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Grand Theft Auto: The Immorality of Business Subsidies

Paul A. Cleveland
Associate Professor of Economics
Birmingham-Southern College

Much energy has been expended discussing how jobs and economic growth might best be secured. In this debate, one theory suggests that it is necessary to subsidize potential businesses heavily in order to spark economic activity and thus gain wealth. The underlying idea here is that such economic activity would not occur if it were not promoted by political action. However, this conclusion is unwarranted and is espoused by abandoning a sound economic and ethical analysis. This article examines the fundamental economic and ethical principles that bolster such thinking.

Introduction

On September 30, 1993, executives of Mercedes-Benz announced that the company would build a plant in Vance, Alabama, where its new sport utility vehicle would be manufactured. As one might expect, the local media heralded the announcement with tremendous fanfare in anticipation of the numerous economic opportunities that would surely arise from such an operation. On the surface, the favorable attention given to the announcement appeared well deserved. By itself, such an economic decision would certainly be good news for the local economy.

Unfortunately, there was more to the story than the announcement of an automaker's intention to build and maintain a manufacturing plant in Alabama. The part of the story that made for bad news was the fact that state and local government officials had promised the company substantial subsidies to choose Alabama as the site for its new plant. The reason this is bad news is that this action ensured that most citizens of Alabama would suffer a loss as a result of this new business venture. In fact, what government officials and company executives accomplished in the process of negotiating the deal was an expropriation of the property of Alabama taxpayers for corporate use. The government had essentially used its power to tax as a means to confiscate the property of taxpayers to provide Mercedes-Benz with numerous benefits. In obligating the citizens of the state to these subsidies, the officials used the logical fallacy of composition that has long been the hallmark of political and bureaucratic argumentation. Specifically, they argued that the subsidies were needed to secure a capital investment, which would lead to the creation of new jobs that would be economically beneficial. To be sure, when economic activity thrives, new job opportunities are created. However, in cases of subsidization, it is not certain that the benefits will exceed the costs.

It is true that some special interest groups benefited from the government's action in this case. However, these benefits were secured by taxing people all across the state, and most of those paying the bill will never receive any tangible benefit from the action. The government's deal with Mercedes-Benz included a number of projects, among which were $77.5 million for building roads and infrastructure to and around the plant site, $17.4 million to buy and develop the site, $30 million to build and equip a training center, $60 million to educate and train workers, and another $10.82 million in other incentives.[1] Clearly, this money must have come from somewhere, and there is only one place from which it could come. The funds for these projects came from the taxpayers who were subject to the various governments involved in the deal. The extent to which Alabama citizens were taxed to provide the funds for these projects, is the extent to which the state forced them to change how they might have chosen to spend their money. Even though the cost imposed upon any one taxpayer was relatively small, it is nonetheless the case that each taxpayer was forced to curtail his or her private plans. Therefore, not only did taxpayers lose, but other businesses with whom they would have related lost as well. In this reduction of expenditures, numerous jobs and economic opportunities were lost at the margin across the state in order to procure an automobile plant. While there is no doubt that some individuals are benefiting greatly from the presence of Mercedes-Benz in Alabama, it is not at all clear that the net benefits for the majority are positive. In fact, good sense would suggest just the opposite. If the investment had been such a good deal, then there should have been no need for the state and local governments to secure it by taxing residents because it would have been forthcoming naturally as a matter of profit-seeking.

In the present example, two important questions arise: First, do the benefits received by special interest groups warrant government subsidization of business enterprise? Second, is it ethical for business executives to pursue and accept special favors from governmental authorities? In the course of this article I will argue that the answer to both questions is negative.

The Nature of Business Subsidies

In addressing the first question, it is necessary to examine closely the nature of business subsidies. A subsidy is a transfer payment whereby the government acts as an agent who transfers property from one party to another. In the case of business subsidies, the government transfers funds from taxpayers to certain designated business enterprises. As we have already seen, this kind of activity is justified by the suggestion that the subsidy will result in greater capital investment than would have occurred otherwise and will thus give rise to greater economic opportunities than would have resulted without the government action.

To see whether or not this is the case, we must examine the nature of this kind of capital investment. Murray Rothbard provides some excellent insight on this issue. He comments:

> Capital is the status of productive goods along the path to eventual consumption. In any sort of division-of-labor economy, capital goods are built, not for their own sake by the investor, but in order to use them to produce lower-order and eventually consumers' goods. In short, a characteristic of an investment expenditure is that the good in question is not being used to fulfill the needs of the investor, but someone else—the consumer. Yet, when government confiscates resources from the private market economy, it is precisely defying the wishes of the consumer; when government invests in any good, it does so to serve the whims of government officials, not the desires of the consumer.[2]

As applied to the Mercedes-Benz case, Rothbard's analysis proceeds as follows. As consumers, taxpayers in Alabama were denied the kind of capital investments that would have been made for them by various business enterprises because the state chose to confiscate their property and to redirect the investment. Therefore, instead of enjoying the marginal increases in business activity among a vast number of smaller enterprises that were more highly valued by consumers, they are left with one rather large and visible investment in the auto plant.

