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Beyond market failures.
The market creating and shaping roles of
state investment banks

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Beyond market failures

the market creating and shaping roles of state investment banks

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Abstract

Recent decades witnessed a trend whereby private markets retreated from financing the real economy, whilst simultaneously the real economy itself became increasingly financialized. This trend resulted in public finance becoming more important for capital investments. Within this context, the paper focuses on the roles played by a particular source of public finance: state investment banks (SIBs). It develops a conceptual typology of the different roles that SIBs play in the economy which together show the market creation/shaping process of SIBs, rather than their mere ‘market fixing’ roles. The paper discusses four types of investments, both theoretically and empirically: *countercyclical*; *developmental*; *venture capitalist role*; and *challenge-led*. To develop the typology, we first discuss how standard market failure theory (MFT) justifies the roles of SIBs, the diagnostics and evaluation toolbox associated with it, and resulting criticisms centred on notions of ‘government failures’. We then show the limitations of this approach based on insights from Keynes, Schumpeter, Minsky and Polanyi, and other authors from the evolutionary economics tradition, which help us move towards a framework for public investments that is more about market creating/shaping rather than market fixing. As frameworks lead to evaluation tools, we use this new lens to both analyse the increasingly targeted investments that SIBs are making, and to provide a new light on the usual criticisms that are made about such directed activity (e.g. crowding out and picking winners).

Keywords: state investment banks, development banking, public finance, market failure, mission-oriented finance

JEL codes: G20 (financial institutions and services: general); O16 (economic development: financial markets); O38 (technological change: government policy); L52 (industrial policy); P16 (capitalist systems: political economy)

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1. Introduction

A well-functioning financial system must transform savings into productive investments that promote economic growth and rising living standards. However, there is increasing evidence that in recent decades private finance has retreated from funding long-term productive investments in the ‘real economy’, as financial innovations coupled with de-regulation have made it easier to earn profits from speculative investments in financial assets (Wray, 2011; Kay, 2012). The ‘short-termism’ of the financial system (Haldane, 2011) has been accompanied by the ‘financialisation’ of business enterprises, the financial departments of which increasingly became main profit centres, to the detriment of core operational activities (Dore, 2008). The 2007 financial crisis made these decade-long processes evident, by revealing the fragility of speculative financial markets and of financialised business enterprises. While the crisis prompted many governments to intervene in the financial system (with new regulations) or to increase spending (with fiscal policies) in order to put the economy back on a growth path (Feldstein, 2009), the need for governments to step up has actually been a result of this longer term process of private finance *retreating from providing capital to the real economy*, beginning with the 1970s de-regulation of the financial sector.

Within this context of a retreat of private finance and an increased role for *public* finance, this paper discusses one of the most explicit forms of public financial activity: state investment banks (SIBs, or development banks). SIBs have stepped up their activities in the aftermath of the financial crisis and subsequent economic recession, increasing not only the quantity of investment but also the quality, moving beyond the usual provision of countercyclical credit. While SIBs are not new, they diversified their roles in the past three decades, going beyond traditional activities in both scale and scope. In so doing, they have promoted the following four types of investments: (1) countercyclical lending to offset the credit crunch during economic recessions (Gutierrez *et al.*, 2011; Luna-Martinez and Vicente, 2012); (2) funding for long-term projects, industrialisation and capital development of the economy (Griffith-Jones and Tyson, 2013); (3) targeted investments in high-risk R&D, innovative start-ups, and lengthy innovations, areas in which private capital has proved to be too short-termist and risk-averse to venture into (George and Prabhu, 2003; Schapiro, 2012; Hochstetler and Montero, 2013; Sanderson and Forsythe, 2013); and (4) promotion of investments around complex societal problems such as climate change and the ageing crisis (Schröder *et al.*, 2011). The paper proposes a new typology through which to understand and evaluate the market shaping and *creating* roles of state investment banks; a framework that goes beyond the usual emphasis on the ‘market-failure fixing’ role of public sector activity.

The standard market failure framework used by economists to inform the formulation and evaluation of public investments is problematic because it explains public intervention in the economy only if it is geared towards the correction of different types of ‘market failures’. Such failures may arise due to various conditions, including asymmetric information (leading to adverse selection) and the existence of public goods with positive externalities (see section 3). In Market Failure Theory (MFT), it is the existence of these conditions that justify public spending on capital-intensive areas like infrastructure, uncertain high-risk basic research (a typical public good) and innovation, financing of risky small firms (whose real ‘quality’ as borrowers is unknown to the investor), or investments in technologies that help to internalise negative externalities. MFT calls for specific structures for public agencies (insulation from private interests in order to avoid particular types of ‘governmental failures’) and specific evaluation exercises (static cost-benefit analysis). The market failure justification for public intervention and associated toolkit has placed SIBs under increased scrutiny and, in some cases, criticism (e.g., *Financial Times*, 2012; Lisboa and Latif, 2013; Mussler, 2013), because any role beyond fixing market failures is seen as unjustified.

This paper argues that the market failure framework is too limited to understand the enhanced roles that public financial institutions—and SIBs in particular—have had to play due to the increased short-termism and speculation of private finance. The fundamental problem is that the market failure perspective is based on a strong assumption: that markets are ‘efficient’ by default (Fama, 1970), so that public intervention should only aim to correct ‘inefficiencies’ in order to bring markets back to

the default position. This perspective ignores the role that the state has played from the beginning of capitalism in *shaping* and *creating* markets (Polanyi, 2001 [1944]). Furthermore, the market failure framework does not capture how, in countries that have been successful in achieving ‘smart’ (innovation-led) growth, the *breadth* of such public investments has been driven by broad ‘mission-oriented’ justifications,¹ such as those that drove investments by NASA, DARPA and the NIH, all of which have gone beyond simply funding public goods like research. It also ignores the degree to which the increased financialisation of modern capitalism, in which profits are de-linked from investments in the real economy, is not just an ‘imperfection’ in financial markets but a feature of the system that has required (and still requires) public finance to do what private finance is increasingly unwilling to do; that is, fund (long-run) productive investments.

The paper seeks to create a framework that can explain and help us better understand the rise of SIBs. We take inspiration from the works of Keynes (1926, 2006 [1936], 1980), Schumpeter (1934 [1912], 1939, 2002 [1912]), Minsky (1992, 1993; Minsky & Whalen, 1996) and Polanyi (2001 [1944]) and draw specifically on the insights from heterodox economics literatures, which can be more useful for describing the process through which public policy actively shapes and creates markets. Key concepts that we mobilise are: *technological trajectories* and *techno-economic paradigm shifts* in evolutionary economics (Dosi, 1982; Perez, 2002); *mission-oriented investments* in science and technology policy research (Mowery, 2010; Foray *et al.*, 2012); *developmental network state* in development economics (Wade, 1990; Block and Keller, 2011), and the *entrepreneurial state* (Mazzucato, 2013a). Our contribution is to apply these literatures to the study of state investment banks (heretofore never done) and to more generally use them to propose a different lens through which to view the *market creation and shaping* process of public policy.²

The remainder of this paper is structured as follows. Section 2 provides an historical overview of the roles that state investment banks play in the economy, through which we identify the four roles cited above: countercyclical, developmental, venture capitalist, and promotion of mission-oriented investments that help to address societal problems. In section 3, we document contemporary evidence of these four roles (with a particular focus on evidence from Brazil’s BNDES, the China Development Bank, the European Investment Bank (EIB), and Germany’s KfW), and present the market failure justification attached to each role. Section 4 discusses the implications of market failure theory for how SIBs actions are structured and evaluated, and links this ‘diagnosis and evaluation toolkit’ to key criticism to the activities of SIBs. While such criticisms highlight some important issues, they are primarily the consequence of a limited perspective, and must therefore be reconsidered in order to take into account the empirical evidence and alternative theories and concepts. Section 5 introduces concepts from heterodox literatures to show the limitations of MFT and to provide the basis for an alternative theoretical framework. Section 6 summarises and contrasts the mainstream perspective with the alternative conceptualisation, and reflects on the implications of the latter for the mainstream criticisms. The concluding section 7 discusses the policy implications of the alternative framework and proposes avenues for a new research agenda that goes beyond MFT.

2. The roles of state investment banks in the economy: Empirical evidence

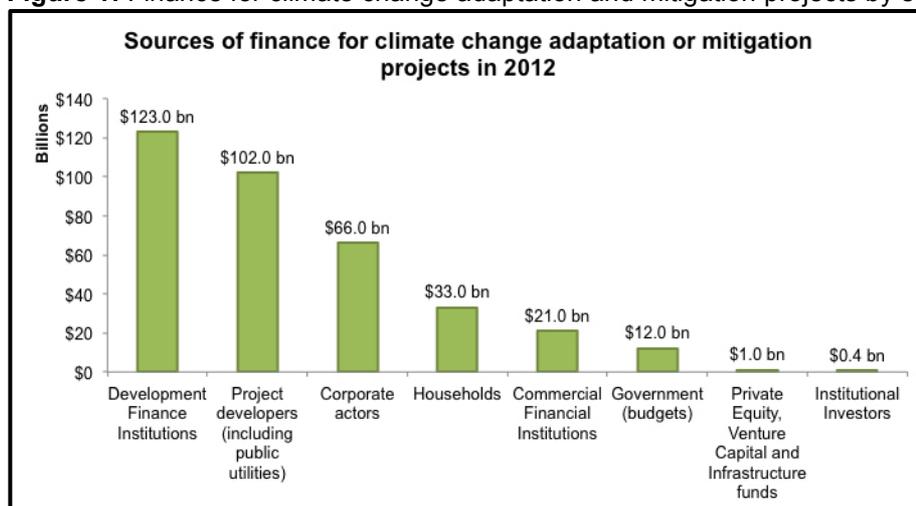
Recent years have witnessed state investment banks increasing their role in areas where private finance fears to tread. This includes, for example, the emerging ‘green’ economy: world-wide investments aimed at the global challenges of limiting carbon emissions. Figure 1 shows that in 2012, the share of development finance institutions (SIBs) in the ‘climate finance landscape’ was 34 percent (the highest share of any single type of actor), compared to 29 percent for project

¹ The classic example of a governmental mission is ‘putting a man on the moon’, which guided policy initiatives that resulted in the development of many revolutionary technologies, later commercialised by private enterprises.

² Our framework may also contribute to the literature on the roles, innovativeness and effectiveness of state-owned enterprises (SOEs), which in recent years has paid particular attention to SOEs from China, without developing, however, a coherent theoretical framework. We thank Rainer Kattel for this insight.

developers (including state-owned utilities), 19 percent for corporate actors, 9 percent for households, 6 percent for *all* types of private financial institutions and 3 percent for executive governments (investments from governmental budgets) (Climate Policy Initiative, 2013).

Figure 1: Finance for climate change adaptation and mitigation projects by source in 2012.



Source: Based on data from Climate Policy Initiative (2013).

This level of investment directed towards an emerging new area recalls the role that state agencies played in the internet revolution and the biotech revolution. In such cases, public investments did not only ‘fix failures in markets’, they actively created them by investing across the entire innovation chain, from basic research to early stage commercialisation (Mazzucato, 2013). However, while the role of public R&D agencies in this process has been studied at length (Mowery, 2010; Foray et al. 2012), the role of public banks in shaping such markets has not been studied. Given the current level of activity of SIBs in the emerging green technology space, we believe it is essential to carefully unpick the different roles that such public banks play, both historically (over time) and across the production landscape. In particular, as will be argued in Section 3.4, we apply for the first time the mission-oriented literature to the study of public banks. Before doing so we look at the emergence of SIBs and their move from traditional development institutions to active innovation institutions.

