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Working Paper

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Working Paper, No. 561

Provided in Cooperation with:

Levy Economics Institute of Bard College

Suggested Citation: Auerback, Marshall (2009) : The return of the State: the new investment paradigm, Working Paper, No. 561, Levy Economics Institute of Bard College, Annandale-on-Hudson, NY

This Version is available at:

<https://hdl.handle.net/10419/31688>

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Working Paper No. 561

The Return of the State: The New Investment Paradigm

by

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May 2009

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ABSTRACT

To save America—indeed, the global economy as a whole—the private/public sector balance has to shift, and the neoliberal economic model on which the country has been based for the past 25 years has to be modified. The role of the state needs to be reemphasized.

The abandonment of a mixed economy and corresponding diminution of the role of government was hailed as the “rebirth of individualism,” yet it caused rising inequality and the decline of median wages, and led to the widespread neglect of public goods vital to its citizens’ welfare. Meanwhile, the country ran through the public investment it had made from the 1930s to the 1970s, with few serious challenges from policymakers or mainstream economists.

The neoliberal model was also aggressively exported: the “optimal” growth strategy for all emerging economies was supposedly one that emphasized limited government, corporate governance, rule of law, and higher levels of state-owned and -influenced enterprise—in spite of significant historical evidence to the contrary. Not even the economic wreckage in Mexico, Argentina, Thailand, Indonesia, and Russia seemed sufficient to challenge, let alone overturn, the prevailing paradigm.

That is, until now: in reaction to the financial crisis, many governments—led by the United States—are enacting massive economic stimulus packages and taking a central role in promoting economic growth strategies. This reemergence of state-driven capitalism constitutes a “back to the future” investment paradigm, one that is consistent with a long and successful pattern of economic development. But once we get beyond the pothole patching and school repairing, what industries can be pushed forward using public seed capital or through Sematech-like consortiums? What must be brought to the fore is the need for a new growth path for the United States, one in which the state has a significant role. There are already indications that the private sector is beginning to adapt to this new, collaborative paradigm.

Keywords: Comparative Economic History; Deflation; Inflation Growth; Public Economics; Industrial Policy

JEL Classifications: E31, H00, L52, P50

Everybody wants to invest with the government. —Warren Buffett

Francis Fukuyama's "The End of History" implied that free markets had won over the centrally planned economies of the former Soviet Bloc; even though there would be some undoubtedly messy cleanup, ideological struggle was over. Much criticism has been leveled against this view; it is now apparent that Fukuyama wrote history off too quickly, since the death of the state has proved exaggerated. At its economic essence, globalization was all about how governmental institutions were being eclipsed by multinational corporations acting to maximize profit in support of shareholders. Governments would have to learn to master "soft" power to be relevant in a globalized world, mostly acting to smooth transactions but otherwise staying out of the way. In a globalized world, small government was supposed to be good. The world was moving toward a universal neoliberal economic model, and political risk was being mitigated (or so the theory went), as the emerging economies simply represented "branch plants" of Washington, Inc. This philosophy was most clearly encapsulated in the so-called "Washington Consensus," which has dominated economic policymaking, particularly in the United States, for the past quarter century. Yet if we have learned anything from the global financial crisis, it is that the state has returned in earnest. The recent U.S. elections reflect just part of a major shift away from the ostensible belief that "the government which governs least governs best"; they seem to know that appeals to self-help or limited government has no credibility in an era of multibillion-dollar bailouts for the financial sector, and the virtual nationalization of the mortgage industry by a GOP administration.

