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Killing the Entrepreneurial Spirit: Government Is Not a Good Investor

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President Barack Obama calls his stimulus bill[1] and proposed budget an "investment" plan, implicitly recognizing that investment—rather than simply spending—creates economic growth. But this plan is based on the faulty assumption that only government is able and responsible enough to invest at this time.

Private investors have a personal stake in the outcome of their investments. But when politicians play entrepreneur with taxpayer money, that link does not exist; instead, the risk/reward is measured in terms of political outcomes.

In addition, central planning of the national investment portfolio can:

- Reduce the diversification of U.S. investments;
- Cause the government to have potential conflicts of interest and compromise its oversight ability;
- Weaken support for the political system;[2] and
- Dis-empower individuals and diminish entrepreneurial capital.

Private v. Government Investments. Successful investments pay for themselves; that is, the return on investment is greater than the cost of the investment. This occurs when resources in the economy are able to produce more of something or something of higher value than in the past. In this way successful investments grow the economy. Unsuccessful investments shrink the economy because the resulting pay-off does not cover the cost of the resources used for the investment.

Having many individuals making many different investments is a way to diversify the risk to the overall economy and achieve higher returns measured in terms of a standard of living.[3]

Those who make investments by risking their own resources have an incentive to do everything in their power to ensure the investment achieves the highest value. They also have an incentive to choose only those investments where they expect the value created, given the risk, to be greater than its cost. This saves resources from being used for investments that are unlikely to succeed.

Private individuals base investment decisions on expected revenues versus expected costs and then measure the success of the investment based on the realization of these expectations. The revenue companies earn is a measure of the value consumers get from the goods or services produced. If the resources used to produce a good or service cost more than the value consumers get, then the revenue earned will be less than the cost, and the firm will have negative profitability, signaling the resources would be more valued elsewhere.

In contrast, the revenue the government receives is not a direct measure of the value citizens get from

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the government's goods and services but rather is a percentage fixed by the government itself. Further, politicians invest other people's money (taxpayers) rather than their own. These two features of government institutions provide a weak economic incentive to forego projects whose costs are greater than the expected benefit.

Since the revenue signal for the government is not tied to any one politician's investment decision, it is difficult to evaluate the performance of specific projects. This reduces the incentive to work as hard as possible to maximize the payoff from the investments and increases the likelihood of wasted resources. Thus, the negative effects of public-sector investments almost always outweigh any positive results.[4]

Capitalism's Checks and Balances. A capitalist system empowers private citizens to act as entrepreneurs. By giving them ownership control over resources, individuals have an incentive to implement ideas that are socially valuable, because it is others in society who judge the value of the product or service by deciding to become a stakeholder either by purchasing it, making it, or investing in it.

Politicians can help private citizens use resources productively by:

- Minimizing distortions to market prices created by taxation and government spending; and
- Implementing oversight procedures that bring relevant information into the marketplace so individuals can make informed decisions.[5]

Complementary Roles. Capitalism helps the private sector and public sector to compliment one another and provide accountability conducive for a vibrant and growing economy. Mixing these roles contributes to a breakdown in accountability, which can destabilize markets.

People naturally desire to keep more of what they earn and retain control over their own resources rather than have the government "invest" those resources for them. This desire is rooted not in a disdain for government itself but rather an understanding of the complementary roles of private citizens and the public sector within the capitalist system.

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1. This is the 2009 HR-1 legislation also known as "The American Recovery and Reinvestment Act."
2. László Bruszt, "Market Making as State Making: Constitutions and Economic Development in Post-Communist Eastern Europe," *Constitutional Political Economy*, Vol. 13, No. 1 (March 2002).
3. The current crisis seems to reveal a lack of diversity in entrepreneurial investment. Many U.S. entrepreneurial investments were concentrated in the financial industry, where opportunities seemed to abound. Research has shown how the mispricing of risk due to both fiscal and monetary policies contributed to an overabundance of investment in this area (see, for example, Rakesh Mohen, valedictory address to the IIF's Asia Regional Economic Forum, September 27, 2007 at *http://www.esocialsciences.com/data/articles/Document112102007100.4691126.pdf* [February 23, 2009]). The theory put forth here—that potential entrepreneurs choose to invest when the expected return is greater than what the resources are currently earning—would predict greater investment in an area where the expected return from an investment is higher due to lower discount factors. The recent crisis highlights the need for a well-diversified economy and a government that focuses on a stable environment of price stability and minimizing distortions in tax and spending policies.
4. See Palle Andersen and David Gruen, "Macroeconomic Policies and Growth," Economic Research Department, Reserve Bank of Australia, October 1995, at *http://www.rba.gov.au/rdp/RDP9507.pdf* (February 20, 2009).
5. See Gary Becker, "Repayment of Tarp Bank Loans," Becker-Posner Blog, April 19, 2009, at *http://www.becker-posner-blog.com/mt/mt-tb.cgi/1808* (April 22, 2009).

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