Historical overview

The first modern state investment bank—the *International Bank for Reconstruction and Development* (IBRD)—has its historical roots in the monetary agreements of Bretton Woods (1944), which were decisively influenced by Keynes’s ideas, and the reconstruction plans for Europe following World War II (the Marshall Plan). The IBRD was meant to promote financial stability through a permanent flow of finance to fund the reconstruction plan and unleash agricultural production potential, thereby preventing the deleterious effects that speculative, pro-cyclical private finance could have on the post-WWII economic recovery (World Bank, 2013). The IBRD made its first loan, to France, in 1947 (World Bank, 2013). Other national development banks were founded around that same time, such as the *Industrial Development Bank of Canada* (1944), the key goal of which was to provide ‘capital assistance to industry with particular consideration to the financing problems of small enterprises’ (cited in Fergusson, 1948, p. 214); or the *Kreditanstalt für Wiederaufbau* (KfW – meaning ‘reconstruction credit institute’) in Germany (1948), which had the aim of channelling international (and national) funds (notably those associated with the Marshall Plan) to the promotion of long-term growth, infrastructure, and modern industry (Schröder et al., 2011). Japan also created development banks. The first, in 1950, was the *Export Bank of Japan* (which became the *Export-Import Bank of Japan* in 1952), which sought to secure strategic

resources to the Japanese economy and promote the insertion of Japanese firms into overseas markets.³ The second, in 1951, was the *Japan Development Bank*, the initial foci of which were development of heavy industries and infrastructure (including electricity).⁴ Another development bank, founded a couple of years later (1953), was the Brazilian *Banco Nacional de Desenvolvimento Economico e Social*⁵ (BNDES; National Bank of Social and Economic Development), which initially promoted a catching-up (industrialisation) agenda (Torres Filho and Costa, 2012). The *Korea Development Bank* (KDB) was founded one year later as the 'Korea Reconstruction Bank', to supply and manage major industrial capital and help develop Korean industries and economy after the Korean War.⁶

In subsequent decades, SIBs diversified their operations and foci. In the mid-1950s, for instance, KfW assumed the responsibility for providing finance for environmental protection and small-and-medium enterprises (SMEs), roles that were intensified in the 1970s, when it also began to target energy efficiency and innovation development (KfW, 2009). In the 1960s, the Japan Development Bank began to focus on financing technological development and innovation, as well as providing finance for projects that tackle environmental problems (such as atmospheric, water and noise pollution). In 1975, the Canadian Development Bank had its name changed to the Federal Business Development Bank (BDC; now the *Business Development Bank of Canada*) and started its venture capital operations. In the 1990s, the BDC created new financing products to promote the development of innovations.⁷ In 1976, South Korea founded a new development bank, the *Export-Import Bank of Korea* to support Korean enterprises in conducting overseas business⁸; meanwhile, KDB began to target the development of new sectors and technologies (electronics and automotive, in particular). In the 1980s, BNDES created lines of credit specifically designed for SMEs, and in the following decade began to experiment with funding programmes targeted at high-tech firms and innovation (Branco, 1994; Pinto, 1997). By the 2000s, the China Development Bank (CDB), founded in 1994, was one of the most active SIBs, investing in regional economic development and industrial catching-up; supporting and nurturing new ventures and innovation; and, later in the decade, targeting finance to projects aimed at 'green growth' (Sanderson and Forsythe, 2013). After the outbreak of the Global Financial Crisis in 2007, SIBs across the world significantly promoted countercyclical lending, increasing their loan portfolios by 36 percent on average between 2007 and 2009, with some (10 percent) increasing their loans by more than 100 percent (Luna-Martínez and Vicente, 2012). They were actually returning to one of the original rationales behind the establishment of the IBRD: providing financial stability throughout the business cycle.

This brief historical overview highlights four conceptually distinct roles that SIBs have played throughout their histories:

- a) Countercyclical role
- b) Capital development (or developmental) role
- c) New venture support (or 'venture capitalist') role
- d) Challenge-led role.

The contemporary evidence in section 3 shows that SIBs are (still) active across these four areas.

³ <http://www.itic.org/Japan-Bank-for-International.html>; accessed 16 June, 2014. In 1999, the Export-Import Bank of Japan (JEXIM) and Japan's Overseas Economic Cooperation Fund were merged into the Japan Bank for International Cooperation (JBIC).

⁴ <http://www.dbj.jp/en/co/info/history/index.html>; accessed 16 June, 2014.

⁵ The Brazilian development bank was founded as *BNDE*; it was not until the 1980s that the name was changed to incorporate an explicit 'social' focus.

⁶ <https://www.kdb.co.kr/ih/wcms.do>; accessed 16 June, 2014.

⁷ http://www.bdc.ca/EN/about/overview/history/Pages/new_mandate.aspx and http://www.bdc.ca/EN/about/overview/history/Pages/until_today.aspx; accessed 16 June, 2014.

⁸ http://www.koreaexim.go.kr/en/exim/glance/manage_01.jsp; accessed 16 June, 2014.

3. The four roles of SIBs: Contemporary evidence and the theoretical justification of Market Failure Theory (MFT)

In what follows, we first document contemporary evidence for each of the four roles, which at times also overlap, and then present the market failure explanation and justification attached to each role. We start with a brief introduction to Market Failure Theory.

The mainstream economics perspective that explains and justifies the role of SIBs in the economy is Market Failure Theory (MFT), which takes the 'First Fundamental Theorem' (FFT) of welfare economics (Arrow, 1951; Debreu, 1959) as the starting point. The FFT states that markets are the most efficient allocators of resources under three specific conditions: (1) There is a complete set of markets, so that all supplied/demanded goods and services are traded at publicly known prices; (2) all consumers and producers behave competitively (all agents are price-takers); and (3) an equilibrium exists. Under these three conditions, the allocation of resources by markets is 'Pareto-optimal'; that is, no other allocation will make a consumer or producer better off without making someone else worse off. Violations of any of the three assumptions lead to inefficient allocation of resources by markets—market failures. If markets are not Pareto-efficient, then everyone *could* be made better off through public policies.

Within this framework, market failure is only a *necessary but not sufficient* condition for governmental intervention. The sufficiency results from an assessment that the gains from the intervention outweigh the associated costs due to 'governmental failures' (Tullock *et al.*, 2002). Thus, there would be a trade-off between two inefficient outcomes, one generated by free markets (market failure) and the other by governmental intervention (government failure). The solutions advocated by Neo-Keynesians focus on correcting failures such as imperfect information (Stiglitz and Weiss, 1981). Solutions advocated by Public Choice scholars (Buchanan, 2003) focus on leaving resource allocation to markets (which may be able to correct their failures on their own) (see section 4.2).

Four broad categories of market failures can be described, according to the source of failure (and, hence, what needs 'fixing') and which condition of the FFT it violates. Each of these four types of market failures can be directly associated with one of the roles that state investment banks play in the economy: (a) **coordination failures** would justify and explain the **countercyclical role**; (b) **public goods failures and situations of imperfect competition** would justify and explain the **capital development role**; (c) **information failures** would justify and explain the **new venture support role**; and (d) **negative externalities** would justify and explain the **challenge-led role**.

3.1. Countercyclical role

Capitalist systems are marked by business cycles (Schumpeter, 1939; Perez, 2002), when periods of economic prosperity are followed by periods of recession or crisis. In times of crisis, SIBs play a crucial role, as they supply countercyclical credit that would otherwise be in shortage due to the higher risk-aversion of private financial institutions. Thus, public investment provides short-term fiscal stimulus for the investments that keep the economy running.

a. Contemporary evidence for counter-cyclical investments

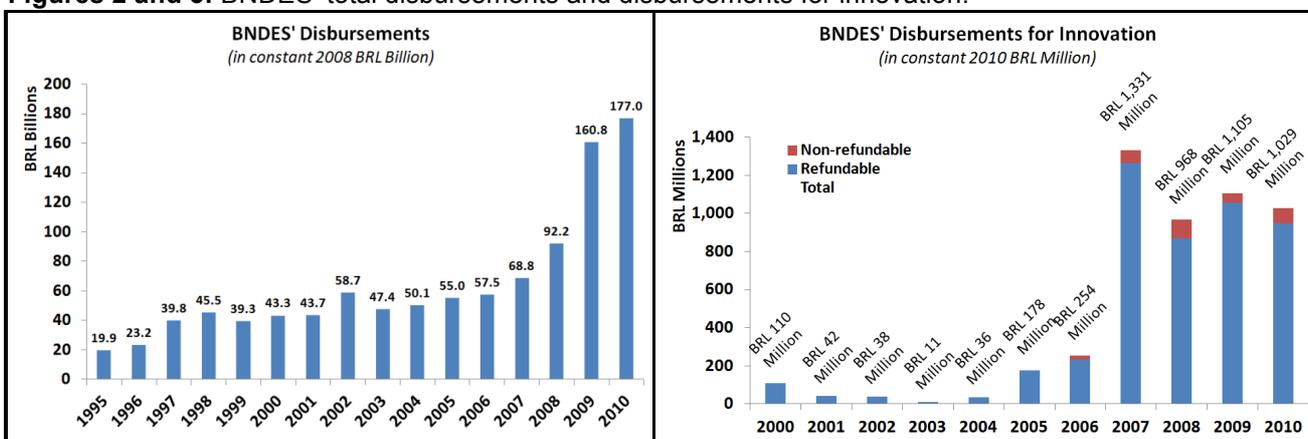
Banks like KfW have been supplying countercyclical credit for decades, including after the two oil crises of the 1970s and in support of developing countries facing the 'debt crisis' of the 1980s (KfW, 2009). Micco and Panizza (2004) provided evidence that state-owned banks throughout the world lent counter-cyclically between 1995 and 2002, which coincides with the period of several economic crises (the Mexican crisis in 1994–1995, the Asian-Russian crisis in 1997–1999; the Brazilian crisis of 1999; and the Argentinean crisis of 2001–2002). When there is a crisis, private finance retreats and public finance steps in—as happened again during the global financial crisis of 2007. Therefore, this role is not new *per se*. However, as we will see below, this kind of counter-cyclicality has been

increasingly intertwined with the other roles, being directed towards innovations or tackling grand societal challenges, such as climate change.

The countercyclical role became evident in the last economic crisis (2007–2010), when SIBs were best positioned to promote countercyclical lending to key sectors of the economy, because they were already familiarised with markets and clients, staffed with experienced professionals and had the financial capacity to respond to the credit crunch in a timely fashion (Luna-Martínez and Vicente, 2012). The EIB, for instance, played a critical role in 2008–2009 in sustaining investments to promote growth and employment in Europe. It expanded loans from €47.8 billion in 2007 to €57.6 billion in 2008 and to €79.1 billion in 2009 (Griffith-Jones and Tyson, 2012)—a 65 percent increase from the pre-crisis level. In developing countries, too, SIBs stepped up to counter the credit crunch. In Latin America, whose central banks were prevented from directly intervening in financial markets (quantitative easing *a la* FED), national and regional SIBs filled the vacuum and increased their assets by 30 percent (Gutierrez *et al.*, 2011). The China Development Bank (CDB) also played a key role in stimulating the economy so that China could ‘continue its growth spurt through the global financial crisis’ (Sanderson and Forsythe, 2013, p. xvi).

In Brazil, the availability of credit was particularly impacted by the crisis, as a consequence of the net decline in capital flows to emerging markets and the repatriation of investments (Kregel, 2009). As a result, both domestic and foreign financial institutions rationed credit to Brazilian industry. Instead of downplaying its ongoing industrial policy plan, the Brazilian government stepped it up through the *Program for the Sustainability of Investments* (PSI), which augmented tax incentives and the availability of credit by transferring resources from the Treasury to BNDES (Bastos, 2012). This decision resulted in increased disbursements by BNDES (Figure 2). In particular, in order to promote *innovation investments* (Figure 3), BNDES lowered interests of its main line of credit for innovation to 3.5 percent per annum and increased the terms of payment to 120 months (BNDES, 2012).

Figures 2 and 3: BNDES’ total disbursements and disbursements for innovation.



Sources: Figure 2 based on data from BNDES annual reports and Giambiagi *et al.* (2009). Figure 3 from Bastos (2012).

In Germany, KfW also played the countercyclical role, as part of the German (federal) government economic stimulus packages. In 2008, KfW launched its ‘Special Programme’, which sought to address the issue of low private investments that resulted in industrial capacity utilisation being below historical lows (1975, 1982, 1993) (KfW, 2010). The Special Programme, which was to be executed mainly by KfW’s subsidiary *Mittelstandsbank*, concentrated on the supply of working capital and other liquidity measures, but KfW also provided more funding for innovation, infrastructure, commercial investments, environmental protection, energy efficiency and rehabilitation (see Table 1). With the phase-out of the Special Programme in 2011, KfW’s trade and industry investments declined by 21.7 percent, returning to the pre-crisis level (KfW, 2012). Figure 3

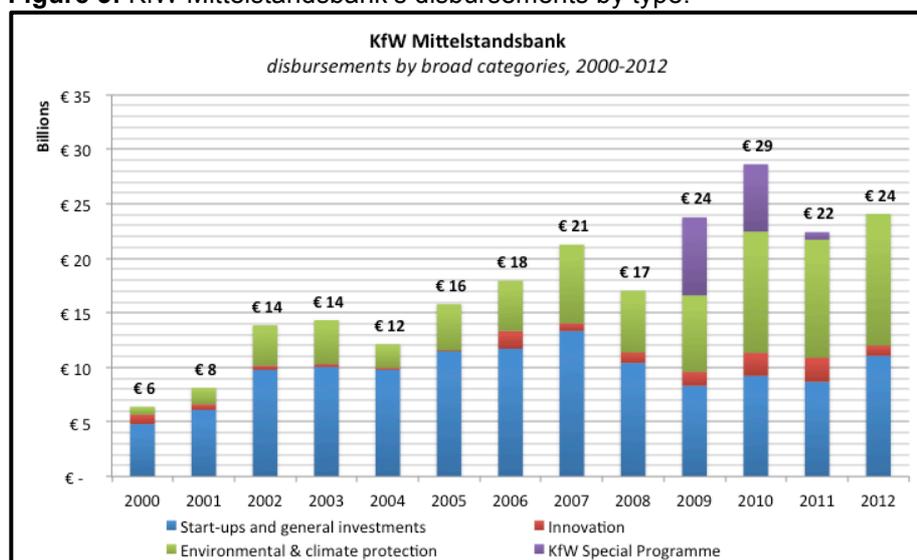
shows the evolution of disbursements by KfW Mittelstandsbank in the past decade, which highlights the significance of the Special Programme in 2009 and 2010.