Of all the significant aftershocks of the credit crisis, one event stands as the ultimate repudiation of the prevailing economic paradigm: former Federal Reserve (Fed) Chairman Alan Greenspan's testimony before Congress in late October, during which he admitted, "I was wrong." Pressed by Representative Henry A. Waxman of California, chairman of the House Committee on Oversight and Government Reform, who asked, "Do you feel that your ideology pushed you to make decisions that you wish you had not made?," Greenspan responded, "Yes, I've found a flaw. I don't know how significant or permanent it is. But I've been very distressed by that fact" (Andrews 2008). In that remarkable admission can be heard the crumbling of at least three decades of ideological dominance. However limited his acknowledgment of error, Greenspan was finally conceding the private sector's inability to manage risk in a largely

deregulated environment, for which the market fundamentalists had successfully lobbied during the past 25 years. Their collective failure was, in the words of economist Jeff Madrick (2009), “the result of a narrowly conceived economic model and the failure of Washington's social contract with America, whose weaknesses were essentially disguised by ever more debt.”

The resulting free-for-all credit did not succeed in protecting workers from rising debt payments or in preventing the loss of health care benefits, withered pensions, or job turnover. Instead, it resulted in propagating ever greater levels of financial instability.

To save America—indeed, the global economy as a whole—the private/public sector balance has to shift, the economic model on which the country has been based for the past quarter century must be modified, and the role of the state needs to be reemphasized. In the 1980s the United States “abandoned a working social contract with its citizens that promised, and even produced, a wondrous but often cruel free-market colossus that worked justly and prosperously for most. The abandonment of that social contract was hailed as the rebirth of individualism and America’s gift to the world: limited government. But it caused rising inequality and the decline of median wages over the course of a generation. It also led to the rampant neglect of public goods vital to the citizens’ welfare and the prosperity of the economy. Meantime, the nation lived off the public investment it made from the 1930s to the 1970s, with little protest from politicians or mainstream economists” (Madrick 2009). The neoliberal model has been aggressively exported: the optimal growth strategy for all emerging economies supposedly required limited government, corporate governance, rule of law, and lower levels of state-owned and state-directed enterprises. In spite of repeated economic wreckage in Mexico, Argentina, Thailand, Indonesia, and Russia, no evidence seemed sufficient to challenge, let alone overturn, the prevailing paradigm. The model was badly implemented, went the charge, or the countries themselves were bastions of corrupt, crony capitalism.

That is, until its consequences hit the United States directly: in reaction to the financial crisis, governments across the world—led by the United States—are now issuing massive economic stimulus packages and playing a more centralized role in the promotion of economic growth strategies. In fact, viewed over the long sweep of history, state-driven capitalism, or at least a model in which the state imparts significant directional thrust to the economy, is nothing new; it has provided the basis for a successful pattern of economic development, even in countries traditionally perceived as “laissez-faire,” for a long time. Today’s revival of the

interventionist state actually constitutes an old investment paradigm, and we suspect that when the history of this period is assessed in the fullness of time, the Washington Consensus will ultimately be perceived as an historical anomaly. However, since the early 1980s, economists, including the Fed's Greenspan, have argued that no study has yet proved that industrial policy—beyond market-friendly rules of property rights—contributes to net optimal economic growth. There is, of course, the case of Asian Tiger economies, but various neoliberal counterarguments have been put forward to explain away that experience. The following are the notable ones:

1. Sectoral-industrial policy helped in Northeast Asia because of circumstances unique to the region; that policy failed in fast-growing Southeast Asia.
2. The “Asian crisis” of 1997–98 showed that the kind of relationships between state and big business fostered by the “developmental state” are prone to inefficiency and breakdowns.
3. Taiwan, South Korea, China, and the other countries in the region have been remaking themselves in line with the Anglo-American economic model, discarding the remnants of a “governed market” system.
4. Therefore, “even if governed markets, sectoral-industrial policy, and the developmental state had some validity in the early postwar decades, their time is past; and WTO rules are making sure that this remains so. The only viable option for developing countries is some variant of the neoliberal Washington Consensus agenda—maximum integration into the world economy plus domestic reforms to stabilize integration and make domestic markets more efficient. . . . Anything . . . intended to foster nationally controlled industries over foreign-owned, or to transfer technology beyond the speed desired by private foreign firms, is out” (Wade 2004).