The principal question centers on whether the single, government-forced investment is better than the large number of much smaller, privately motivated investments. The answer to this question depends upon the relative economic efficiencies of the various enterprises involved. It would be impossible to answer this question through empirical investigation because the relevant data do not exist. It is impossible to know exactly what has been given up to obtain the Mercedes-Benz plant, since the foregone business activity never materialized. It would have arisen only if people had in fact been free to spend their money as they saw fit. Since such enterprises do not exist, it is impossible to compare the relative economic efficiencies between the two alternatives. However, we need not resign ourselves to the dark in this situation. A good deal of light can be shed on the matter if we investigate some of the implicit economic incentives when the government subsidizes business activity.[3]

When the government offers to subsidize a particular business, the subsidy provides a cushion for the company receiving the benefit. As such, the managers and other employees of the firm are insulated from the rigors of the competitive marketplace in which they sell their products. When a firm is being subsidized, there is not as great a need for the company to engage in entrepreneurial action. Managers need not be as diligent in their pursuit of improving the quality of the firm's products, nor do they need to be as conscious of the costs of production, nor do they need to be as active in searching for new product lines. In essence, the money provided by the government insulates the company from the competitive pressures of the marketplace. Put simply, managers can shirk their entrepreneurial responsibilities without being penalized for doing so. Instead, the penalty is imposed upon taxpayers, who must bear the burden. As a result, it is likely that business subsidies will lead to greater complacency among those who work for subsidized business organizations.

In addition to this problem, there will be a growing tendency to seek out additional subsidies from government when competitive threats arise. That is, once a business organization enjoys the ease of operating in a world of subsidization, it is likely that managers will continue to seek refuge there whenever competitive pressures intensify. Instead of being engaged in product development and improvement over time, a firm entrenched in receiving government subsidies will develop a tendency to use its resources to lobby the government for more extensive benefits. Consequently, the initial complacency of employees will tend to increase with time, which will lead to a squandering of scarce resources that might have been otherwise invested. However, rather than making such capital investments, the firm will attempt to use its wherewithal to procure the favor of politicians. But this action does not produce anything of value and will most certainly lead to greater inefficiencies. In turn, politicians will have every incentive to prostitute themselves to the various companies who are seeking governmental favor. In effect, they will sell their votes to raise funds to finance their campaigns for election or re-election.

If this process continues, the public treasury will come to be seen as a common pool of funding to be tapped for any purpose. When this occurs, special interest groups will engage in the same kind of rent-seeking behavior in an effort to garner benefits for themselves at the public's expense. In turn, this activity will lead to increased pressure on public finances. In response to this pressure, governments will increase tax revenues to provide funds for the growing numbers of beneficiaries. However, this increase will result in a growing burden of taxes, which will tend to erode away the financial well-being of taxpayers who are forced to pay larger and larger portions of their income and property to governments. In other words, they will have less and less to spend as they see fit.

In summary, the incentive structure resulting from the extension of government subsidies leads to greater economic inefficiencies in the marketplace. This occurs because business managers have an incentive to become complacent and shirk their entrepreneurial responsibilities. Specifically, "transfer spending or subsidies distort the market by coercively penalizing the efficient for the benefit of the inefficient.... Subsidies prolong the life of inefficient firms and prevent flexibility of the market from fully satisfying consumer wants."[4] In time, the process is most likely to be extended to other special interest groups who will compete for government favors at the expense of real economic investments. Finally, the expansion of government benefits leads inevitably to increased taxation that diminishes the economic well-being of taxpayers, thereby undermining their ability to consume the goods they desire. This last consequence is critically important since business firms cannot survive without customers who are willing to purchase their products.

While we do not have the empirical data to measure the net benefits of specific subsidy programs, there is empirical evidence in history to suggest that the argument developed above is, in fact, what transpires when government subsidizes business activity. The historian Burton Folsom has done some excellent work in this area. In his book, *The Myth of the Robber Barons*, Folsom compares numerous businessmen and their strategies for success.[5] He groups these individuals into two classes: those who sought their wealth through political favoritism and those who sought their wealth through the marketplace. His fundamental conclusion is that those operating in the market made real contributions to the welfare of society, while those seeking political favoritism produced a measure of wealth that was momentary.