Table 1: Four KfW components of the stimulus packages.

Four KfW components	Description	Volume of lending (forecasted)
1. Corporate financing, particularly to SMEs	• <i>New programme:</i> KfW Special Program	€40.0 billion
2. Energy-efficient construction and rehabilitation	• <i>Stepping up the existing programs for energy-efficient construction and rehabilitation</i> • <i>New programme:</i> Senior-friendly conversions	€8.5 billion
3. Innovation and energy-efficiency of enterprises	• <i>Stepping up existing programmes:</i> - ERP Innovation Programme - ERP Energy Efficiency Programme - ERP Start Fund • <i>New programme:</i> - KfW Programme Renewable Energies (supplement)	€1.0 billion
4. Infrastructure	• <i>New programme:</i> Investment Offensive Infrastructure	€3.0 billion
Total		€52.5 billion

Source: KfW (2010, p. 43).

Figure 3: KfW Mittelstandsbank's disbursements by type.



Source: Data from KfW's annual reports.

b. Market Failure Theory justification for countercyclical investments

The MFT justification of the countercyclical role is based on the notion that business cycles create an intertemporal dynamic that lead to situations in which the economy follows a Pareto-inefficient path (Stiglitz, 1974). In such situations, capital, labour and natural resources will be underutilised, because supply and demand for them do not match (Stiglitz, 1991). Such **coordination failures** occur when agents are unable to coordinate their expectations and preferences throughout the business cycle so that markets do not reach an equilibrium: supply does not match demand, workers do not find employment, and savings do not get invested.

From this perspective, the **countercyclical role** of SIBs would be justified as a way to address a type of coordination failure that arises from private agents' (such as banks and firms) being too procyclical (lending and investing too much in the boom and too little in the bust), putting the economy on a downwards path, and not realising that by increasing lending they would be helping the economy out of recession (Levy-Yeyati *et al.*, 2004). Therefore, MFT assumes that SIBs are 'risk-neutral' and capable of absorbing risk during an economic crisis, spreading risk over time and cross-sectionally (Arrow and Lind, 1970; Gutierrez *et al.*, 2011). It is this assumption that justifies the countercyclical role of SIBs. For instance, in times of crisis, greater risk aversion of private

agents may lead to underinvestment. To address this issue, SIBs may increase public investment to provide short-term fiscal stimulus to keep the economy running.

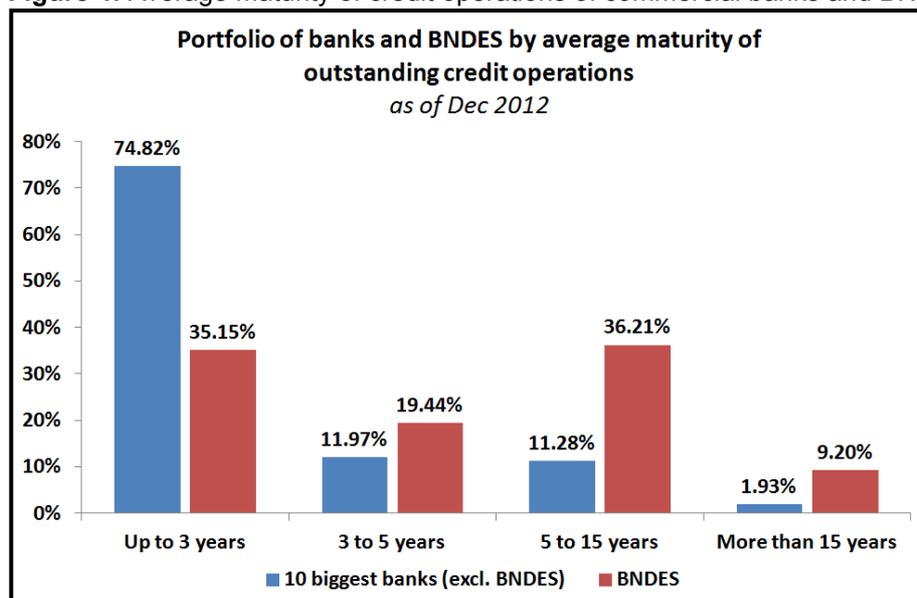
3.2. Capital development (or developmental) role

SIBs also play important roles during periods of economic boom, promoting strategic investments for economic development that lead to a multiplier effect. This was one of the original roles of many multilateral and national development banks, such as the IBRD (World Bank), JDB, KDB, BNDES and KfW. It is also the key role performed by export–import banks. Therefore, this role is not exclusive of SIBs from developing countries engaged in industrial catching-up, as could be expected. Indeed, despite Germany’s status as a developed economy, KfW still plays a developmental role (see below), and the original funds from the Marshall Plan are still revolved and invested in promotional areas (KfW, 2009).

a. Contemporary evidence for capital development investments

Today, the China Development Bank is the prime example of a SIB playing the capital development role, as it is the key financier of China’s five-year strategic plans. In the last two decades, CDB has ‘provided the capital and investment for China’s economy to catch up from a starting point without a modern banking system, small stock and bond markets’ (Sanderson and Forsythe, 2013, p. 177). Since 1994, CDB financed infrastructure and urbanisation projects to the tune of more than US\$2 trillion (*idem*). Brazil is another country whose SIB visibly plays the capital development role. BNDES is the main source of ‘patient’ finance for long-term capital development projects that are not financed by private initiatives. Even with the flourishing of a domestic capital market in recent decades, the private financial sector (particularly commercial banks) has concentrated on supplying credit to household consumption and short-term credit to firms, for which it could charge high interest rates with relatively little risk. Moreover, instead of funding long-term projects, *private investment banks* have tended to invest in Brazilian government bonds, which offer high yields (Kregel, 2009). Indeed, Brazilian private commercial banks’ loan portfolio is concentrated on loans with terms of less than five years (75 percent). In contrast, BNDES’ portfolio is made up of 37 percent of credit operations with 5–15 years of maturity and 9 percent with more than 15 years (Figure 4).

Figure 4: Average maturity of credit operations of commercial banks and BNDES.

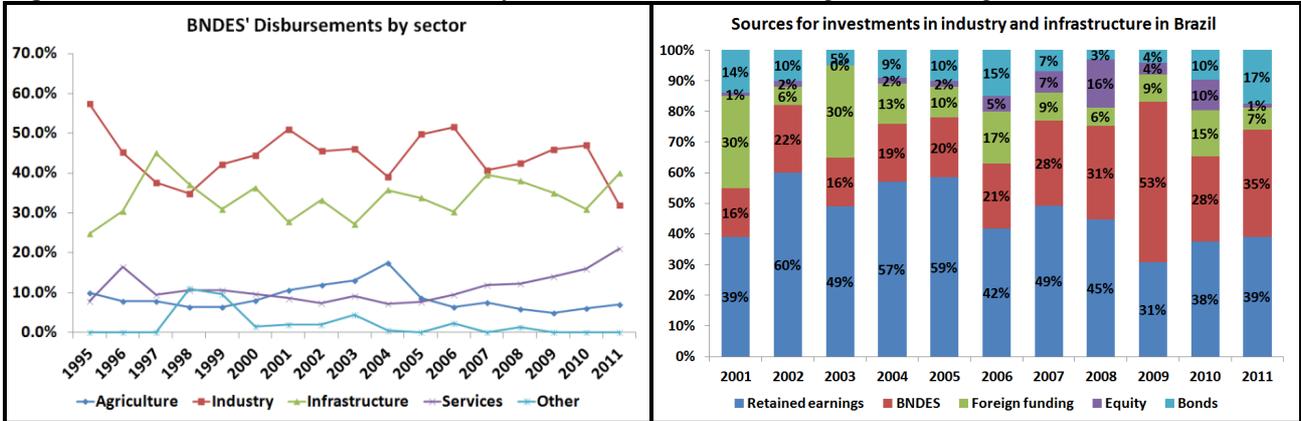


Source: Based on data from Portugal (2013).

The Brazilian private financial sector’s retreat from providing long-term funding for infrastructure and industry projects has meant that BNDES has historically concentrated its disbursements on these

sectors, a trend that has continued in recent decades (Figure 5). In fact, over the last decade, credit from BNDES was, on average, second only to retained earnings as source of funding for industry and infrastructure (Figure 6), while domestic private sector funding (equity and bonds) contributed with an average of less than 14 percent.

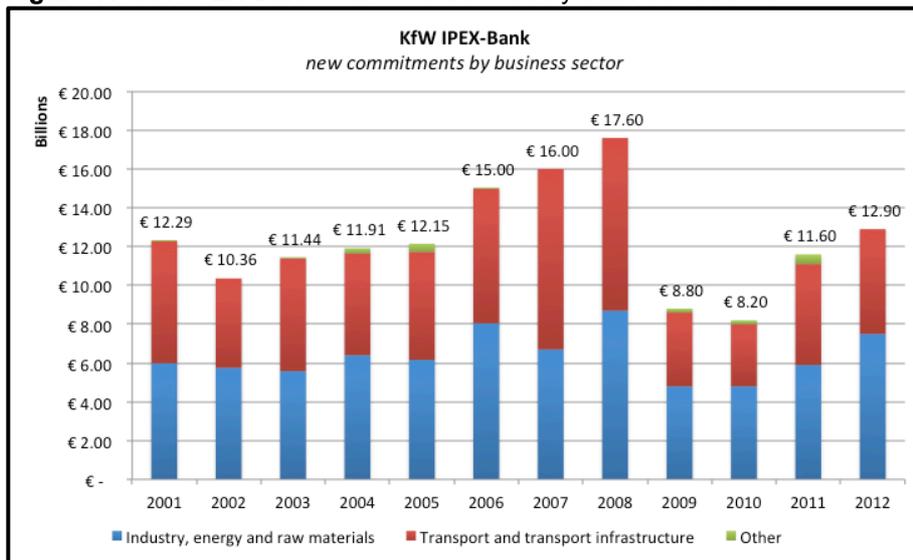
Figures 5 and 6: BNDES disbursement by sector and sources of long-term funding in Brazil.



Sources: Figure 5 based on data from Giambiagi *et al.* (2009) and BNDES' financial reports, and Figure 6 on data from Costa (2011).

In Germany, which has one of the most developed industrial bases, KfW continues to supply funding for the capital development of the economy, in the form of finance for infrastructure projects, exports, housing, etc. For example, KfW's independent subsidiary *KfW IPEX-Bank* provides project finance and export finance to promote competitiveness and internationalisation of German companies. While the rest of the KfW group mostly invests in SMEs, IPEX also structures project finance for big corporations, such as Airbus.⁹ Figure 7 shows KfW IPEX-Bank's new commitments by business sector, both in Germany and abroad. While detailed figures for KfW IPEX-Bank's domestic commitments are not available, an average of 30 percent of the bank's commitments were in Germany in 2008–2012, which represents approximately €3.3 billion per year, with 38 percent invested in the rest of Europe and 32 percent in other regions.¹⁰

Figure 7: KfW IPEX-Bank new commitments by business sector.



Sources: Based on data from KfW's annual reports.

⁹ The IPEX-Bank provides finance for the acquisition of Airbus aircrafts.

¹⁰ Our calculation based on data from KfW's annual reports.

Note: In 2009, accounting of IPEX-Bank's commitments by KfW changed due to IPEX-Bank becoming a legally and financially independent subsidiary.

b. Market Failure Theory justification for capital development investments

Wherever private lenders have limited incentives to finance projects with 'public good' characteristics (non-excludable and non-rival), or in situations of imperfect competition, the market is not an efficient allocator of resources, which means that public investments (through SIBs, for example) is justified. Examples include private markets underfunding of goods with very high spillovers or socially desirable infrastructure projects with positive externalities; both are characterised by value that cannot be internalised by private agents. R&D investments generate new knowledge, which cannot be fully appropriated by the original investor (who cannot 'exclude' other agents from using the knowledge to their own benefit). Thus, private agents tend to underinvest in R&D and innovation, because they cannot internalise benefits that would compensate for the development costs and make the investments worthwhile. Market failures associated with industry structures ('competition failures') are another rationale for the developmental role. Competition failures arise when there are high natural barriers to entry (due to scale economies or network effects), which also lead to Pareto-inefficient situations (Stiglitz, 1991). SIBs provide finance in situations of monopoly and monopsony, in order to promote entry of new agents, increase the pool of producers and consumers, respectively, and foster competition. Export–import development banks usually seek to address competition failures in global markets that prevent successful entry of national firms due to cost barriers. Thus, supporting the production of **public goods** (for example, provision of clean air or new knowledge) and addressing situations of **imperfect competition** (for example, natural monopolies, network effects, supply and demand-side economies of scale) are both key reasons for industrial policies and the associated **capital development role** of SIBs.

