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Why Politicians Lose So Much Money Trying To Pick Winners

I'm a Senior Fellow at the Cato Institute and have written for a wide range of newspapers, magazines and websites. My books include "FDR's Folly," "Bully Boy," "Wilson's War," "Greatest Emancipations," "Risk, Ruin & Riches," "Gnomes of Tokyo" and "The Triumph of Liberty." I graduated from the University of Chicago in economic history. Research has taken me to England, Germany, Switzerland, Argentina, Brazil, Japan, India and China. Milton Friedman wrote that my "analysis is thoroughly documented, relying on an impressive variety of popular and academic literature both contemporary and historical." Thomas Sowell: "a warning of what can happen when leaders are chosen for their charm, charisma and rhetoric." David Landes: "Powell is one tough-minded historian, willing to let the chips fall where they may." Paul Johnson: "Jim Powell is a man of great energy, determination, obstinancy and courage, and all these qualities have gone into his work." John Stossel: "A terrific read."

The Solyndra scandal offers us a reminder that government isn't very good at picking winners and shouldn't try to do it. Thanks to Obama administration connections, this California-based solar panel maker had a $535 million spending blowout at the taxpayers' expense, then fired everybody – some 1,100 jobs. But there continues to be relentless lobbying for government to back other ventures touted as essential for our future.

Perhaps we need to reflect a little on why government hasn't been able to pick winners. For starters, nobody has a crystal ball. Media reports of official government news releases regularly describe as "unexpected" the latest numbers on unemployment, housing starts, the gross domestic product and other economic indicators. Financial bubbles, stock crashes, bond defaults, terrorist attacks, world wars, natural disasters, rising prices, falling prices and so much else have taken politicians by surprise.

It can be just as difficult to predict all sorts of things in our lives, like which new car models will be successful. Every year for decades, automakers have introduced new models. There have been hundreds and hundreds, but most weren't in production very long.

Defunct models include the Capitol (1889), Whitney (1896), Stanley Steamer (1897), Packard (1899), Baldner (1900), Studebaker (1902), Acme (1903), Beebe (1904), Eagle (1905), Detroit Electric (1907), Economy (1908), Hudson (1909), Crosley (1913), Cartermobile (1915), Gem (1917), Heifner (1919), Hoskins (1920), Wing (1922), Barbarino (1923), Newark (1924), Diana (1925), Ruxton (1929), Littlemac (1930), De Vaux (1931), Jaeger (1932), New-Era (1933), Brewster (1934), Tucker-Miller (1935), Cord (1936), American Bantam (1938), Albatross (1939), Electricar (1950), Skorpion (1952), Rambler (1958), Edsel (1958) and Delorean (1981). Presumably there were entrepreneurs and investors who thought each new model offered an opportunity to make money, and many of them did for a while, but most turned out to be wrong.

Although a business might develop a winning product, it's likely to have trouble as consumer tastes change, as the business environment changes, as competitors arise more quickly, develop better products, cut prices and so on. The computer industry is littered with the wreckage of businesses that failed to continue making the right moves fast enough and were ultimately acquired or shuttered — like Compaq, Kaypro, Microdata, Mostek, Osborne, Wang, Control Data, Data General, Digital Equipment, Remington Rand and Tandem Computer, among others.

Being a winner with one technology doesn't mean a business will be a winner with the next technology. In part, this is because businesses have incentives to continue squeezing more revenue from old technologies they invested in. By contrast, new businesses have everything to gain from their new technologies and nothing to lose from the demise of old technologies they never invested in.

During the 1940s, for example, the leading makers of vacuum tubes were Sylvania, Raytheon and RCA, which seemed most likely to dominate the next technological revolution. But it turned out to be germanium transistors manufactured by Texas Instruments, a firm that had started in an entirely different industry – oil exploration. Texas Instruments' first transistors reached the market in 1952, and the company seemed to be riding the wave of the future, but along came Intel that hit the jackpot with microprocessors and random access memory chips.