In one particular example, Folsom traces the history of the building of the transcontinental railroads. People typically point to such efforts to bolster their argument for government subsidies. However, in time, all the transcontinental railroads but one went bankrupt, and the only one that survived was constructed entirely with private money. The lone survivor was James Hill's Great Northern Railroad. Unlike the other lines, Hill sought to use the best materials in constructing his line and extended it only when he had the necessary capital and business connections to do so. On the other hand, the other lines were subsidized by the mile of track laid. Therefore, cheaper materials were used and companies paid little attention to whether there was sufficient business to warrant the extension of their lines. In essence, the latter businessmen were in the business of laying track and not in building a railroad. Thus, they went bankrupt, while the Great Northern thrived. James Hill always knew his real business and paid attention to it, not to the government's offer of special favors.

It is interesting to note that the wisdom of the ages also forewarns of these consequences. In the Proverbs of Solomon, we find numerous passages that speak against engaging in practices such as business subsidies. The crux of the argument for subsidization is the assumption that greater economic gains can somehow be reaped through using the government's taxing power to create a common pool of funds out of which to bestow benefits on those who are most worthy. But the Bible speaks out against such practices. Proverbs 1:10 reads, "My son, if sinners entice you, do not consent. If they say, 'cast in your lot among us, let us all have one purse'—my son, do not walk in the way with them." Indeed, it was recognized in ancient Israel that such schemes result in poverty and hardship, not in prosperity because they do not create wealth. In more recent times, the nineteenth-century French economist Frederic Bastiat has written, "The state is the great fictitious entity by which everyone seeks to live at the expense of everyone else."[6]

The Rule of Law and the Ethics of Business Subsidies

We can now turn our attention to the issue of whether the pursuit and acceptance of business subsidies is ethical. The need for business executives to behave in an ethical fashion is indisputable. Ethical business practice is being stressed increasingly in business administration programs around the country. According to one author,

> A firm's commitment to business ethics can be measured by the tendency of the firm and its employees to adhere to laws and regulations relating to such factors as product safety and quality, fair employment practices, fair marketing practices, the use of confidential information for personal gain, community involvement, and bribery.[7]

Yet, beyond the mere need to act within the context of legal stipulations, it must be observed that true ethical behavior is consistent with a standard of morality that transcends the legal code. Just because an action may be legally permissible, does not mean that it is morally permissible. For instance, slavery was once a legally protected institution with certain corresponding rights and obligations. Nevertheless, many citizens rightly refrained from participating in slave ownership and slave trading because they found these practices to be morally repulsive. In this instance, those citizens acted in accord with the transcendent moral law, rather than merely exercising their legal right to own and trade slaves. In fact, it was the willingness of such individuals to decry the legal practice of the slave trade that eventually led to its demise and illegality.

Therefore, in our investigation of the morality of business subsidies, it will do no good to argue that this activity is acceptable merely because it is legal and widely practiced. Instead, we must consider the essence of the natural law within which governments must function and within which the legal code is developed. If legislation is enacted that condones an action at odds with the natural law, then the morally responsible option is to refrain from engaging in the practice and to advocate its elimination.

Frederic Bastiat wrote a short essay titled, *The Law,* just prior to his death in 1850. In this essay, Bastiat examines the proper role of government in society.[8] He begins his examination from the natural law tradition, which he had inherited from John Locke and other classical liberals. Bastiat argues that "life, liberty, and property do not exist because men have made laws. On the contrary, it was the fact that life, liberty, and property existed beforehand that caused men to make laws in the first place."[9] He reasons further that since this is true, then governments must be formed as a means of protecting the individual person from those who would seek to take his life, or violate his liberty, or steal his property. In short, he insists that governments exist to be "the collective organization of the individual right to lawful defense."[10]

Following from Bastiat's line of reasoning, government can be seen as an institution uniquely authorized to protect citizens and punish wrongdoing. In particular, government's aim must be to use its power to protect natural human rights. This argument recognizes the right of the individual to defend his life, liberty, and property from the abuses that might be inflicted upon him by other people or institutions. It also recognizes that governmental protection of the individual from such abuses is a key ingredient in making community life possible in a world in which people are not all that they should be. Such protection is needed because people do not always govern themselves in a way as that respects the dignity and property of others. Therefore, it can be said that government is legitimately called upon to protect its citizens, but its role as protector is limited.