In order to correct for these kinds of market failures, the state may invest in early-stage blue-sky research, infrastructure and other public works, enforce competition policies, regulate natural monopolies, establish early technical standards, and so on. What also links those sources of failures is that they all focus on using macro industrial policies to promote investments in public goods that are under-produced in prevailing market conditions or to tackle situations of monopoly and monopsony (by promoting the entry of new agents to increase the pool of producers and consumers or avoiding collusion, thus fostering competition). As the evidence presented above has shown, SIBs are often the lead financing agent behind macro-industrial policy plans, both in developed and developing countries. SIBs sometimes fulfil their developmental role by promoting investments that seek to create a 'national champion', which seems at odds with the goal of promoting competition if one considers the national market. Nonetheless, this is a type of investment that seeks to promote the entry of a new producer in the world market.

3.3. New venture support role

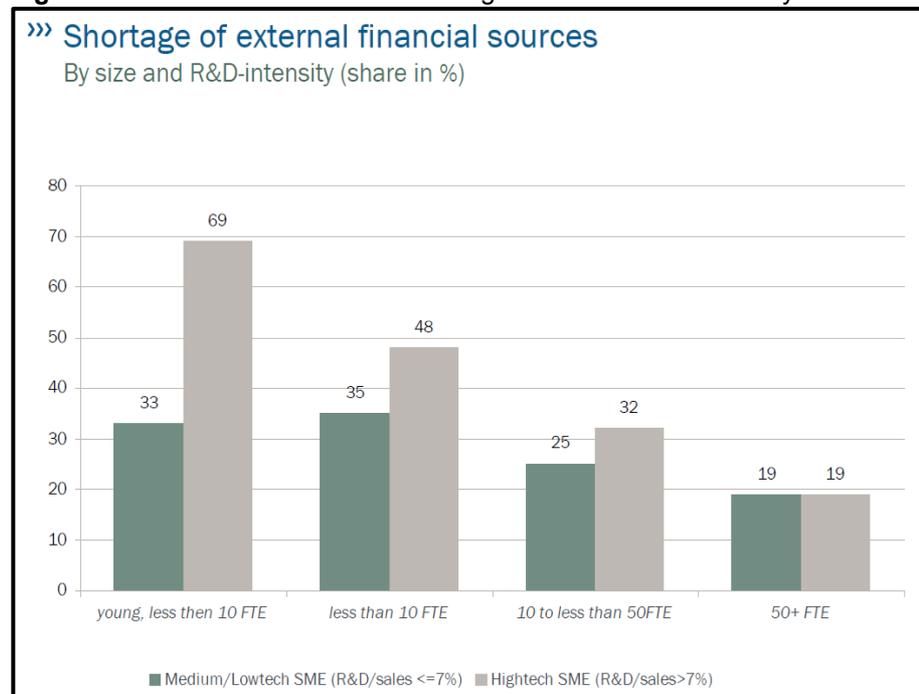
Investment in new ventures, such as small-and-medium enterprises (SMEs) and innovation development, has been the focus of SIBs since the 1950s, an activity that has intensified recently (KfW, 2009; Griffith-Jones and Tyson, 2013; BNDES, 2012). Underlying the initiative is the fact that SMEs face difficulties in securing external finance due to a lack of guarantees and collaterals or of a track-record of profitable investments. Innovation development also presents problems in securing external finance, due to the economic and technical risks and uncertainties that underlie the innovation process.

a. Contemporary evidence for venture investments

In industrialised economies, SIBs are particularly important in helping to address the SME 'funding gap', whereby small enterprises, particularly start-ups that are highly innovative, lack both internal and external sources of finance for innovative projects (Griffith-Jones and Tyson, 2013). In Europe, the European Investment Bank (EIB) created the European Investment Fund (EIF) in 1994, which is

dedicated to SME and venture capital investment.¹¹ In 2009, when the EIB was engaged in countercyclical lending, 19 percent of its total funding went to SMEs (Griffith-Jones and Tyson, 2012). In Germany, SMEs in general report difficulties in securing external financial sources, but the problem is more acute for young high-tech firms (Figure 8).

Figure 8: Lack of external finance for high-tech SMEs in Germany.

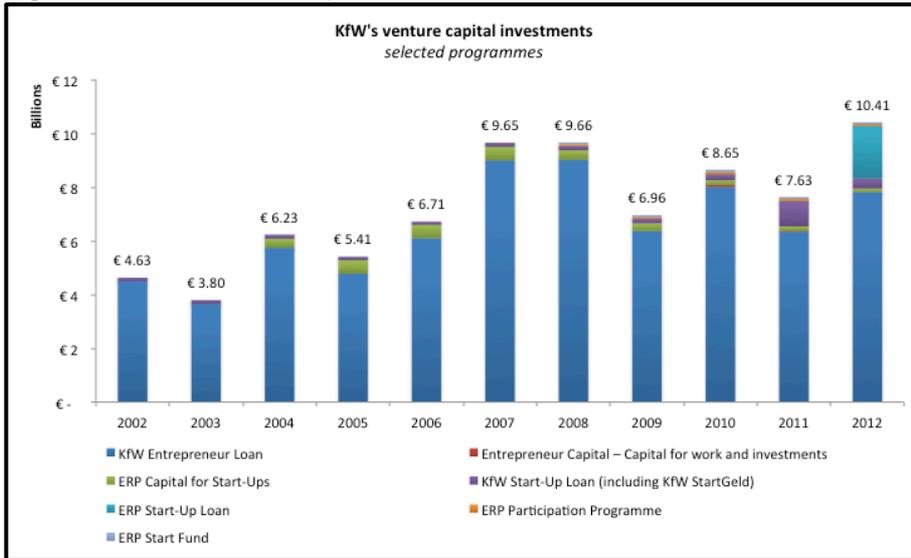


Source: Tchouvakhina (2013).

Therefore, another aspect of the funding gap is connected to innovation, which has led SIBs to increase their role in financing innovation in recent years. Many SIBs have programmes that do not target small firms *per se*, but those firms that are most innovative and engaged in technological development. KfW has a long tradition of providing venture capital to start-up firms developing new technologies (see Figure 9, which shows KfW's venture capital investments in the past decade). For instance, KfW's *High-Tech Start-Up Fund* provides VC finance to young technology companies in their seed phase (defined as its first year of existence), with the aim of supporting start-ups' innovation efforts until the proof-of-concept phase (product prototype) or even the proof-of-market phase (product launching) (KfW, 2012). The *ERP Start-Up Fund* provides VC finance to young companies that have passed the first stages of development, and it is designed to complement the EIB's *Investment Fund and Angels Fund*, in that it can match funding provided by EIB (KfW, 2012). Between 2008 and 2012, the ERP Start-Up Fund invested an average of €68 million per year.

¹¹ See <http://www.eif.org/>, accessed on 29 October 2013.

Figure 9: KfW's venture capital investments, 2002–2012.



Sources: Based on data from KfW's annual reports.

To finance innovative start-ups, the China Development Bank founded *CDB Capital*, a public equity fund with 35 billion yuan (c. US\$ 5.76 billion) in seed capital (Sanderson and Forsythe, 2013) that is used to finance high-tech companies (such as telecom firms like Huawei). At BNDES, equity investments are executed by its full subsidiary BNDESPar, which in recent years has started to invest in young and innovative companies. According to data published in Mattos (2008), BNDESPAR holds direct investments in approximately three dozen small and mid-sized innovative companies. One-third of these are ICT and electronics companies and a further 15 percent are biotech or biopharma companies. The data also shows that BNDES has invested in nanotech, defence, and medical equipment companies, among others. Since 2008, a significant portion of BNDES' equity investments have happened through the CRIATEC investment fund, which supplies seed capital for innovative start-up companies that develop disruptive technologies in high-tech and new sectors. CRIATEC establishes a clear link between risk-sharing and reward-sharing, as it 'aims to achieve capital gains through long-term investment in early-stage companies (including 'zero stage') that have an innovative profile and [offer] high-return prospects'.¹²

Another part of BNDES' support for research and development with commercial (innovative) potential consists of non-reimbursable funding (grants). BNDES reserves 1.5 percent of its profits¹³ to the technology fund FUNTEC, which is dedicated to support science and technology (S&T) institutions engaging in applied research, technological development and innovation. The FUNTEC has several goals, particularly the development of innovative solutions to promote environmentally sustainable development of Brazil (BNDES, 2012). FUNTEC resources are targeted toward the following specific technologies: (1) alternative energy, specifically bioenergy (such as new-generation biofuels), solar energy, and thermal energy; (2) nanotech and biotech solutions to address issues of waste disposal, land and water pollution; (3) bio-electronics, specifically *organic* electronics and other innovative integrated circuits; (4) new materials; (5) biochemistry; and (6) electric-drive vehicles, particularly technologies for the production, charging and storage of electricity in automotive vehicles. Although FUNTEC is marginal, given its size, it represents a radical departure from BNDES's traditional role of promoting catching-up strategies. It is a project to make Brazil a first-mover in radically innovative sectors to promote low-carbon growth, which is only possible when BNDES is successful in and profits from its other investments.

¹² See <http://www.fundocriatec.com.br/>, accessed on 12 June, 2013.

¹³ The percentage is shared with other social, cultural and economic research funds.

b. MFT justification for venture investments

The MFT justification of the **new venture support or venture capitalist role** is related to market inefficiencies at the micro level. An example is **information failures** arising from incomplete markets with high transaction costs and information asymmetries, such as unavailability of public information on bad vs. good borrowers (leading to adverse selection or moral hazard behaviours). Such market failures create inefficiencies associated with non-equilibrium situations that result from the interaction between agents (microeconomic exchanges). For example, microeconomic Pareto inefficiencies may be caused by information asymmetries that lead to adverse selection of potentially good borrowers (Stiglitz and Weiss, 1981); or they may be the result of high costs to carry out a transaction through markets (Coase, 1960). Classic examples are the lack of finance for small enterprises or for R&D/innovation projects, both of which are risky and uncertain. Underinvestment in R&D projects due to information asymmetries¹⁴ can even occur in the presence of strong intellectual property laws, macroeconomic stability, free-trade and contract enforcement, because markets are ‘incomplete’ (Stiglitz, 1991; Rodrik, 2004). In these situations, SIBs’ investment in SMEs and innovation, through loans, equity or grants, would be justified in order to promote economic diversification, growth and development.

3.4. Challenge-led role

In identifying SIBs’ challenge-led role, we take inspiration from science, technology and innovation (STI) studies that looked at mission-oriented policies (see, for instance, Mowery, 2010; Foray *et al.*, 2012). *Mission-oriented* are those kinds of policies that target the development of particular technologies that address a given societal challenge, such as ‘putting a man on the moon’, in the case of the Apollo Project. The mission-oriented literature developed many useful empirical studies and insights, but it has been limited to the analysis of agencies that focus on science, technology and innovation policies and finance STI projects through non-reimbursable funding. Indeed, most studies in a recent special issue of *Research Policy* (Volume 41, Issue 10) on historical mission-oriented policies looked at quite particular types non-reimbursable public finance for basic research, such as grants, subsidies (including tax credits), and innovation prizes.¹⁵ Given this limited focus, the literature overlooked the rise of state investment banks as sources of mission-oriented/challenge-led finance, a trend to which we turn now.

a. Contemporary evidence for challenge-led investments

The challenge-led role of SIBs is informed by missions pre-defined in bold public policy plans, such as Germany’s ‘energy turnaround’ (*Energiewende*), which seeks to phase out nuclear energy and fossil fuel and substitute them with renewable energy sources in order to tackle climate change, protect the environment (save resources) and promote energy security. Other challenges that SIBs are tackling around the world are the inclusion of populations to health systems (BNDES), demographics and globalisation (KfW and EIB), and the transition to a green economy (development banks of China and Korea). Here we concentrate on presenting evidence about their investments in projects aimed at addressing climate change (‘green investments’).

