The paradox of US industrial policy: The developmental state in disguise

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The continental Europeans, most successfully the Germans, have long deployed the might of the State to boost their manufacturing base, using largely pragmatic arguments. The Anglo-Americans, in contrast, have for the past several decades embraced a consensus against such a role, at least at the level of principle. Their rationale has rested largely on ideology, especially the ideology of the more politically oriented branch of neoclassical economics known as neoliberalism.

Ever since the election of Margaret Thatcher in 1979 and Ronald Reagan in 1980, by which time Keynesian ideas were already sidelined, strong political and intellectual forces mobilized around neoliberal or market fundamentalist ideas, as expressed in the dictum that "[t]he free market is what works, and having the state help it is usually a contradiction in terms" (Kasperov, 2012). The simplest free market champions claim that hearty entrepreneurs like Bill Gates and Steve Jobs, backed by venture capitalists and generous philanthropists, can create the innovations needed for progress – provided the government stops interfering. As Michael Lind writes, "It would be easy to get a thousand PhD economists [trained in the Anglo tradition] to sign a manifesto insisting that we should ignore history whenever it conflicts with theory … about generic firms competing in abstract markets" (Lind, 2012).

This Anglo-American consensus has ensured that the phrases "industrial policy" and even "technology policy" and "innovation policy" are anathema in policy circles, synonymous with "pork barrel politics", "corporate welfare" and, worst of all, "picking winners". The United States presents a paradox, however. On one hand, public policy discourse has long been dominated by the "market fundamentalist" narrative, which draws acceptance from its smooth elision of "market forces" with such desirable values as "freedom", "democracy" and "meritocracy", and its equally smooth elision of "government intervention" with "the nanny state" and "economic sclerosis" and "the road to serfdom". On the other hand, the US government has in fact undertaken much more industrial policy than this narrative implies, from the founding of the Republic to today, including the promotion of what became major technological innovations ("general purpose technologies"). As a recent study of the biotechnology sector says of the recent period:

> The knowledge economy [in biotech] did not spontaneously emerge from the bottom up, but was prompted by a top-down stealth industrial policy; government and industry leaders simultaneously advocated government intervention to foster the development of the biotechnology industry and argued hypocritically that government should let the free market work (Vallas, Kleinmann and Biscotti, 2011).

What is more, much of the technology-intensive private sector in the United States has been *cutting* investment in basic technologies in order to focus on "value extraction", relying even more than in the past on public agencies for the basic research (Mazzucato, 2013).

This chapter explores the US paradox.[1] The first section examines the arguments used to justify the claim that the US government does not or should not try to boost certain industries except in occasional cases of "market failure". These arguments and the political forces that carry them set the deeply hostile context through which proponents of industrial policy have had to navigate. In response, proponents have tried to keep their programmes out of sight of the market fundamentalists massed in politics, the media, think tanks and universities. They have barely attempted to promulgate a narrative to counter the dominant market fundamentalist narrative. The most striking example is the proponents' failure to emphasize that a US government agency's programme spawned the Internet. The rate of return on the publicly financed part of this one innovation must be big enough to offset by far whatever alleged mistakes the government made elsewhere across the whole domain of industrial policy.

If the American government has in fact been much more active in promoting particular technologies and industries than is generally understood, it is important that this be more generally known, because the American government

[1] This chapter is one of several papers about industrial policy by the same author: for example, Wade (2004, 2010 and 2012).

both directly and indirectly, through organizations such as the World Bank and the World Trade Organization (WTO), has long told the rest of the world that, in the words of Nobel Laureate in Economics Gary Becker, "[t]he best industrial policy is none at all" (Becker, 1985); or in the words of John Williamson, "[l]ittle in the record of industrial policy suggests that the state is very good at 'picking winners'" (Williamson, 2012); or in the pithy words of Lawrence Summers, government "is a crappy VC" (venture capitalist).[2]

In late March 2012 Gene Sperling, director of the White House's National Economic Council, declared that a national manufacturing renaissance would be strongly in America's interest. His speech (Sperling, 2012) was notable for two reasons. First, it was the first time that a key figure in the Obama administration – or for that matter in any of the past several administrations – spoke positively of manufacturing and the need to mount industrial policies to help the sector. Second, almost no one paid attention to the speech; it disappeared without trace. Industrial policy remains a dangerous subject in America, because to express sympathy risks being classed as an incompetent or worse.

