The crowding-out myth

By Robert Skidelsky
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The argument that public investment invariably "crowds out" private capital is wrong both theoretically and empirically. States have always played a leading role in allocating capital, either through direct investments, or by deliberately encouraging certain types of private investment.

Three economic effects of COVID-19 seem to be generally agreed upon. First, the developed world is on the brink of a severe recession. Second, there will be no automatic V-shaped recovery. And third, governments will therefore need to "support" national economies for an indefinite period. But, despite this consensus, little thought has been given to what private firms' prolonged dependence on government support will mean for the relationship between the state and the capitalist economy.

The main obstacle to such thinking is the deeply entrenched notion that the state should not interfere with long-term capital allocation. Orthodox economic theory holds that public investment is bound to be less efficient than private capital. Applying an oversimplified logic then leads to the conclusion that practically all investment decisions should be left to the private sector.

The two generally recognized exceptions are "public" goods such as street lighting, which private firms have no incentive to supply, and "essential" goods like defense that must be kept under national control. In all other cases, the argument goes, the state should allow private enterprise to select investment projects in line with individual consumer preferences. If the state were to substitute its own choices for such rational market-based allocations, it would "crowd out" higher-value activities, "pick losers," and impede growth.

But the crowding-out argument is wrong both theoretically and empirically. First, it assumes that all resources in an economy are fully employed. In fact, most market economies normally have underemployment or spare capacity, meaning that public investment can "crowd in" resources that otherwise would be idle. This was John Maynard Keynes's key argument, and it cannot be stressed often enough. And the superior efficiency of a boom-and-bust private investment system dominated by financial oligarchs is far from obvious.

Second, the state has in practice always played a leading role in allocating capital, either through direct investments of its own (including most nineteenth-century railway-building), or by deliberately encouraging certain types of private investment.

For example, Toyota, which started out as a textile-machinery manufacturer, became a leading global automobile producer from the early 1960s onward with the help of tariff protection and state subsidies. Nor did Silicon Valley succeed because the state got out of the way of risk-taking venture capitalists and garage investors. From the Internet to nanotechnology, most of the major technological advances of the last half-century were financed by government agencies. Private firms entered the game only once the returns were within clear sight. And then there's China, whose economic ascent is the apotheosis of state-led development today.

Governments also have frequently intervened to rescue large, tottering private firms from the consequences of their own follies or unexpected shocks, with the 2008 bailout of the banking system being the most recent example. But these operations have rarely led to constructive institution-building; rather, governments have sought to return the rescued firms to private

ownership as soon as they became profitable again.

Of course, we can never prove that a country will invest better if the state has a hand in the process. Moreover, many countries have lacked the state capacity needed to make public investment work. But one historical example of state investment in industrial firms – that of the Italian holding company Istituto per la Ricostruzione Industriale (IRI) – sheds light on the conditions under which it might succeed.

IRI's establishment in 1933 was the unintentional consequence of the bailout of Italy's three largest banks, which were on the verge of collapse following the Great Depression. It quickly became obvious that the banks' balance sheets could not be restored without restoring profitability to the hundred or so firms in which the banks owned equity stakes, but for which no unguaranteed private capital was available. Through IRI, the state became the owner of the country's biggest industrial complex, eventually owning 21.5% of Italian joint-stock company shares.

The three "lives" of IRI highlight the benefits and potential pitfalls of public investment. During the remainder of the 1930s, the companies in IRI's portfolio recovered under the direction of the anti-fascist businessman and statistician Alberto Beneduce, whom Benito Mussolini had the good sense to appoint as the holding company's first president. Under the fascist system, pork-barrel politics were not allowed to interfere with IRI's investment decisions.

IRI enjoyed a second successful period immediately after World War II, when the technocratic tradition inherited from the 1930s kept political influence at bay. As Laurie Macfarlane and Simone Gasperin of the UCL Institute for Innovation and Public Purpose tell it, IRI spearheaded Italy's post-war reconstruction and economic miracle. In this period, IRI companies accounted for about 50% of Italy's steel output, and supplied high-quality, low-price steel to the vital machine-goods sector (where IRI accounted for more than one-quarter of total production). Similarly, the holding company's shipping firms boosted the shipyards that it owned. IRI also built Italy's motorways and telephone networks in the 1960s, and developed the national airline Alitalia.

Moreover, IRI became the national and often a European leader in aerospace, microelectronics, complex systems engineering, and telecommunication technologies. "What became known as the 'IRI formula,'" write Macfarlane and Gasperin, "involved mixed private-public ownership of certain companies."

But the story did not end happily. By the 1970s, IRI's losses grew, owing to its heavy investments in declining sectors, especially steel. Whatever the causes of its decline, IRI increasingly appeared to conform to the neoliberal model of the inefficient, corrupt state corporation. Its assets were gradually sold to pay its mounting debts, and the company was finally wound up in 2002.

IRI's mixed record raises the crucial question of how such statist institutions can succeed. The answer, surely, is to give them a broad mandate that reflects an accepted national purpose, while insulating their commercial decisions from political meddling.

This is easier said than done. But we should give the matter constructive thought, rather than surrender to neoclassical first principles. A market-driven economic system that lacks political accountability and periodically crashes is simply too dangerous.

Robert Skidelsky, a member of the British House of Lords, is Professor Emeritus of Political Economy at Warwick University. He is the author of a three-volume biography of John Maynard Keynes.