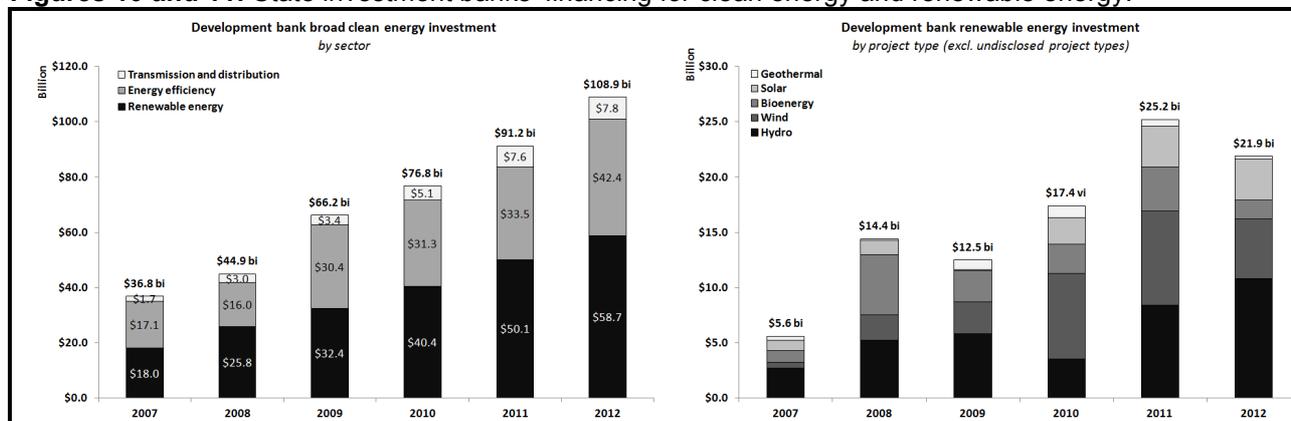
Relatively well-established green energy technologies, such as solar, wind and biofuels, which first received development impetus following the 1970s energy crisis, still require the active support of governments for patient long-term committed finance (Mazzucato, 2013a). Indeed, in the emerging green economy, too little private finance is going into the most capital-intensive and high-risk areas of renewable energy (Ghosh and Nanda, 2010). The few investments that have been made in this area have diminished since the financial crisis of 2007 (FS-UNEP/BNEF, 2013; Geels, 2013). There

¹⁴ As explained above (section 3.2), R&D projects may also be underfunded because the knowledge they generate is a public good. Therefore, R&D projects suffer with market failures both at the micro and macro levels.

¹⁵ One exception is Edquist and Zabala-Iturriagoitia (2012), who looked at Public Procurement for Innovation (PPI) as a means to address societal problems. However, as the authors argue, this is not a funding instrument: PPI is a demand-side policy that indirectly supports developmental costs by guaranteeing the acquisition (procurement) of the final product.

is increasing evidence that since 2007, it has been SIBs that have been making the core investments in clean-energy projects (Climate Policy Initiative, 2013). Figure 10 shows how SIBs have trebled their investments in renewable energy between 2007 and 2011. Figure 11 breaks up investments in renewable energy by project type.

Figures 10 and 11: State investment banks' financing for clean energy and renewable energy.



Source: Based on data from FS-UNEP/BNEF (2013).

Some SIBs, such as BNDES, CDB, EIB and KfW, are particularly active in promoting green energy investments. In Brazil, BNDES supplies mission-oriented funding for applied research and development projects through targeted 'sectoral' programmes (Schapiro, 2012). For instance, the so-called PAISS programme aims to reposition Brazil in the race for cellulosic ethanol. BNDES estimates that, by 2021, investments to fully diffuse the technology (and substitute for first-generation production methods) will require \$60 billion, which will lead to net savings in planted area (and indirectly save carbon emissions from deforestation) and to a 60 percent increase in efficiency in the use of sugar cane crops (Ramundo, 2013). BNDES also takes part in the *Business Innovation* programme established by the federal government as part of the most recent industrial policy plan (*Plano Brasil Maior*; PBM), which targets innovation in strategic areas with a higher risk profile and aims to develop a green economy in Brazil (Brazilian Ministry of Finance, 2012). One of the areas is *energy innovation*, which focuses on renewable energy, for which BNDES (together with FINEP, the Brazilian agency for financing innovation projects and R&D) will supply \$2.8 billion (Ramundo, 2013). Another area is *Environment* (greentech), which will receive another \$1 billion in investments from BNDES. In addition, BNDES funds cutting-edge technology development projects in the areas of alternative energy, nanotech, biotech and electric-drive vehicles through the FUNTEC, which can therefore also be seen as contributing to BNDES' challenge-led role.

The CDB has a track record of funding alternative energy firms to develop their technologies, such as the solar company *Yingli Green Energy*, which received approximately US\$1.7 billion from 2008 through 2012 and has a US\$5.3 billion line of credit opened for it at CDB (Sanderson and Forsythe, 2013). Since 2010, the CDB has made available US\$47.3 billion in credit lines for Chinese wind and solar energy companies and another US\$30.6 billion for clean energy transmission, distribution and efficiency investments. In 2010, the list of Chinese alternative energy technology companies receiving CDB lines of credits included LDK Solar (US\$9.1 billion), Sinovel Wind (US\$6.5 billion), Suntech Power (US\$7.6 billion) and Trina Solar (US\$4.6 billion), which 'allowed Chinese companies to further ramp up production and drive down costs' of renewable energy technologies (Sanderson and Forsythe, 2013, p. 151). Thus, CDB is a key element in China's mission of producing 20 percent of its energy from renewables by 2020.

Since the establishment of the EU 2020 strategy, the EIB has increased its commitments to new sectors such as renewable energy, and supported the modernisation of European energy grids to facilitate transmission of renewable energy sources. Furthermore, it has promoted energy efficiency in housing and the development of 'smart cities', where advanced infrastructures substitute for

carbon-dependent ones.¹⁶ EIB's 2010–2012 *Operational Strategy* defined environmental protection and sustainable development as key focal objectives. In accordance, the EIB stepped up its investments in climate-protection projects. In 2010, EIB's investments for climate action reached €20.5 billion, including €4.1 billion for greentech R&D, €6.2 billion specifically for renewable energy and €7.9 billion for sustainable transport (such as electric vehicles and related infrastructure). In 2012, EIB launched the pilot phase of the *Europe 2020 Project Bond Initiative*, which aims to stimulate investment in key strategic EU infrastructure in transport, energy and broadband. The EIB committed €230 million to the initiative, which will enable it to provide funding to infrastructure projects worth more than €4 billion. Amongst the first projects financed through the initiative are new grid connections to several offshore wind farms in the UK and Germany. The EIB's investments also targeted the development of radical low-carbon innovations. In 2009, these investments included financing the R&D of electric and energy-efficient cars and of wind turbines (Table 2), each carried out by leading private companies. In 2012, EIB announced a €180 million loan to the Renault Group for the development of new generation of batteries and motors for electric vehicles.

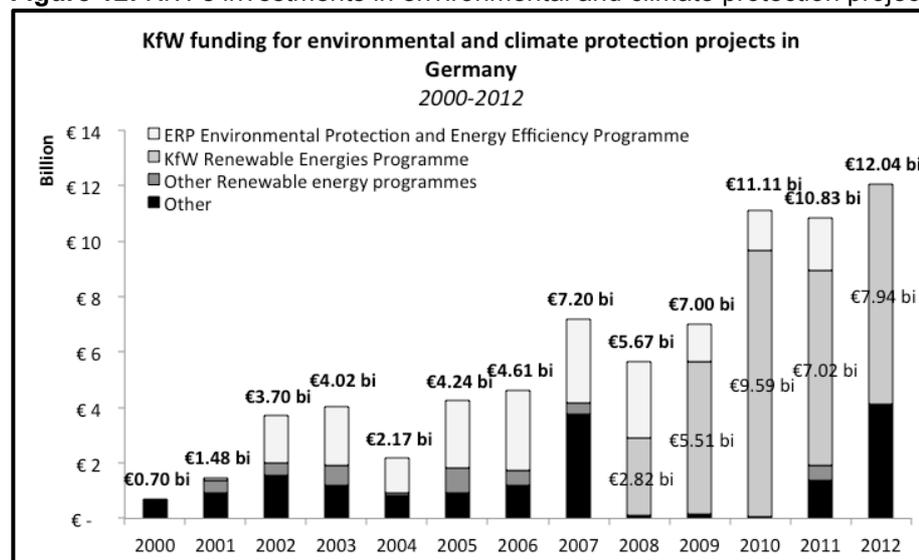
Table 2: Examples of cutting-edge projects financed by EIB in 2009.

Project description	Countries	Private sector partners	Investment size
R&D of Electric & energy-efficient cars and related infrastructure	Germany, France, UK, Spain	BMW, Daimler, Renault, Nissan	€1.3 billion
R&D of wind turbines	Denmark	Vestas Wind Systems	€250 million

Source: Griffith-Jones and Tyson (2013).

In Germany, KfW has a long tradition of investing in the development of green innovation and in the modernisation of industries, urban infrastructure and housing to promote the reduction of CO₂ emissions through the use of new technologies. Figure 12 depicts the trend in KfW's investments in environmental and climate protection projects in Germany from 2000 to 2012, showing that the level of investments increased more than 10-fold in the period. In addition to its funding programmes, KfW provides advice and covers costs associated with expert advice, a service-side measure that seeks to motivate existing firms to invest in energy efficiency by countering their lack of information on savings potential or ability to use renewable sources.

Figure 12: KfW's investments in environmental and climate protection projects in Germany.



Source: Based on data from KfW's annual reports.

b. Market Failure Theory justification of challenge-led investments

¹⁶ In 2010, it committed €14.7 billion to sustainable cities projects such as transport and urban renewals (Griffith-Jones and Tyson, 2013).

Such kind of investments to tackle societal challenges can also be justified through MFT, as they seek to address **negative externalities** arising from the production or use of goods and services such as climate change, traffic congestion, or antibiotic resistance, for which there is no market. Indeed, from a market failure perspective, most societal challenges are seen as negative externalities, a source of market failure that works at the system level. In other words, they amount to 'system failures', which would justify SIBs' **challenge-led (or systemic) role**. The socio-economic system as a whole results in 'costly' outcomes that are undesirable from a societal point of view. Negative externalities are not reflected in the price system: there is no 'equilibrium' price because there is no market for negative externalities. For instance, climate change can be seen as a negative externality from carbon-intensive production methods or the burn of fossil fuels. Indeed, the *Stern Review* on the economics of climate change (Stern, 2006) stated: 'Climate change presents a unique challenge for economics: it is the greatest example of market failure we have ever seen' (Stern, 2006, p. 1). SIBs' mission-oriented investments would seek to internalise such external costs by promoting the development of new technologies and innovations that represent a 'solution' to a given societal challenge.

4. The MFT evaluation toolbox and associated criticisms

4.1. The MFT evaluation toolbox

Each of the four roles of SIBs are justified through MFT as a mean of addressing a particular type or source of market failure. The countercyclical role seeks to address coordination failures; the (macroeconomic) capital development role seeks to provide public goods or address situations of imperfect competition; the (microeconomic) new venture support role seeks to address informational problems that result in funding gaps (for SMEs or innovation); and the systemic challenge-led role seeks to address issues of negative externality. Thus, MFT calls for a limited role for SIBs, the activities of which should be restricted to very specific areas (that is, those that suffer from market failures) to fill in the gaps left open by private initiative (Gutierrez *et al.*, 2011). This should be done in a way that minimises the risk of government failure, from crowding out to cronyism and corruption.

MFT assumes that once the sources of the failure have been addressed, market forces will efficiently direct the economy to a path of growth and development. For this to happen, MFT calls for an institutional structure that *insulates* the public sector from the private sector (to avoid issues such as agency capture). In this view, the role of the state is limited in time, size and scope: it is simply to correct market failures and perform a subsidiary role to private initiative, so that once sources of market failures were addressed, it would be sufficient to have little more than a 'minimal' state that performs only 'unanimously approved' functions, such as guaranteeing property rights and enforcing contracts (Atkinson & Stiglitz, 1980). In other words, the size of the state apparatus could decrease, which would reduce the roles and importance of SIBs over time.

In MFT, these normative rationales are accompanied by a toolbox for public investment decision-making, implementation and evaluation. The market failure framework has developed concrete indicators and methods to evaluate public investments, which stem directly from the theory itself, usually through a cost-benefit analysis that estimates whether the benefits of public intervention compensate for the costs associated, both with the market failure and the implementation of the policy (including government failures). The mainstream diagnostics and evaluation approach (based on market failure theory) involves identifying the sources of the market failure and targeting policy interventions on their correction. It mostly entails *ex-ante* considerations about administrative and fiscal requirements and the political-economic consequences of the intervention (Rodrik, 2004). Such an exercise usually consists of the following steps:

- An *ex-ante* cost-benefit analysis that weighs up the costs of the failure, the (private and social) benefits from addressing it, and the costs and risks of government failure.
- An *ex-ante* identification of sources of market failures and of 'second-best' policy tools to address these failures.

- An *ex-ante* diagnostic of the best principal–agent structure that avoids governmental capture by private interests (insulation/autonomy) and that forces private agents to do what the principal (government) wants.
- An *ex-post* evaluation of the outcomes of the intervention vis-à-vis the *ex-ante* quantifiable prediction of the likely outcomes of the intervention.