Reflecting on the purpose of the government, Bastiat developed a formidable defense of the free market and the context in which the rule of law should operate. His argument in favor of the free market is developed as follows. First, it must be realized that life in this world requires hard work and labor in order to procure the material goods that make life both possible and enjoyable.

Furthermore, it must be recognized that in their efforts to achieve their own ends, people make choices. They can either accomplish their goals according to their own productive efforts or by preying upon the work of others. It is the frequent use of this latter option that gives rise to the need for government to restrain theft so that society might flourish. In one of his many essays, Bastiat writes,

> People believe that, when we demand free trade, we are motivated exclusively by the desire to allow labor and capital to take the direction most advantageous to them. Public opinion is mistaken on this point; this is merely a secondary consideration with us. What grieves us, afflicts us, horrifies us in the protectionist system is that it is the negation of law, justice, and property rights; that it turns the law, which should guarantee justice and the right to property, against them; that it both subverts and perverts the conditions under which society exists.[11]

We should also point out a very important problem with government: It will not operate perfectly. The reason for this is that government is run by people. Since people are imperfect, government operations will be imperfect as well. Consequently, there will never be a perfectly good government in this world. The role of government is enacted by people who are flawed. For this reason, it is always possible that the power of government can be diverted and used for immoral, rather than moral, ends. When this happens, the government will promote injustice rather than justice. The question we must ask ourselves is, How can we tell whether or not a particular action is justified? Bastiat provides an easy test by which to discern the difference. He argues that all we need to do is to ask whether an action taken by government officials would be condoned if it were undertaken by an individual. If not, then we can conclude that the government practice is a violation of the natural and moral law.

In the case of government subsidies, it is fair to inquire whether it would be legitimate for corporations to take the property of others by force to fund their business operations. Clearly, such an action would be denounced as a great evil and seen as an affront to justice. How, then, is it any different when the government uses its power to tax as the means by which property is taken from some and given to the corporation? Clearly, there is no material difference. The only difference resides in the fact that it is the government and not an individual who uses power to force the expropriation of property. However, such an argument would never suffice in a court of law to protect the mastermind of a criminal gang who planned all the crimes but did not actually participate in any of them. To be sure, in a court of law, the leader would be found just as guilty of the crimes as the members of the gang who actually committed them.

Conclusion

While a direct empirical assessment of the net effects of any specific act of subsidization is impossible, good reason can be given to suggest that such actions are economically imprudent. Stated differently, the incentives provided by the subsidy, all other things being equal, lead to decreased economic efficiency and a reduction in economic well-being. Furthermore, there is good historical evidence to suggest that government subsidies, in fact, have disastrous economic consequences. Subsidies tend to divert business decision makers from the development of their core businesses to competing for government dollars. Finally, a good case can also be made that the practice of subsidizing business enterprise is morally suspect. As a result, prudence and wisdom both counsel business decision-makers to conclude that it is not in the best interest of their companies or their customers to participate in a government subsidy program.

Notes

1. Jeff Underwood, "Some Fear Alabama Paid Too Dear a Dowery to Woo Plant," *The Birmingham News*, 30 September 1993: 1.
2. Murray Rothbard, *Man, Economy, and State*, vol. II (Princeton, N.J.: D. Van Nostrand Company, 1962), 816–17.
3. The analysis presented here is adapted from a paper written by Jennifer Roback Morse, "The Modern State As an Occasion of Sin: A Public Choice Analysis of the Welfare State," *Notre Dame Journal of Law, Ethics & Policy* 11.2 (1997): 531–48. In this essay, Morse analyzes the impact of welfare transfer payments. Many of the same principles likewise apply to the issue of corporate transfers.
4. Rothbard, *Man, Economy, and State*, 817.
5. Burton W. Folsom, Jr., *The Myth of the Robber Barons* (Herndon, Va.: Young America's Foundation, 1991).
6. Frederic Bastiat, "The State," in *Selected Essays on Political Economy*, ed. George B. de Huszar (Irvington, N.Y.: Foundation for Economic Education, 1964), 144.
7. Eugene F. Brigham and Joel F. Houston, *Fundamentals of Financial Management*, 8th ed. (New York: The Dryden Press, 1998), 17.
8. This argument is adapted from my paper, "The Life and Work of Frederic Bastiat: One Man's Call for Liberty," *Journal of Private Enterprise* 10.1 (Summer 1994): 35–52.
9. Frederic Bastiat, *The Law* (Irvington, N.Y.: Foundation for Economic Education, 1987), 6.
10. Ibid., 6.
11. Frederic Bastiat, "Plunder and Law," in *Selected Essays on Political Economy*, ed. George B. de Huszar (Irvington, N.Y.: Foundation for Economic Education, 1964), 234.