In short, the advocates of the Washington Consensus have consistently argued that the “success” of globalization and neoliberal economic reforms support the proposition that

liberalized markets are the best way to organize economies, developed or developing. The state, they argued, “should protect property rights and ensure the supply of public goods, but not impart directional thrust. More specifically, the state should create and sustain (a) efficient, rent-free markets, (b) efficient, corruption-free public sectors able to supervise the delivery of a narrow set of inherently public services, and (c) decentralized arrangements of participatory democracy. The more these conditions are in place the more development and prosperity will follow” (Wade 2004).

For several decades, America’s two leading parties have generally grouped around a prevailing neoliberal consensus on free trade: let Adam Smith’s “invisible hand” operate freely, and different countries will produce and export what they naturally do best (i.e., David Ricardo’s notion of “comparative advantage”) and import products at which their partners excel (Galbraith 2008, p. 68). But as James K. Galbraith has noted, it is not always obvious that each country will always be the relatively most efficient producer of exactly one good. “And then what?” he asks. “Does the country that has no ‘comparative advantage’ cease trading?” Moreover, he notes that countries able to diversify across multiple industries are far more likely to weather economic demand shocks than those committed to a single industry or product line. In fact, Galbraith’s contention is the antithesis to Ricardo’s notion of comparative advantage; diversification, not specialization, he argues, is the main path to economic development. Effective diversification requires a strategic approach to trade policy. In other words, some form of the “dreaded” industrial policy. None of the most successful trading countries, including Japan, Korea, Taiwan, and now mainland China, reached their current status by adopting neoliberal trade policies. Thus, even before the U.S. subprime mortgage market blew up, there was virtually no supporting evidence to suggest that “efficient, rent-free markets,” coupled with a neutral, supposedly incorruptible state, provided a sufficient precondition to optimal economic growth.

As political economist Robert Wade (2004) has argued, “Almost all now-developed countries went through stages of industrial assistance policy before the capabilities of their firms reached the point where a policy of (more or less) free trade was declared to be in the national interest. Britain was protectionist when it was trying to catch up with Holland. Germany was protectionist when trying to catch up with Britain. The United States was protectionist when trying to catch up with Britain and Germany, right up to the end of the World War II.” Alexander Hamilton (1791), the first U.S. Secretary of the Treasury (1789–95), set out a strategy for

building up American industry behind tariffs to the point where American manufacturers would be able to compete against foreign rivals unaided. Hamilton also favored a robust state role in promoting the country's manufacturing interests. More recently, Japan's industrial growth has come on the back of an extensive state sector, as was the case for Korea, Taiwan and most of Southeast Asia throughout much of the postwar period. Per Wade, all had massive state intervention to promote economic growth. "Hong Kong and Singapore are the great exceptions," he writes, "in that they did have free trade and they did catch up—but they are city-states and not to be treated as economic countries."

"Within the 'transitional' countries (moving from communism to capitalism) the comparison between Russia and China provides the extreme case in point: Russia—massive liberalization and privatization (shock therapy), catastrophic economic performance; China—gradual liberalization and privatization, excellent economic performance (by standard measures). Within each region (central Europe, southeastern Europe, the former Soviet Union, East Asia), one finds that the more radical liberalizers performed worse economically in the 1990s than those that moved more gradually. For example, the Czech Republic pursued the most ambitious economic liberalization and privatization compared to Slovakia, and has had substantially worse economic performance" (Wade 2004). Ironically, immediately following their "Velvet Divorce" in 1993, the Czech Republic was deemed to be in pole position thanks to the aggressive embrace of a neoliberal model, and Slovakia was disparaged for its go-slow approach. In fact, over 1997–2008, the latter's gaps with the Central European and Western European GDPs have diminished significantly, with Slovakia amongst the biggest relative winners, currently outpacing its Czech counterpart (Blogactiv 2008). The Baltic States, which quickly embraced neoliberalism following their liberation from the Soviet bloc, are now experiencing economic depressions, with any meaningful recovery years away.