So, against this background of emphatic rejection of industrial policy, the second section of this chapter gives a brief history of US industrial policy going back to the first years of the Republic and continuing through the nineteenth and twentieth centuries. The third section describes the emergence of "network-building" industrial policy in the past two decades or so. Here we see a variant of the model of the "developmental state", although rather different from the East Asian variant (Wade, 2004). The fourth section gives some examples of current network building. The fifth section offers a broad assessment of their effectiveness. The sixth and concluding section assesses the advantages and disadvantages of the US approach and suggests two directions of reform.

It should be noted that the defence of industrial policy given here does not equate industrial activity with "making tangible objects". Rather, it uses the term "industrial policy" referring to the whole value chain involved in making things, including the services of the scientists and engineers who design and test the things – the medical pills, the automobiles, the smartphones, and the rest (whose actual manufacturing may be abroad). What differentiates industrial policy from other policy is that it is necessarily selective among industries, products and stages of the value chain.

[2] Quoted in Nocera (2011).

14.1 The rejection of US industrial policy: Ideological and political economy arguments

For the past three decades, the US government has espoused a *norm* of something close to laissez-faire in economic issues, more strongly than almost any other advanced capitalist country.[3] The laissez faire norm has been translated into programmes of deregulation, de-unionization, privatization, and free-trade agreements, which have carried neoliberal ideals into every corner of American life. Even universities, hospitals, churches and the Post Office compete to put themselves onto "sound market principles".[4]

The success of the conservative ideal in America[5] owes much to the fact that the Right has taken concerted intellectual work and ideological promulgation much more seriously than the Centre-left. Out of economics departments such as that of the University of Chicago and think tanks such as the American Enterprise Institute (founded in 1943), the Cato Institute, the Manhattan Institute and the Heritage Foundation (all founded in the 1970s) came intellectual justification for propositions such as: "freedom is only possible under laissez faire"; "governments are inherently corrupt and inefficient"; and "interference with market outcomes is bad for welfare" (Roemer, 2011).

Not even the Great Slump, which began in 2007 and continues at the time of writing, has altered the tide, contrary to the normal response to hard times – the normal response being to support more regulation and more social insurance. Indeed, the mass embrace of free-market theory and intensified distrust of government since 2007 is unique in the American history of hard times (Frank, 2012). In 2010 Friedrich von Hayek's polemic, *The Road to Serfdom*, was ranked at number 241 on the Amazon Best Sellers list – remarkable for a book published as long ago as 1944 (Farrant and McPhail, 2010).[6] By 2011 just 10 per cent of Americans said they trust government to do the right thing most of the time.[7] The

[3] In contrast, US norms towards finance have been more ambivalent, and its norms towards social issues like abortion and same-sex marriage have been more interventionist than in many other capitalist economies.

[4] In this vein Jacquelyn Brechtel Clarkson, a New Orleans city councillor saw "nothing better than free enterprise and the free market to decide how this city is rebuilt" following the devastating floods there (quoted in the *Financial Times*, 10 January 2006).

[5] By 2010 roughly two people in America identified themselves as "conservatives" for every person who self-identified as "liberal" (in the American, not European, sense of "liberal").

[6] Hayek's argument was immediately taken up by leading American conservatives. General Douglas MacArthur, by then a civilian, gave a keynote address to the 1952 Republican Convention. He said that the Democratic Party "has become captive to the schemers and planners who have infiltrated its ranks of leadership to set the national course unerringly toward the socialistic regimentation of a totalitarian state".