If business is challenging when entrepreneurs make decisions for sound business reasons, it's doomed when politicians become involved, because they make decisions for political reasons. Politicians like to pay off big campaign contributors by steering government contracts their way, regardless of how dubious the campaign contributors might be as business executives.

Politicians want projects they can brag about during an election campaign, whether or not the projects make business sense. Politicians demand that projects be located in their districts or states, even when such locations create problems like higher costs.

And of course, politicians expect that those who receive government funding will help their re-election campaigns. No surprise that many businesses have chief executives best

known for their ability to find a place at the public trough, rather than boosting sales in free markets.

Government attempts to pick winners are most likely to increase the amount of money lost betting on losers. This is because with the power to tax, subsidize and mandate, politicians are able to pour money into unprofitable projects that private investors would never touch voluntarily.

For example, once upon a time politicians declared corn ethanol was our energy of the future, because supposedly it would reduce emissions of greenhouse gases and help the United States end its dependence on Mideast oil. Since producing ethanol cost more than consumers were willing to pay, the federal government began subsidizing ethanol production, and the government mandated that ethanol be mixed with all gasoline sold to motorists.

But ethanol reportedly increases emissions of formaldehyde and other volatile organic compounds, contributing to smog. Moreover, according to a Cornell-University of California (Berkeley) study, producing a gallon of ethanol involves burning about 98,000 BTU's (coal, natural gas or nuclear power), but a gallon of ethanol has only about 76,000 BTU's. The net effect is to increase energy consumption!

Meanwhile, the federal government has been doling out ethanol subsidies for more than 30 years, and they now cost over $7 billion annually. This will be going up because of legislated mandates, and subsidies are only one of ethanol's costs – others include higher food prices. In 2010, ethanol's greatest promoter, Al Gore, admitted it was a huge mistake. "Once such a program is put into place," he said, "It's hard to deal with the lobbies that keep it going."

Indeed, when government starts spending money on anything, it's politically almost impossible to stop. This is because interest groups promoting a particular program have more at stake than taxpayers, each of whom pays only a small part of the total cost. Interest groups have incentives to fund an aggressive lobbying operation — Solyndra hired six lobbying firms — whereas taxpayers are being nickel-and-dimed for thousands of government programs and can't possibly keep track of them all.

The more industries politicians become involved with, the bigger the losses. In Britain, for instance, economist Alan N. Miller reported that "In aggregate, the performance of nationalized industries was below that of the private sector…[nationalized] industries' total return on capital was close to zero…Customer satisfaction with the services and products of nationalized industries was often low…employment costs per employee in the large nationalized industries increased faster than the national average, without equivalent increases in productivity…Nationalized industries were characterized by high costs, high prices, low productivity and inefficient use of resources."

The most effective way to identify and nurture winners? Free market capitalism that can perhaps be understood as a discovery process. It involves continuous trial and error, trial

and success as entrepreneurs search for ways to serve customers and make money. Precisely because one never knows where innovators might come from, free markets are open to all comers, foreign and domestic. Market economies are more flexible and dynamic than government-run economies.

Unlike taxpayers who are dragooned into paying for political schemes, private investors are volunteers risking their own money or money they worked hard to raise. If they make mistakes, it will be harder for them to raise more. Investors constantly revise their estimates of business performance in light of the latest information. Investors pull capital away from laggards, which can help discipline them if anything will. Investors reward solid performers with more capital, helping them do more good work.

As we know, entrepreneurs and investors back plenty of ventures that fail, but free market capitalism has a crucial advantage over government-run enterprises: namely, bankruptcy proceedings to limit the amount of money spent on unsuccessful business experiments. When a failed venture is shut down, resources are released for others to use. It is in free markets, where businesses must sink or swim, that entrepreneurs will have the easiest time attracting talent, capital and other resources needed for businesses of the future.

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