By refusing to acknowledge any weaknesses associated with their championed model of economic development, the advocates of neoliberalism/market fundamentalism unwittingly doom their cause to irrelevance. While very few of us would advocate a retreat into the mindless protectionism and economic nationalism that characterized much of the 1970s, the inflexible, indeed theocratic, manner in which a market fundamentalist agenda has been imposed throughout the developing world has done little to yield improved aggregate economic performance (Auerback 2002). "On the contrary, world economic growth has fallen sharply,"

Wade (2004) notes, in aggregate as well as for Organisation for Economic Co-operation and Development (OECD) countries and developing countries separately. “Per capita growth in the OECD fell from 3.5 percent between 1965 and 1979 to 1.8 percent between 1980 and 1998,” he writes. “Per capita growth of developing countries fell from 2.4 percent over 1965–79 to 0.0 percent between 1980 and 1998.” Obviously, if we incorporated today’s data, the numbers would look even worse (Easterly 2001). Yet, perversely, these depressing results only served to reinforce the Washington Consensus: they were taken to show the need for even more market liberalization. From the beginning in the mid-1980s all the way to the mid-aughts, the communiqués from the regular meetings of the G7 finance ministers consistently emphasized the need to raise growth rates, cut unemployment, reduce the role of the government, and stabilize exchange rates by curbing budget deficits, tightening monetary policy, and making labor markets more flexible. Industrial policy was dismissed; in fact, attempts at industrial policy were proscribed under the WTO rules.

As Wade (2004) writes, “There is much evidence against the Washington Consensus. But perhaps the most compelling is the experience of the East Asian capitalist countries since World War II. The same broad” development history applies “to Taiwan, South Korea, and Japan; and at a stretch for Singapore too. . . . The record of these countries in the use of state power to impart directional thrust via market mechanisms stands as enduring evidence against the Washington Consensus.” According to the World Bank (1993), these countries sustained the greatest quantum leap in living standards in the shortest recorded time in history. As Wade notes, they achieved this outcome by employing “common state policies to transfer resources away from ‘unproductive’ toward ‘productive’ uses—often in the form of transfers from unproductive groups to productive groups and sometimes in the form of policies to convert unproductive groups into productive ones. Creating ‘rents’ (above normal market returns) by ‘distorting’ markets through state interventionist policies was essential, first, to induce more-than-free-market investment in activities that the government regarded were important for the economy’s transformation, and second, to sustain a political coalition in support of these policies. Disciplining rent-seeking so that it remained consistent with these two objectives was also essential. All these states had either authoritarian regimes or tightly circumscribed democracies until late in the transformation, which limited the scope for those seeking rents in unproductive activities from paralyzing the polity until they got their way.”

American relations with East Asia have evolved over the decades, but they still reflect this hegemonic reality: Japan, South Korea, and other countries in the region are dependent on American military protection and the American market, the quid pro quo being that these countries were allowed to build up their manufacturing apparatuses in a manner ultimately antithetical to the Washington Consensus, as a bulwark against encroaching communism. “By the start of the 1980s, when the U.S. began to move from competing in manufactures to dominating through finance—and importing a rising fraction of manufactured goods—capitalist East Asia was well placed to ride the surge of U.S. import demand and even to provide out of its growing financial surpluses the savings needed to cover escalating U.S. current account deficits” (Wade 2004). Could the United States rely on this sort of strategy? It should now be abundantly clear that a “growth strategy” predicated simply on militarism and unrestrained credit contains the seeds of its own destruction. With the crash of 2008, it is undeniable that the U.S. economy “was built on a financial mirage” (Kuttner 2008). Growth relied on loans from foreign central banks to finance the U.S. trade imbalance, steadily hollowing out its manufacturing sector as Washington asserted the primacy of finance capitalism. And the truth of the matter is that Washington itself has never fully bought into the alleged Washington Consensus. In spite of the United States’ own imbalances, policymakers have never imposed on the country the kind of “shock therapy” that former Treasury secretary (and current Obama adviser) Robert Rubin promoted in Russia and the rest of the former Soviet bloc, or the kind that’s being imposed on Iceland today. Just the opposite: since the 1980s, the U.S. tax system has promoted rent seeking and speculation on credit to ride the wave of asset-price inflation. This strategy increased the asset values in the balance sheets as long as asset prices rose faster than debts (that is, until last year) without adding to industrial capacity. Meanwhile, tax cuts caused the national debt to soar, prompting U.S. Vice President Dick Cheney to comment, “Reagan proved deficits don’t matter.” Cheney’s remarks are only true for debts collateralized against income generating assets, not for debts used to support speculative bubbles. Even today, the Treasury (until recently headed by former Goldman Sachs CEO Henry M. Paulson Jr.) “is subsidizing America’s financial markets so as to save its financial class (minus some sacrificial lambs) and support its asset prices” (Hudson and Sommers 2008), without much curb on the behavior that led to the excesses in the first place. Nothing akin to the kind of restrictions now being placed on Detroit in exchange for its paltry \$17.4 billion loan package was ever contemplated for the banking sector, which has