[7] Brooks (2012), based on an October 2011 *New York Times*, CBS News poll.

central conviction of the other 90 per cent is that government is corrupt because it is captured by rent-seekers and predators.

Much of Americans' pervasive distrust of government stems from the perception that finance – Wall Street – has put the government over a barrel. A case in point for them is the TARP (Troubled Asset Relief Program), initiated after the Lehman Brothers collapse in late 2008 and designed by then Treasury Secretary Hank Paulson, former CEO of Goldman Sachs, and by Ben Bernanke, Chairman of the Federal Reserve Board. TARP was aimed almost entirely at saving large financial institutions and resuscitating Wall Street after its disastrous mistakes, *rather than keeping people in their homes and helping regional banks*. Incoming President Obama did not break with the programme or make plans to reduce the grip of the banks on American politics. He also did not replace the management of those banks in which the government was forced to take a controlling share, thereby confirming Simon Johnson's description of a "silent coup" (Frank, 2012).

By contrast, the Roosevelt administration of the 1930s presented itself as an agent for resuscitating the economy independently of Wall Street dictation, aggressively pursuing financial wrongdoers through the US Congress and the courts and bolstering organized labour as a source of countervailing power and influence. It used the Reconstruction Finance Corporation to spread public "bail-out" resources around the nation, pouring funds into small-town banks, agriculture, public works, education, and more. Roosevelt broke up the big banks with the Glass-Steagall Act and regulated those that remained with the new Securities and Exchange Commission. At the same time the administration promulgated a narrative to the American people as to why it was doing these things in their interest.

This time around, the perception that the government is an instrument of Wall Street (a major source of funding for both main political parties) has been fuelled by an extraordinary concentration of income at the top of the income hierarchy; to the point that the top 1 per cent of households received 95 per cent of the increase in national income in 2009–12 (Saez, 2013). Income concentration has provoked mass anger and even strengthened the hand of market fundamentalists who argue that a compliant government, as much as large financial firms themselves, was the real cause of the financial crisis.

The recent grip of market fundamentalism in US politics has reinforced the longer standing hostility to any idea of "industrial policy", the hostility spanning Congress, the executive branch (especially the Department of the Treasury), the media, think tanks, academic economics departments, and the public at large. This long-established near-consensus is that "industrial policy" is synonymous with distortionary government intervention that corrodes the values of an entrepreneurial culture, undermines the efficacy of market competition and stacks the wider incentive system in favour of one or another rent-seeking group ("Governments cannot pick winners but losers can pick governments").

The policy conclusion is straightforward. As Tim Leunig of the London School of Economics explains: "The government should be providing conditions that help all businesses – namely, effective infrastructure, a skilled workforce and better planning. We should make no attempt to pick winners – whether individual companies, specific sectors, or manufacturing as a whole" (Leunig, 2010). In this view, if any special help is given to industry, it should only be "functional" or "horizontal", such as subsidized credit for SMEs to offset possible failures of capital markets to supply such firms – and the credit must be equally available to SMEs in all sectors.

14.1.1 A more subtle rejection of US industrial policy

The preceding market fundamentalist argument could be described as "ideological", in the sense that it derives directly from the values and analysis of stylized firms in idealized markets. It readily generates universal prescriptions like "governments are corrupt and inefficient", "the [competitive] market is an efficient allocation system", "the laws of economics, like the laws of engineering, hold in all times and places".

There is also what could be called a political economy argument against industrial policy. It is based on an analysis of what works in a particular political setting rather than on an ideologically based presumption that industrial policy is everywhere bad. This argument comes from what is known as the "varieties of capitalism" literature. Peter Hall and David Soskice, two of its better known proponents, have no driving ideological agenda against "government" and in favour of "markets". They argue, rather, that the shape of State–market institutions in the United States is such that industrial policy is unlikely to be effective in improving on market outcomes, when judged by a national interest test.

