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Seven Reasons Loan Guarantees Are Bad Policy

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Advocates of loan guarantees claim that this subsidy is a success when the recipient company remains in business. This is a superficial and misleading way to view loan guarantees. Indeed, loan guarantees are among the most pernicious ways that governments distort markets and harm American families and businesses alike. Here are seven reasons why.

1. Loan Guarantees Deny Capital to More Competitive or Less Politically Favored Companies. As anyone looking to start a business or buy a home in recent years can attest, acquiring a loan can be very difficult. Loan guarantees make that process even more difficult because the government essentially pulls capital out of those limited reserves and dictates who should receive it. While sure-bet companies can still get a loan, those that are more on the margin may lose that opportunity.

Consider a lender that is reviewing loans for two companies. Both are long shots with promise, but one has the backing of the federal government. Obviously, that company is more likely to receive a loan, because the government mitigates the financial risk even if the business is no more promising.

2. Loan Guarantees Deny Americans Access to Technologies and Services. Capital is in limited supply. A dollar loaned to a government-backed project will not be available for some other project. This means that the higher-risk, higher-reward companies that drive innovation and bring new services and technologies into the marketplace may not get support, while companies with strong political connections or those that produce something that politicians want do.

Over time, this approach to investment retards progress, leaving Americans with a plethora of politically connected companies that meet government interests better than they do the needs of American businesses and families.

3. Loan Guarantees Skew the Rules of Free Enterprise. The success of the free-enterprise system requires that all participants be subject to the same set of evenly applied rules, take full responsibility for their decisions, and freely engage in market interactions. Loan guarantees diminish these privileges and responsibilities.

The federal government sets many of the rules that govern commerce. The more government participates in the market as an investor, the greater its temptation to shape the rules to advance its own interests. Further, because they are not risking their own money, politicians and bureaucrats will bear almost no responsibility for the outcome of the investment. This allows them to take credit when an investment succeeds and deny blame when it fails.

This can incentivize politicians to support projects that are actually market viable. A successful venture that enjoys political support creates the impression that the politicians are good stewards of

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taxpayer money when in fact they merely provided an unfair advantage to a company that would have succeeded on its own.

These successes then provide political cover to funnel resources to unviable companies that eventually fail. The politicians then justify ongoing subsidies in the face of such failures by pointing to the companies that remain in business.

This process corrupts the efficiency with which the market meets the needs and wants of individuals, families, and businesses. Ultimately, consumers pay for this inefficiency with higher prices, less choice, and lower standards of living.

4. Loan Guarantees Empower Bureaucrats and Politicians to Pick Winners and Losers. Loan guarantees distort the normal process by which private investments flow toward new technologies and business ventures. Rather than the best ideas with most promise attracting the most investment, loan guarantees allow political preferences and special interests to enter into the calculation. Because the federal guarantee removes the risk of loss, private financiers are given incentive to support high-risk projects. This creates a system where bureaucrats and politicians—rather than private actors—are directing capital flows and picking winners and losers in the marketplace.

5. Loan Guarantees Beget Corruption and Cronyism. Programs such as loan guarantees create a symbiotic relationship between government officials and specific businesses. In essence, both have very strong incentives for the other to be successful. In this relationship, the politician helps the business to gain a market advantage, and the successful business helps the politician advance his political agenda.

The result is, at best, a brand of cronyism where businesses develop strong relationships with public officials to ensure that public policies support their economic interests. This para-market activity often leads to even more pernicious corruption. A far better system is one where politicians set the rules and allow businesses to compete in a free market.

6. Loan Guarantees Can Hurt Recipient Companies. Recipient companies are subject to reams of additional regulation and bureaucracy. Indeed, this has led to some companies to forego the program entirely.

The more damaging impact, though, can be on businesses at the threshold of independent success. In a free market, these companies would have innovated, sought additional efficiency, or enacted other reforms to become profitable. Government interventions such as loan guarantees short-circuit this process by allowing unprofitable businesses to become synthetically successful even if the underlying business model is flawed. This diminishes the incentive to innovate and instead creates the incentive to maintain the status quo in order to keep the government subsidy. When the subsidy ends, the synthetic success quickly becomes real failure.

7. Loan Guarantees Just Plain Do Not Work. Loan guarantees do nothing to change the underlying strength of the subsidized business or the real conditions of the market. Instead, they allow recipients to offer their products at subsidized prices. This may provide some government-induced competitiveness, but ultimately, whether a business fails or succeeds has nothing to do with the loan guarantee. A loan guarantee either artificially prolongs the life of a business that will ultimately fail or subsidizes a business that would have succeeded anyway.

End Loan Guarantees Now. Washington should stop micromanaging the energy economy. Interventionist policies such as direct mandates, subsidies, tax preferences, and loan guarantees distort rational decision making, hamstring businesses that do not enjoy the government's good favor, give a crutch to those that do, and reinforce overextended and dishonest governance. Energy investment is one area in which less from Washington is most certainly more.

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