received 20 times as much money as U.S. automakers. Interest rates are being lowered to stabilize asset prices rather than raised in an effort to elevate the external value of the dollar or slow domestic price inflation (Hudson and Sommers 2008).

Looking at this economic calamity, President Obama has proposed several policies that veer dangerously close to the sin of industrial policy, notably in the automobile sector, where the president hopes to induce substantial innovation via higher corporate average fuel economy (CAFÉ) standards, much like its Japanese counterparts. And he wants to use such standards to induce a broader state-led push in favor of cutting-edge green technology. Obama hopes the state will play a major role in this strategy, in to order to help avoid a depression. One can already envisage the concerns of those who fret that the resulting budget deficits will push interest rates up, “crowd out” the private sector, and ultimately generate substantially less growth. But as we noted before, the manner in which the debt is used is crucial here. The experience of the 1930s and 1940s, for example, suggests that “deficits are often necessary to stimulate and maintain high rates of growth, and the higher wages that result in turn create the savings required for investment. Raising savings rates in the short run, on the other hand, often does just the opposite of what is intended. By reducing demand, it ultimately leads to slow growth, smaller incomes and less savings. Keynesian demand stimulus in an underperforming economy will not crowd out private investment due to federal borrowing but rather crowd it in by creating business opportunities due to more sales and prospective buying power. Strong sales are what generate capital investment “(Madrick 2009).

The United States, unlike many European countries, lacks a reasonably good physical infrastructure; public expenditure in this sector would be very rewarding. To have an idea about the seriousness of the problem, one need look no further than the American Society of Civil Engineers’ “Infrastructure Report Card” on the United States, which the society published every few years. In the latest report, issued in 2005, “not a single one of its fifteen public service categories received a grade higher than a C. Ten of the fifteen categories—including drinking water, waste-water management, navigable waterways, transit, and schools—received scores in the D range” (Goldhagen 2007).

Public works has a long history in the United States, from the days of Alexander Hamilton to the highway construction programs of Eisenhower. The best example, however, is the New Deal, which ultimately created the foundation for decades of American prosperity in

spite of efforts of historical revisionists to denigrate the achievements of Franklin Delano Roosevelt. The “managerial model of capitalism,” predominating from that period until the 1980s, delivered high growth. “Finance was made subordinate to industrial development and full employment” (Hudson and Sommers 2008).