Advanced capitalist economies, they argue, tend to cluster with little hybridity into one of two types at the national level: the "liberal market economy" (LME), exemplified by the United States and United Kingdom, and the "coordinated market economy" (CME), exemplified by Germany and Japan. Firms in LMEs coordinate their activities mainly through the institutions of markets and hierarchies, and they tend to invest in "switchable assets" (allowing rapid entry and exit). Firms in CMEs coordinate relatively more through institutions that support ongoing cooperation, encourage credible commitments and exchange of information, and "provide actors potentially able to cooperate with one another with a capacity for deliberation" (Hall and Soskice, 2001). Examples of such institutions include business associations, trade unions, cross-shareholding networks, and legal systems that facilitate information sharing.

Hall and Soskice and others in the "varieties of capitalism" school argue that industrial policy is more likely to be effective in CMEs than in LMEs because of the weakness of institutional support in the latter. For the United States, specifically, they argue that industrial policy is further hobbled by two fundamental political features: (1) strong separation of powers between the executive, legislature and judiciary; and (2) strong separation of powers between the federal, state and local levels. Similarly, Michael Mann argues that:

> There is no serious American industrial policy; this is left to the post-war powerhouses of the US economy, the large corporations. Much of this [industrial policy failure] is due to the radical separation of powers enshrined in the US constitution. A coordinated political economy cannot easily be run by a President and his cabinet, two Houses of Congress, a Supreme Court and fifty 'states' (which are also fragmented by the same separation of powers) – especially when they belong to different political parties (Mann, 1997).

In these conditions the government may practice what is called industrial policy – meaning, in practice, that vested interests capture the relevant parts of the state apparatus and sluice resources in their favour – but it will be uncoordinated and yield negative net welfare gains. It will be "pork barrel" or "crony capitalism". As Kevin Philips writes, industrial policy in a fragmented political structure like that of the United States is both "inevitable and ineffective" (Philips, 1992).

14.2 A brief history of the US developmental state

The two lines of argument just described agree on the conclusion that, regardless of whether the US government or any government "should" do industrial policy, it cannot be effective in the US political economy. However, the conclusion rests on the assumption that industrial policy means that centralized coordination agencies develop national "visions" and national programmes to develop (or "pick") specified industries, perhaps even extending to specified firms; in short, it rests on the assumption that industrial policy means "picking winners". This reflects a standard (and substantially wrong) understanding of East Asian and French industrial policy.

Recent research by Fred Block, Andrew Schrank and Josh Whitford, among others, presents a different picture (Block and Keller, 2011).[8] It finds that US governments – including state and city governments as well as the federal government – have undertaken much more industrial policy than the standard narrative says, with generally positive net effects according to a national interest test. But much of it has been hidden, for the reasons given earlier. Before discussing this recent research, a reinterpretation of the longer history of the US developmental state is in order.

14.2.1 The visible developmental state

As also in continental European countries, fighting wars and preparing to fight wars spurred American innovation and economic growth. Alexander Hamilton, the first Secretary of the Treasury, outlined a strategy for promoting American manufacturing in order both to catch up with Britain and provide the material base for a powerful military. Published in 1791, Hamilton's *Report on Manufactures* promoted the use of subsidies and tariffs. George Washington, the first President, supported the plan. Also, from the first years of the Republic, the government invested in technological expertise for military purposes, creating the Army Corps of Engineers in 1802 and putting army engineers to work building canals and lighthouses and improving river navigation. Later, Abraham Lincoln presided over what was by then called "The American System" for promoting economic growth, using high tariffs to protect strategic industries, federal land grants, government procurement to secure markets and subsidies to infrastructure development. All through the nineteenth and early twentieth centuries up to the 1930s, US industrialization proceeded behind average applied industrial tariffs exceeding 30 per cent, amongst the highest in the world and still justified by Hamilton's ideas (Kozul-Wright, 1995).

Lincoln launched the building of the transcontinental railway in the 1860s,