This is a limited toolbox for evaluating public investments, because doing so represents a static exercise of evaluation of an intrinsically dynamic process. Therefore, as we argue in section 5, there is a mismatch between the intrinsically dynamic character of economic development and the static tools with which the role of the state in the process is evaluated.

4.2. MFT-related criticisms to state investment banks

MFT provides a normative rationale for and precise tools to evaluate the roles of state investment banks. In practice, however, the consensus regarding the importance of SIBs has changed substantively over time, ‘from a clear case for the need for DBs in the 1950s to the view that DBs created more inefficiencies and distortions to a more eclectic view of market friendly interventions within a general limited role for the institutions’ (Gutierrez *et al.*, 2011, p. 6). Accordingly, some economists and economic commentators have criticised the enhanced roles that SIBs have been playing in the economy, suggesting that their actions often lead to outcomes that are worse than the issues they seek to address. Criticisms of SIBs stem directly from the market failure perspective and can be categorised into four broad types:

a. *Financial repression and crowding out*

One of the most widespread criticisms of the activities of SIBs is that their investments crowd out private investments. For instance, in a recent article about the level of investments carried out by the Brazilian development bank BNDES, the *Financial Times* wrote that ‘[c]ritics have long pointed to the BNDES as a big impediment to the formation of mature capital markets in Brazil. About three quarters of all corporate loans lasting three years or more come from the BNDES. What chance is there of developing a functioning market based on the needs of the other quarter that can’t get BNDES funding?’ (Wheatley, 2013: online). In other words, by displacing (crowding out) private initiative, BNDES’ investments would prevent the development of a long-term capital market instead of being a solution to its absence. In academic terms, this criticism is conceptualised through the Financial Repression Hypothesis (McKinnon, 1973), according to which the use (by development banks or other central planning institutions) of low or negative (in real terms) long-term interest rates is the cause, not the consequence, of the inexistence of a long-term credit market. Managed long-term interest rates would crowd out credit that would otherwise be supplied by private agents in a free-market, thereby inhibiting both the activity of commercial banks and the creation of a capital market. Another example of the criticism is the fear that KfW’s dominance of the German long term capital market, commercial bank margins for long-term infrastructure and industry projects in Germany are not sustainable, which therefore prevents the full development of the market (Mussler, 2013).

Theoretically, crowding out criticisms are associated with some mainstream (Neo-Keynesian or New Classical) growth models that result in public investments crowding out private investments, particularly if governmental deficits are financed through debt (Friedman, 1979; Hemming *et al.*, 2002). Based on the results from these models, academic critics argue that development banks may crowd out private investments through a direct and/or an indirect route. The former occurs when public investment substitute for private investments, that is, they subsidize or directly fund investments that offered a large enough return on investment to motivate financing by profit-seeking firms (Cohen and Noll, 1991, *apud* David *et al.*, 2000); the latter when public investments induce changes in interest rates and exchange rates, which lead to lower private investments. There have been numerous scholarly attempts to test the crowding out hypothesis and they have reached contradictory conclusions (for reviews, see Hemming *et al.*, 2002; Hur *et al.*, 2010; for a review of studies that investigated whether public R&D crowds out private R&D, see David *et al.*, 2000).

Because the crowding out hypothesis is derived from specific economic models, its validity remains controversial (Tassey, 2012). Thus, a demonstration of the direction of causality between public investments and the inexistence of a long-term capital market or confirming the crowding out hypothesis has proved elusive.

b. Misallocation of resources due to political biases

Krueger (1990) argued that, historically, 'government investment programs were highly inefficient and wasteful... [and] led to high rates of inflation, with their attendant consequences for resource allocation, savings [behaviour], and the allocation of private investment' (p. 3). She also claims that misallocation of resources by the public sector is often accompanied by 'large-scale and visible corruption' and benefits the most affluent members of society. In short, the criticism of misallocation of resources due to political biases states that public ownership politicises resource allocation and reduces the efficiency of SIBs. In the case of public investments in R&D and innovation, Cohen and Noll (1991) argue that most public investment programmes are in fact instances of "pork-barrel politics". They are created to reward regional constituencies and particular interest groups or to secure passage of other, unrelated, legislative proposals ('logrolling'), being susceptible to performance under-runs and cost overruns (see also discussion in Etzkowitz and Leydesdorf, 2000).¹⁷

In line with this view, critics argue that due to political interference, SIBs would tend to finance government-sponsored projects without giving proper consideration to the objective of optimal resource allocation; instead, the goal would be to leverage an otherwise constrained government budget (Gutierrez *et al.*, 2011). In most cases, the criticism goes, government-sponsored projects are those that are highly visible (big projects) or those that favour their allies/constituencies (pork-barrel politics), often well-connected incumbents that want to expand their businesses (La Porta *et al.*, 2002; Hanson, 2004). The flip-side of the argument is that politicians will be reluctant to 'let a project fail' due to the political consequences of such a failure. Ultimately, if the portfolio of (government-sponsored) projects do not provide enough cash flow, the SIB will become insolvent and even face bankruptcy (Gutierrez *et al.*, 2011).¹⁸ Such criticisms may lead to other practical consequences. For example, BNDES, which is often the target of criticisms due to its size relative to the Brazilian economy and to its active policy of supporting large national companies ('champions'), was downgraded by Moody's in 2013, due to 'concerns that they had become too heavily exposed to their biggest borrowers' (Leahy, 2013: online), because this would risk BNDES's solvency if these 'champions' prove themselves to be losers.

c. Incapacity to 'pick winners'

Many SIBs target their finance at particular technologies and sectors, in an attempt to pick winners. However, critics argue, SIBs (and governmental agencies, in general) are poor at doing this because they lack the necessary capability, information and incentives to succeed in these attempts (Hanson, 2004). This view argues that politicians and bureaucrats are bad or biased managers and lack the discipline provided by markets. Therefore, governmental attempts to pick winners 'ignore both government's deficiencies in forecasting industrial change and managing entrepreneurial activity, and the lessons from past experience' (Grant, 1982, p. 29). While governments could be in a better position than private business to forecast technical change, their selection of 'winners' would necessarily reflect a consensus instead of a variety of views (as when markets select

¹⁷ Therefore, in many cases public R&D and innovation projects would be attempts to solve interest group conflicts and Arrow's Impossibility Theorem (that is, the fact that pluralistic democracies cannot have a voting structure that meets specific fairness criteria such as Pareto efficiency, because voting preferences are not well-behaved and consistent amongst alternative candidates). Cohen and Noll (1991) confirm this hypothesis in six case studies of government funding for near commercial stage projects (in aerospace and energy). We thank one anonymous reviewer for calling our attention to the nuanced argument of misallocation of resources due to political biases (and for the reference).

¹⁸ Hanson (2004) cited examples from public banks in Indonesia and India. Krueger (1990) cited examples from Thailand and Sri Lanka.

technologies); this in turn would result in the selection of a suboptimal technology (Grant, 1982). The criticism was summarised in an article in *The Economist* titled ‘Picking Winners, Saving Losers’, which concluded: ‘The present round of industrial policy will no doubt produce some modest successes—and a crop of whopping failures’ (The Economist, 5 August 2010, online). In the case of SIBs, critics also argue these public financial institutions are also incapable of picking winners, because political considerations substitute for commercial considerations (Hanson, 2004). Thus, due to a supposed technical and political incapacity, Lisboa and Latif (2013) criticised BNDES, which ‘has been picking up “winners” that neither invests [sic] in capital-intensive projects nor in projects that improve their performance’ (p. 38). Similarly, through an in-depth analysis of BNDES investments, Lazzarini et al. (2015, p. 250) argue that “BNDES is lending to firms that are not changing their performance and investment conditional on the new loans... By targeting those firms, development banks may be cherry picking borrowers, leaving mostly high-risk firms to private lenders, hence inhibiting the emergence of a private market for long-term lending”. In this sense, BNDES would not be picking winners, while at the same time crowding out private investments.

d. *Inefficient governmental structures*

Critics argue that SIBs should be structured in a way that balances the need to hold managers accountable for their decisions against the risk of capture by private interests (Gutierrez *et al.*, 2011). Therefore, the optimal principal–agent structure (governance) for a SIB would facilitate the setting up of incentives for managers to meet the different objectives defined by the state (for example, supporting the development of industry, creating employment, providing finance to SMEs, promoting innovation, addressing societal challenges, etc.) and allow the state to judge SIB performance and hold management accountable (Hanson, 2004). It would also insulate management from influence by other (private sector) stakeholders engaged in rent-seeking (Krueger, 1974), who would be willing to use political pressure and even bribery to obtain a subsidised loan from the state development bank. Critics argue that, in practice, SIBs (or public banks in general) ‘tend to lack good information systems, because of widespread operations, weak national communications, and the lack of information technology personnel as well as funds to hire them, let alone buy equipment’ (Hanson, 2004, p. 10). This results in a non-transparent bureaucratic structure that is prone to inefficient and political capture. Lisboa and Latif (2013), for instance, accused Brazil’s BNDES of not complying ‘with the key design attributes for a successful industrial policy ... There is no transparency on BNDES operations. No available data on total subsidies provided, benefited companies or sectors and the cost-benefit of policies. Furthermore, the evaluation of the outcome of BNDES investment decisions is also unavailable’ (p. 38).

5. Towards a new framework: The roles of SIBs from heterodox economics perspectives

In this section, we will show the limitations of the market failure justification in explaining the increased role of these banks and propose an alternative framework based on notions from heterodox perspectives, which have either provided a critique of market failure theory or produced concrete insights on the roles of state investment banks, and yet they have achieved little systematic impact in the way state action is justified, formulated, implemented and evaluated. The key theories and concepts that we draw on include Keynes’ notion of *socialisation of investments*; Minsky’s stage view of capitalism (his concept of *money manager capitalism*) and proposal for *community development banks*; Schumpeter’s conceptualisation of *economic development as a dynamic process*; Polanyi’s view of *markets as shaped and created by the state*; Neo-Schumpeterian studies on microeconomic dynamics and the concepts of *technological trajectories* and *techno-economic paradigm shifts* in evolutionary economics (Dosi, 1982; Perez, 2002); *mission-oriented policies* in science and technology policy research (Mowery, 2010; Foray *et al.*, 2012); *developmental network state* in development economics (Wade, 1990; Amsden, 2001; O’Riain, 2004; Block & Keller, 2011); and Mazzucato’s (2013a) *entrepreneurial state*. By combining concepts from these theories, we aim to develop a qualitatively different typology that represents the seeds for a new theoretical framework of what SIBs do.

5.1. Countercyclical role

Recent cycles of boom-and-bust have been exacerbated by dysfunctional financial markets that focus on speculative gains even during periods of burst. Thus, the issue is not so much that private agents are risk-averse and preferences are pro-cyclical (as in MFT), but that they became increasingly speculative over the past decades. The Post-Keynesian literature has showed that the type of financial structures in an economy (for example, the quantity and type of banks) is not inconsequential to the workings of the real economy and productive enterprises. Some structures are conducive to what Minsky calls the ‘capital development’ of the economy (see also next section), which includes privately owned capital equipment, technologies, skills, and public infrastructure (Minsky, 1992). However, capital development is hampered when speculative finance targets low-risk, short-term gains through the trade of securities and other investments types that ‘[amount] to little more than pyramid schemes’ (Wray, 2012, p. 310). Minsky described the laissez-faire financial architecture that was established in the 1980s as ‘Money Manager Capitalism’, which he believed was inhibiting the ‘capital development of the economy’, because it led to speculation, short-termism, volatility, uncertainty and financial instability (Minsky and Whalen, 1996; Papadimitriou and Wray, 1998). So, the problem is not so much of risk aversion but of financialisation and speculation, which affect the countercyclical role as well as the other three roles of SIBs.

This situation, which has repeated itself in capitalist history (Perez, 2002), does call for public policy intervention, which may take the form of a reform of the financial system and/or of innovation and fiscal policies (for example, through SIBs)—both of which were policies implemented in the United States with the New Deal, which has been influenced by the ideas of Keynes. In the realm of fiscal policy, Keynes called for ‘socialisation of investments’ as ‘the only means of securing an approximation to full employment’ (Keynes, 2006 [1936], p. 246). However, Keynes was not so much concerned with underinvestment as he was with underutilisation of productive resources, particularly labour. The goal of his policy proposals was not to increase investments per se but to decrease unemployment. As Tcherneva notes: ‘Public investment is a direct approach to reducing unemployment. Add to that the secondary employment effects produced by the multiplier effect and we can estimate how much public-works spending is needed to close the [labour] demand gap. Whenever Keynes spoke of how much national income and expenditure are needed to maintain full employment, his “calculations are in terms of equivalent men... and women, if they are unemployed...”’ (Keynes, 1980, p. 298) (Tcherneva, 2008, p. 18).