Consider some figures. The GDP was \$97.4 billion in 1930. It dropped sharply and continuously under Hoover, and by 1933, just after Roosevelt finally took over, it stood at \$57.6 billion—a fall in GDP of 49 percent over the period. Roosevelt ended the crisis by imposing a rash of emergency economic measures in his first 100 days in office. The GDP then rose some 6.25 percent, to \$61.2 billion in 1934 (under FDR). By 1937, it had risen by 38.76 percent, reducing unemployment from 25 percent to 9 percent. The United States was out of depression by 1937 and only reverted when the fiscal activism of the previous four years was completely reversed by one based on balanced budget and a nonsensically tight monetary policy, brought on by the Fed as deflationary pressures abated and moderate inflation began to appear by the middle of that year. FDR, capitulating to the urgings of his Treasury secretary and the more conservative members of Congress, presented a balanced budget.¹ The Fed also began to tighten at this stage, as inflation had risen to 4 percent. The result was that the economy contracted by 6 percent, to \$66.1 billion in 1938, and the recovery slipped. After FDR reverted again to fiscal activism, by 1939 (during which the budget deficit rose to 3.1 percent of GDP) the GDP rose to \$89.1 billion. It rose a further \$8.5 billion, to \$96.8 billion in 1940, which is almost where it was at the start of the Great Depression in 1929. Around 1940, Congress and FDR lost any inhibition and ramped up the GDP by spending massively. By 1943, the United States was running a budget deficit equivalent to 30.3 percent of GDP. By 1944, GDP was \$210.9 billion, more than double what it was when the Great Depression began. There has never been anything close to the severe downturns that occurred prior to FDR’s administration.² Not until now, and that, unsurprisingly, has come at a time when much of the legislative framework put in place by Roosevelt has been

¹ Roosevelt was a fiscal conservative before the Great Depression, favoring debt reduction and a balanced budget.

² These include the secondary postwar depression, which lasted from about 1874 to 1880; the recession of 1883–86; the panic of 1893, which led to two consecutive recessions/depressions over five years; the “rich-man’s panic of 1904; the Panic of 1907, which resulted in a severe recession/depression as well as a bank panic; the primary postwar depression that followed World War I; and, of course, the catastrophic Great Depression, which began in 1929 and saw the U.S. economy decline a staggering 40 percent in little more than three years.

eviscerated. FDR's long-term stabilizers in fact worked very well, but were inexplicably gutted during an unprecedented period of corporate predation, which found its apotheosis in the recent credit boom and the growth of the so-called "shadow banking system." Before this market fundamentalist philosophy took root during the Reagan era, the financial sector accounted for only 2 percent of U.S. corporate profits. Today, it is 40 percent.

The U.S. economy, then, "rose to dominance as a result of Progressive Era regulatory reforms prior to World War I, reinforced by popular New Deal reforms put in place in the Great Depression. Neoliberal economics was promoted as a means of undoing these reforms. By undoing them, the Washington Consensus would deny to foreign countries the development strategy that has best succeeded in creating thriving domestic markets, rising productivity, capital formation and living standards. The effect has been to decouple saving from tangible capital formation. They need to be re-coupled, and this can be achieved only by restoring the kind of mixed economy by which North America and Europe achieved their economic growth" prior to 1980 (Hudson and Sommers 2008).

There are already indications that the private sector is beginning to adapt to a new paradigm in which the state plays an important collaborative role. One sees glimmers of this in the automobile industry, as Detroit seeks to make the leap to electric cars. There is a historic precedent, as Rebecca Smith (2008) notes: "Fourteen U.S. technology companies are joining forces and seeking \$1 billion in federal aid to build a plant to make advanced batteries for electric cars, in a bid to catch up to Asian rivals that are far ahead of the U.S. The effort, the latest pitch from corporate America to inject federal dollars into a project, is similar to an alliance that two decades ago helped the U.S. computer-chip industry restore its competitiveness. Participants include 3M Corp. and Johnson Controls Inc." As the article goes on to note, this is not a new model: "The consortium is modeled on Sematech, the group formed by U.S. computer-chip companies in 1987 to compete with the Japanese. . . . Sematech is credited with helping U.S. companies regain their footing by focusing on manufacturing and design advancements with funding from the federal government."³ Sematech had succeeded by first identifying the

³ Sematech was funded over five years by public subsidies allocated to the U.S. Defense Advanced Research Projects Agency. These funds, totaling \$500 million, ultimately enabled U.S. chip manufacturers to introduce a new generation of computer chips vastly superior to those produced by their Asian competitors (Browning and Shetler 2000).

