by the Department of Energy.[6] Beyond Solyndra, the Washington Post found that "$3.9 billion in federal grants and financing [from the Department of Energy] went to 21 companies backed by firms with connections to five Obama administration officials."[7]

THE DEPARTMENT OF ENERGY'S 1705 LOAN PROGRAM[8]

The Department of Energy's 1705 loan program is a good example of the gap between what subsidy proponents claim they will achieve and what actually happens. The program was a key part of the Obama administration's 2009 stimulus program and was justified on the grounds that viable renewable energy companies lack sufficient access to capital. The alleged imperfections of capital markets is a common—and mistaken—claim often used by policymakers to justify government intervention in various areas of the economy.

In reality, nearly 90 percent of the 1705 loan guarantees went to subsidize projects backed by large, politically connected companies including NRG Energy Inc. and Goldman Sachs. Thus, it's hard to believe that taxpayer-backed loans were necessary to make up for a supposed lack of capital available to economically viable commercial concerns.

The 1705 program is also a good example of the government favoring multiple interest groups at the expense of taxpayers: (1) lenders who are reimbursed by taxpayers in the event of a default and (2) the companies that

5. See Mancur Olson, *The Logic of Collective Action* (Cambridge, MA: Harvard University Press, 1971); and Gordon Tullock, "Rent Seeking," *New Palgrave Dictionary of Economics*, ed. Steven N. Durlauf and Lawrence E. Blume (Palgrave Macmillan, 2008).
6. Eric Lipton and John M. Broder, "In Rush to Assist a Solar Company, U.S. Missed Signs," *New York Times*, September 22, 2011.
7. Carol Leonnig and Joe Stephens, "Federal Funds Flow to Clean-Energy Firms with Obama Administration Ties," *Washington Post*, February 14, 2012.
8. This section is a summary of testimony I previously delivered on the subject, which is attached: Veronique de Rugy, "A Guarantee for Failure: Government Lending under Sec. 1705" (Testimony before the House Committee on Oversight and Government Reform, Subcommittee on Regulatory Affairs, Mercatus Center at George Mason University, Arlington, VA, July 18, 2012).

borrow at beneficial rates and conditions. But while banks and companies that receive the guarantees get the upside of the program, taxpayers bear the risk and shoulder the burden when companies like Solyndra go under and default on their loans.

While the results of the 1705 loan program speak for itself, the true problem is deeper than the numbers. Like most government interventions, this program—and government interventions in general—create serious and systemic distortions in the market. These distortions create the conditions for businesses to maximize profits by pleasing government officials rather than customers. This is called cronyism, and it entails enormous—and, most often, unseen—economic costs.

CONCLUSION

When the government subsidizes businesses, it weakens profit-and-loss signals in the economy and undermines market-based entrepreneurship. Most of America's technological and industrial advances have come from innovative private businesses in competitive markets. Indeed, it is likely 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 governments and dominant businesses receiving special treatment.

Policymakers who are interested in supporting the entrepreneurs and companies that will deliver the next generation of energy supplies and products should focus their attention on correcting the federal government's hostile tax climate and dispense with the futile hopes of outsmarting the marketplace.