In summary, while the need for public promotion of countercyclical credit is usually seen as resulting from coordination failures, SIBs actually do much more than just correct markets in this role. SIBs play an important short-term role of *directing* finance to productive opportunities, and in this sense, the countercyclical—or, more accurately, the intertemporal coordination role—provides the basis for all other SIB roles, laying the groundwork for the capital development of the economy, the full utilisation of labour resources, the creation of new technologies and sectors, and the direction of techno-economic change through challenge-led/mission-oriented investments.

5.2. Capital development (or developmental) role

In Schumpeter (1934 [1912]), economic development is a discontinuous *endogenous* process and results from investments in ‘new combinations’: new methods of production, new products, opening of new markets, new sources of supply, and new forms of organisation—all of which disturbs the prevailing economic equilibrium. From the entrepreneur or the corporation point of view, the objective of introducing new combinations is the creation of ‘monopoly rents’ (or ‘Schumpeterian rents’). Interventions and investments that seek to address a market failure aim to bring the economy back to equilibrium of perfect competition, thereby ‘killing’ Schumpeterian rents. This is at odds with Schumpeter’s view of economic development. In fact, in the ‘lost’ seventh chapter of *Theory of Economic Development*, Schumpeter points to the limitation of the static perspective of mainstream economics that sees development as an exogenous process:

Our most important result is that such economic development really exists. [...] This conception is the contrary of an alternative explanation which can be expressed as follows: an economic equilibrium, once attained, will be maintained, as long as there is no disturbance coming from the outside. [...] According to this conception the purely economic plays only a passive role in development. Pure economic laws describe a particular [behaviour] of economic agents, whose goal is to reach a static equilibrium and to re-establish such a state after each disturbance. [...] It is true that this way of thinking corresponds to the fundamental principles of static economics. It allows for the precise formulation of static laws... Yet we maintain that the conception described is not sufficient to explain the real development of the economy. (Schumpeter, 2002 [1912], p. 96–97)

The limitation of the market failure view on the developmental role becomes more apparent when we look at the work of developmental economists studying catching-up and industrialisation processes (e.g. Prebisch, 1950; Singer, 1950; Hirschman, 1958; Nurkse, 1966). It was Moses Abramovitz (1986), an economist more concerned with growth, productivity and business cycles in developed economies, who originally formulated the 'catch-up hypothesis': 'Countries that are technologically backward have the potential for generating growth more rapidly than that of more advanced countries, provided their *social capabilities* are sufficiently developed to permit successful exploitation of technologies already employed by the technological leaders' (p. 390 – *our italics*). Key in this definition is the 'social capabilities' qualification, a variable that is difficult to measure but includes technical competence and political, commercial, industrial and financial institutions (Abramovitz, 1986). In fact, Prebisch (1950), Singer (1950), Nurkse (1966), among others, had theorised about problems of (lack) industrialisation, terms of trade imbalances, and insufficient availability of capital in underdeveloped countries, providing the foundation of active development strategies through governmental investments and policies. From this perspective, economic development is not the result of natural (exogenous and ex-ante) competitive advantages, but of the endogenous creation of new opportunities that lead to the establishment of competitive advantages (Rodrik, 2004).

Work on the *developmental state* has revealed the importance of the 'visible hand' of the state in industrialisation and technological change (Wade, 1990; Amsden, 2001; Chang, 2002). More recently, this literature has also emphasised the developmental *network state* as being key: a decentralised network of different types of state agencies that can foster innovation and development. This requires the cost structure of an economy to be discovered in order to identify which types of goods and services that already exist in world markets can be produced in a domestic economy at low cost (Rodrik, 2004). In line with this alternative view, SIBs play a central role in developing social capabilities and fostering the catch-up process; in many instances, they also represent a 'lead agency', coordinating a network of actors in latecomer countries' development efforts (Mathews, 2006). In order to do this, a development bank/SIB may work as an agency to nurture knowledge development; invest in infrastructure; promote strategic trade (such as import substitution, securing sources of materials) and financial leverage; prioritise investments in existing strategic sectors (reinforcing comparative advantages); create 'national champions' that are able to compete in international markets; and provide coherence to economic policies (Reinert 1999; Mathews, 2006; Etzkowitz and Ranga, 2009).

While the need for some of these activities may be explained by market failure theory (for example, investment in public goods like knowledge and infrastructure), in fulfilling this developmental role SIBs do much more than just provide financial capital to fix failures. Because economic development is an endogenous process, they provide *social capital* for the development of social capabilities, coordinate initiatives and public-private partnerships, foster synergies, and promote the introduction of new combinations that create Schumpeterian rents. In this sense, the developmental role of SIBs also underlies (and overlaps with) the roles of supporting new ventures and promoting mission-oriented investments.

5.3. New venture support role

There are two key reasons why a focus on *smallness*, as implied by the market failure perspective on the new venture support role, is misguided. First, Minsky suggested that one form that the Keynesian socialisation of investments should take, is of *community development banks*, which were established to fill the gap in banking and financial services for small firms and individuals in certain local communities (Minsky, 1993). The ethos of community development banks were to promote the financial *inclusion* of certain strata of the society and certain regions, but this is not an end in itself, as would appear from a market failure perspective. Minsky was concerned with the capital development of the economy, which he conceived as the *development of human capital and social capital*. Therefore, the goals of community development banks that would execute the microeconomic role of SIBs are dynamic: the *inclusion and development* of individuals, firms and communities otherwise excluded from the economic system. Incidentally, this is often achieved through the provision of venture capital to small firms or micro-finance to individuals.

Second, not all SMEs face a problem of capital supply due to adverse selection and moral hazard concerns. It is a myth that all SMEs are equal in terms of their propensity to innovate and grow (Mazzucato, 2013a). There is no systematic evidence of a uniform relationship between firm size and growth (Haltiwanger *et al.*, 2013). Furthermore, small firms appear as less productive than larger ones, due to management issues (Bloom and Van Reenen, 2007). The challenge for SIBs is not so much to provide abundant finance for all SMEs, but to find and nurture the so-called 'gazelles' (Nightingale and Coad, 2014); that is, young, high-tech firms that are SMEs. Nurturing this group requires as much financial capital (in the form of VC) as social capital (sometimes networking and co-management). Identifying the economic gazelles is akin to what Rodrik (2004) called the process of 'discovering' an economy's cost structure and activities that can be profitably exploited to promote growth. Therefore, the microeconomic development role is also a type of industrial policy, as it complements the macroeconomic development role by selecting specific firms and projects that have the potential of generating Schumpeterian rents and economic development.

Moreover, economists working in the Schumpeterian tradition further theorised about technology development and innovation ('new combinations') as an endogenous process to economic growth and development. Therefore, the issue is not one of 'information asymmetries', which assumes that some parts know the risks of an innovation project succeeding or failing. Innovation is a venture that is not only risky, but fundamentally uncertain, so no one knows the odds of success. Innovation requires finance, but the type of finance received affects the types of investments made (O'Sullivan, 2004; Mazzucato, 2013b). In fact, innovation requires *patient, long-term, committed finance*. But from a market failure perspective, *any* kind of finance and even tax breaks would support high-tech SMEs and innovation development. The mutual causation between types of finance and investments is a key reason why SIBs have been increasingly mobilised to provide long-term committed venture capital for *high-tech start-ups*; that is, firms (usually small) that develop radical innovation projects. In this sense, the new venture support role also provides a basis for SIBs' mission-oriented investments that seek to promote radical innovations that address societal challenges.

SIBs 'new venture support role' is akin to the actions of an *entrepreneurial state*. This concept, introduced by Mazzucato (2013a), builds on the notion of the 'Developmental State', but pushes it further by focusing on the *type* of risk that the public sector has been willing to absorb and take on. Mazzucato (2013a) describes the risk-taking role the state has played in the few countries that have achieved innovation-led growth, and shows that, in those countries, the state played a lead investment role across the *entire* innovation chain, from basic research to early-stage seed financing of companies to finance for commercialisation and market entry. This added focus on the type of risks taken by the state led Mazzucato (2013a) to conclude that ignoring the high-risk and uncertainty that the state has absorbed has caused the fruits of innovation-led growth to be privatised, even though the underlying risk was socialised that is, funded through tax-payers

money). It is usually assumed that the returns to the state will occur through higher tax income. However, given that this return-generating system is broken, more thinking is needed on concrete ways in which direct mechanisms can be generated for the state to create a 'revolving fund', so that inevitable losses (caused by the uncertain nature of innovation) can be covered, and the next round funded—as is the case with private venture capital. State investment banks provide a concrete mechanism through which 'socialisation of rewards' can be achieved. This is because, in many of their new venture support investments they retain equity, so that if these venture investments are successful, they may result in windfall gains. Moreover, even for its less risky investments, the use of loans (instead of grants, subsidies or tax breaks) provides another mechanism through which SIBs are rewarded.

5.4. Challenge-led role

From the market failure perspective, societal challenges are negative externalities that impose a cost to society that, by definition, is not reflected in prices. However, such a view is limited in its ability to explain what SIBs do to address societal challenges. Science and technology policy research on mission-oriented initiatives (see below) provides an alternative and more complete conceptualisation of SIBs' systemic role because, in performing it, they go beyond addressing a market failure in order to internalise external costs. In this role, SIBs help to 'make things happen that otherwise would not', as Keynes called for the state to do (Keynes, 1926). More importantly, they pave the way for a 'Great Transformation', as described by Polanyi (2001 [1944]), who showed that capitalists markets are deeply 'embedded' in social and political institutions, rendering meaningless the usual static state vs. market juxtaposition. In their challenge-led role, SIBs are not simply fixing failures from markets; they are *shaping and creating* new technologies, firms and sectors, and, ultimately, markets—all of which will help to address a societal challenge.

A new great transformation, required to address the big contemporary challenges, will not arise from market forces, because markets are 'blind', and even if they do not fail in a Pareto sense, they are incapable of providing a new, qualitatively different direction to economic development. The concepts of technological paradigms and technological trajectories (Dosi, 1982; Nelson and Winter, 1982) reveal the limitation of market forces in providing a direction to economic development. A technological paradigm has a threefold definition (Dosi, 1982, p. 148): it is an *outlook* of the relevant productive problems confronted by firms (as producers of technologies or innovators); it represents a set of procedures (routines) of how these problems shall be approached; and it defines the relevant problems and associated knowledge necessary for their solution. A technological trajectory, in turn, represents the direction of progress within a technological paradigm. Therefore, technology development is a problem-solving activity, and a technological paradigm 'embodies strong prescriptions on the *directions* of technical change' (p. 152). This is why market signals are limited in terms of providing direction to techno-economic development; they only work within the parameters of the paradigm, and therefore influence the rate of change more than its direction. When two or more technological paradigms compete, markets may influence which one is selected (the one which minimises costs). Once established, however, paradigms have a powerful 'exclusion effect' whereby some technological possibilities are discarded because they are incompatible with the prevailing paradigm and are therefore 'invisible' to agents. Thus, a techno-economic system of innovation may be locked into a self-reinforcing, path-dependent trajectory (Dosi and Nelson, 1994). This becomes a problem if the trajectory being followed (or the paradigm itself) is inferior or suboptimal to what could be achieved with technologies that transgress the paradigm (or with a different paradigm).

Perez (2002) expanded the notion of technological paradigm to *techno-economic* paradigm in order to account for the non-technological forces (economic and social institutions) that characterise certain periods of capitalist history and affect both the economic and social systems. Her theory of 'techno-economic paradigm shifts' is a historical perspective on the long-waves of development that accompany technological revolutions. When a new technological revolution emerges, the socio-economic system remains stuck within the bounds of the previous (socio) techno-economic

paradigm, which means that market forces are incapable of directing the system towards a new one; consequently, the modernising and rejuvenating potential of the new revolution is stifled. In other words, there are mismatches between elements of the social- techno-, and economic systems (for example, social expectations, R&D routines, tax regimes, labour regulations, etc.). In order to overcome these mismatches, it is necessary to build new institutions that favour the diffusion of the new paradigm. In all previous technological revolutions, governments have led the process of institution-building that allowed new techno-economic paradigms to replace the old ones. Perez (2002) specifically pointed to the role of public policy in allowing the full deployment of technological revolutions, such as the effect of suburbanisation on the ability of the mass production revolution to diffuse throughout the economy. Due to their experience and superior position in the economy, SIBs represent a concrete tool through which public policy can promote great transformations. In fact, this has happened in the 19th century, when industrial banks—the predecessors of modern SIBs—played a key role in providing the finance for the construction of continental European railway network (Aghion, 1999). This network totally transformed the socio-economic landscape to the point that Perez (2002) called the third technological revolution ‘the age of railroads’.