companies with the best operating solutions and then disseminating these practices throughout the industry. But the progress would have been impossible in the absence of a significant state role, guiding industrial policy.⁴ We suspect that this will represent the new model of U.S. industrial development going forward. The auto bailout might well represent the next area where this kind of private/public partnership (PPP) becomes operative, as the above article suggests. This is one of those tasks that only the federal government can accomplish.⁵ Indeed, “the PPP market in the United States has been likened to dealing with 50 independent developing countries. Federal government efforts to provide a uniform approach to project structure and administration could contribute to creating a standard platform for the development of structures governing PPPs. Design-build PPP projects in the United States that involve turning over the asset to the state after the project is completed work well as long as there are no serious start-up delays” (Orr and Kennedy 2008). The proposed National Infrastructure Reinvestment Bank could help in this regard, particularly given that, as a federal government–controlled entity, it will likely be able to borrow at virtually zero cost of capital and interpose itself amongst the states when the cost of funding has risen exorbitantly.⁶

Whilst the ideology of the Washington Consensus may well be bankrupt, its attempts during the last quarter century have not succeeded in undermining the fundamental stability and versatility of the quasi-public institutions in the United States. American universities and research centers remain amongst the world’s leading technical and scientific institutions, and the government itself can be repaired. Mechanisms for creating new institutions are likely required,

⁴ Ironically, this is now banned under the current WTO rules championed by the Washington Consensus.

⁵ A telling example of why state and local governments cannot implement this task alone comes from New Mexico, which has recently completed a new four-lane highway: when that highway reaches the Colorado state border, it shrinks to two lanes, because Colorado has not ponied up the funds to continue it (Goldhagen 2007).

⁶ It should be remembered that infrastructure projects “are not always multimillion dollar investments. The infrastructure needs of many poor communities do not require an electrical grid or large dam or irrigation project but low-cost treadle pumps and drip irrigation sets. Small-scale projects, which can have a significant developmental impact, can be financed through micro loans. . . . Interestingly, the rate of defaults on micro loans is less than that on AAA credits. The loans, which have a repayment rate of 98.9%, are made at market rates and the borrowers are principally women. The model is ideal because its implementation bypasses the state governmental structure, going directly to the people in need. The idea is not new: it was the concept under which the World Bank was originally set up. The key now is to find a match between appropriate financing systems and appropriate small-scale water treatment, irrigation, electricity generation and communications technologies. This is an area where the multilateral organizations and foundations, such as the Gates Foundation, could provide some meaningful support” (Orr and Kennedy 2008).

and forging new directions for existing institutions, such as Fannie Mae and Freddie Mac, are also needed. At the same time, we must abandon the “private sector first, last, and exclusively” mentality that has afflicted the American polity for the past quarter century and come to grips with the need for effective financial reregulation to break, in the inimitable phrase of Galbraith (2008), the “culture of predation.” What is required is a vision of a new growth path for the United States. If public backlash is to be marshaled to something more than retribution and class warfare, this must come to the fore, and the state must have a significant role. Even the patron saint of laissez-faire capitalism, Adam Smith (2000, p. 723), recognized this fact: It is the “duty of the sovereign or commonwealth” he wrote, to erect and to maintain “those public institutions and those public works, which, though they may be in the highest degree advantageous to a great society, are, however, of such a nature that the profit could never repay the expense to any individual or small number of individuals, and which it therefore cannot be expected that any individual or small number of individuals should erect or maintain.” According to architecture critic Sarah Williams Goldhagen (2007), “Infrastructure is the classic public good that the free market does not and cannot provide. On the scale that is necessary, only the federal government can make the difference.” Government should not be a dirty word. By the same token, the United States should leverage the advantages it now has, given its control over the financial system. We should use Fannie and Freddie to help stabilize the housing market rather than wait for the private banks to get over their current self-induced risk aversion. We should employ the current quasi-nationalized financial structure to build up the coalitions needed to support broader public objectives, thus helping to implement industrial policy, for the revitalization of America’s manufacturing base. Firms are dissuaded from opposing or subverting such government objectives by the knowledge that opposition might render access to credit problematic (see Wade 2004).

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