The stream of research on technological and techno-economic paradigms highlights the importance of cognition—rather than of ‘preferences’ and ‘expectations’, as in market failure theory—when establishing the direction of technological change. Paradigms are powerful enabling and constraining institutions that favour certain directions of techno-economic development and obstruct others. In order to coordinate techno-economic development towards a new, qualitatively different route, we need a paradigm shift that will avoid the constant renewal of prevailing trajectories, which happens if market forces provide directionality to the system. From this perspective, the challenge-led role of SIBs concerns the creation of a *new vision* that will coordinate cognitive efforts of different (public and private) agents and direct their action to areas beyond the existing paradigm. It therefore complements the developmental role, which operates in long time frames, in that the vision provided by the challenge-led role is a mechanism to coordinate actions and expectations in the short-run.

Historically, innovation policies have created such a vision through the establishment of ‘missions’ that gave a direction to techno-economic change. Previous mission-oriented policies were those driven by military or national security motives (such as those behind the origin of DARPA in the US Department of Defense or NASA) and aimed to achieve clearly defined technical goals (creating a network of connected computers or putting a man on the moon). In recent years, there have been calls for a return to such policies to address ‘grand societal challenges’ (see Mowery *et. al*, 2010). However, Foray *et al.* (2012) contrasted missions of the past, with such contemporary missions as tackling climate change. While missions of the past aimed to develop a particular technology (with the achievement of the technological objective signalling that the mission was accomplished), contemporary missions have addressed broader and more persistent challenges, which require long-term commitments to the development of technological solutions. Thus, mission-oriented motivations have more recently been used to set up dynamic public agencies in other non-military areas such as energy security (ARPA-E) and health (National Institutes of Health, NIH). By building on their accumulated capability and expertise in fulfilling the other three roles, SIBs seem well positioned to play a central role in the execution of new mission-oriented policies. Therefore, analysis of how SIBs fulfil their challenge-led (or mission-oriented) role represents a new and important research agenda, given the pressing need to carry out investments that promote smart, inclusive and sustainable growth and tackle societal challenges.

6. Discussion

6.1. Summary: Mainstream vs. heterodox conceptualisations of the roles of state investment banks

Table 3 summarises our discussion in the previous sections into a synthetic typological framework, which, we argue, provides the seeds for the development of a new *theoretical* framework. Row 1 summarises our discussion of how market failure theory justifies what SIBs do and should do. Rows

2, 3 and 4 of the table summarise our discussions of the limitations of MFT and of alternative conceptualisations provided by heterodox theories. Row 5 presents the usual criticism attached to SIBs (see further discussion in subsection 4.2.1.). Rows 6 and 7 hypothesise about the risks and uncertainties involved in each role and the potential of each role to generate ‘windfall gains’ (see further discussion in subsection 4.2.2.).

Note that this framework table is an ‘ideal type’; what SIBs actually do in reality often overlaps, as the evidence documented in section 2 has shown. Furthermore, as we made explicit in our discussion in section 5 and indicated in rows 4–7, each role builds on or overlaps with the previous one, so that, for example, the mission-oriented role requires the provision of visionary, venture, social and financial capital. As such, aspects theorised by one author are relevant for more than one role. However, based on our discussion of MFT and heterodox theories, we claim that these four roles are conceptually different.

Table 3: Analytical framework: characteristics of different functions of state investment banks.

	Countercyclical role	Developmental role	New venture support role	Mission-oriented role
<i>Market failures</i>	Coordination failures	Public goods, network externalities	Information asymmetries, adverse selection	Negative externalities
<i>Market failure limitation</i>	Not just underinvestment and risk-aversion: underutilisation of labour and financialisation	Not just infrastructure and knowledge: Schumpeterian rents, capital development and social capabilities	Not just SMEs and tax breaks: community development banks in support of <i>gazelles</i> and R&D/innovation development; discovery process	Not just internalising costs: Making things happen, great transformations; blindness of markets
<i>Beyond</i>	Full employment, multiplier effect, socialisation of investments	Capital development, strategic trade, national champions	Entrepreneurship, technical innovation	Addressing societal challenges; creating visions through missions; shaping and creating markets
<i>Type of capital</i>	Financial capital			
		Social capital		
			Venture capital	
				Mission/Vision capital
<i>Criticism</i>	Crowding out			
		Misallocation of resources		
			Incapacity to ‘pick winners’	
				Inefficiencies
<i>Risk & Uncertainty</i>	Lowest			
		Lower		
			Higher	
				Highest
<i>Potential for windfall gains</i>	Lowest			
		Lower		
			Higher	
				Highest

Source: Authors’ elaboration.

6.2. The mainstream criticisms of SIBs reconsidered

Justification for public investments inevitably affect the tools that are used to evaluate and assess such investments. If we move away from a market fixing justification towards a market shaping/creating role, it is essential to reconsider how this different framework affects the evaluation of public investments and, therefore, related criticisms.

a. *Financial repression and crowding out*

Crowding out critics (see section 4.2) often assume that the state should not invest in profit making areas. Indeed, if the state does earn a profit this becomes a *de facto* indicator of ‘crowding out’—that is, hurting the private sector from its ability to make its deserved profits (Mussler, 2013) or substituting for investments that would have been done anyway by profit-seeking firms (Cohen and Noll, 1991). Yet once we admit that the state has not only fixed markets but also actively shaped and created them such logic falls apart. Most bets that the state makes in the market creation process fail, as is also true for private venture capital. While private VC is described as a lead risk taker and investor, the public sector is not and hence unlike VC is not allowed to reclaim some of the returns from the upside, to cover the inevitable downside (Mazzucato, 2013; Lazonick and Mazzucato, 2013). This different view of the market process thus produces a different view of who has the ‘right’ to make profits and why.

Furthermore, the crowding out hypothesis cannot apply to economies that are not close to full employment of resources or that have not seized all available productive opportunities (as when SIBs perform the countercyclical role). In the capital development role, SIBs *crowd in* investments by playing a lead role in the economic development or industrialisation strategy in order to create network synergies. In the new venture support role, SIBs *dynamise in* the economy by identifying and supporting young, high-tech firms. And in the challenge-led role, SIBs help *envision* the future and direct economic efforts to superior techno-economic paradigms.

b. *Misallocation of resources due to political biases*

If SIBs are essential to the process of economic development, then it is also essential to understand the appropriate structure for such development. Performing the developmental role requires SIBs to make choices, but not necessarily through a centralised system of decision-making, insulated from private initiative. In fact, the experiences with developmental network states, on the one hand, and with soviet-style planned economies on the other, both show that success seem dependent on a system in which the state makes choices within a capitalist framework and in coordination with private agents. However, MFT is at odds with this alternative evidence-based conceptualisation because it calls for the state to intervene as little as possible in the economy in a way that minimises the risk of misallocation of resources due to political biases. This results in a structure that *insulates* SIBs from the private sector (to avoid issues such as agency capture), which, in turn, would result in a diminishing role for SIBs over time, through delegating or outsourcing its roles to private initiative. However, outsourcing often rids public institutions of the knowledge capacities and capabilities (around IT, for example) that are necessary for managing change (Kakabadse and Kakabadse, 2002). Without such talent and expertise, it is nearly impossible for SIBs to fulfil its roles of coordination and provision of direction to private actors, of discovering the cost structure of the economy to promote investments that foster economic development, and of identifying gazelles. In order to promote true economic development (and not just facilitate growth), SIBs must organise themselves so that they have the intelligence (that is, policy capacity) to formulate and execute bold policies, and the ability to experiment and explore the underlying landscape. Therefore, instead of insulating the state from the private initiative to avoid misallocation of resources, SIBs should be structured in a way that maximises their ‘absorptive capacity’ (Cohen and Levinthal, 1990) so that they can learn with and from private actors in a process of investment, discovery and experimentation. This is not *in opposition* to market forces, but *complementary* to them—the state (and SIBs) making choices that coordinate private initiative so as to promote the capital development of the economy. Furthermore, even in the case of “pork-barrel” or “log-rolling” projects, one could argue that investments do result in the build up of regional competencies and firm-level capabilities that would otherwise not happen, and that lead in the long-run to increased private R&D investments or higher marginal innovation yields by the regions or firms (Etzkowitz and Leydesdorff, 2000; David et al., 2000)—this seems to be the case, for instance, of investments in the Silicon Valley, which some accused to be engaged in pork-barrel politics (e.g. Rodgers, 1998).

c. *Incapacity to pick winners*

Market failure theory says little about cases in which the state is the *lead investor and risk taker* in capitalist economies. Having a vision of which way to drive an economy requires direct and indirect investment in particular areas, not just creating the conditions for change. This also requires crucial choices to be made, the fruits of which will create some winners, but also many losers. Therefore, focusing on failed cases of picking winners is misleading. The issue of picking winners involves SIBs adopting a portfolio approach for their investments (Rodrik, 2013). In such an approach, (a) success from a few projects can cover the losses from many projects and (b) the state learns from its losing investments (Mazzucato, 2013a). What matters in this approach is not so much the matching between failures and fixes, but an institutional structure that ensures winning policies provide enough ‘rewards’ to cover for the losses, and that losses are used as learning cases to improve and renew future policies. In fact, new metrics and indicators are needed for evaluating SIBs’ (and other public agencies’) activities. These should take into account also non-monetary and non-market outcomes, particularly in the case of mission-oriented and transformative investments. One of the few comprehensive analysis of the results of a portfolio of governmental investments—investments in energy efficiency and fossil fuel projects by the US Department of Energy (DoE)—has shown that *most projects* resulted in negative returns on investment, with just a few resulting in positive (qualitative and quantitative) net benefits: the positive net results from the handful of projects were however enough to cover the costs of the whole portfolio (National Research Council, 2001).

d. *Inefficient governmental structures*

One key limitation of market failure theory is its inability to justify or explain the active role that the state has played in shaping and creating markets—not just fixing them when they fail—and promoting ‘great transformations’. In the most economically successful and innovative countries, public policies go beyond fixing market failures. The state has been integral in promoting the industrialisation of all currently developed countries, investing not only in basic research and infrastructure, but also picking and nurturing technologies, firms and sectors (Reinert, 1999; Chang, 2002). In sum, active public policies have given *direction* to economic development and promoted great socio-economic transformations. Understanding the role of the state in coordinating and giving a direction to private initiative requires a broader conceptualisation than that which is enabled by market failure theory, which results in static considerations and a limited focus on efficiency. However, when economic development and the transformation of the socio-techno-economic landscape is seen (i) as a non-probabilistic risk-taking process surmounted by uncertainty about technical and economic outcomes (Mazzucato, 2013a); (ii) as a process of experimentation and discovery (Hirschman, 1967; Rodrik, 2004); and (iii) as a continuous process of learning that leads to some successes and failures measured beyond static monetary analysis of the costs and benefits attached to quantifiable outcomes, then the strict focus on the *economic efficiency* of governmental structures is misleading. Instead, a more appropriate focus for organizing SIBs (and other public agencies) should be on which skills/resources, capabilities and structures can help increase the chances that a SIB will be effective both in learning and in establishing symbiotic partnerships with the private sector—and ultimately in implementing mission-oriented and transformative policies.

7. Conclusion

This paper has focused on the roles played by a particular source of public finance: state investment banks (SIBs). After identifying four roles that SIBs play in the economy – a *countercyclical role*; a *developmental role*; a *venture capitalist role*; and a *mission-oriented role* – and providing contemporary evidence for them, we sought to explain and theoretically justify these roles. To do so, we built our argument by first discussing standard market failure justifications for the role of SIBs in the economy, the associated diagnostics and evaluation toolbox, and resulting criticisms. We then proceeded to show the limitations of the market failure perspective based on insights from Keynes, Schumpeter, Minsky and Polanyi, and other heterodox economics literatures,

which provide us the conceptual pillars to talk about public sector activity as market shaping and creating not only market fixing. Based on this alternative conceptualization, we proposed a new lens through which the activities of state investment banks can be understood beyond fixing market failures. This provided new light on the criticisms that result from market failure theory. While we developed the framework through an analysis of the specific activities of state investment banks, our future work is dedicated to elaborating it as a more general tool for understanding the role of other public institutions and state agencies.

The importance of state investment banks in the economy, particularly for transformative goals, is increasingly evident.¹⁹ In particular, SIBs represent an important alternative to 'old' mission-oriented funding mechanisms. In a time in which many countries are trying to not only stimulate growth but to address key societal challenges, SIBs seem well positioned to effectively promote the much needed capital development of the economy in a smart, inclusive and sustainable direction. In this sense, analysing, theorizing and constructively criticizing what is being done is a new agenda for economists, and we believe our novel framework represents a first step in this direction. In this paper, we developed the pillars of an alternative framework of SIBs. We propose three areas for future research that would help advance the framework and that represent a new research agenda for evolutionary, innovation and developmental:

- Development of indicators that help evaluate each of the four roles of state investment banks. This is necessary, because standard economic indicators that are used in market failure cost-benefit analysis fail to capture precisely the aspects that make the market failure perspective limited.
- Cross-comparison of different state investment banks and their model of operation. This could help to establish 'best-practices' that may increase the efficiency and effectiveness of SIBs.
- In-depth case studies of a single SIB or a single SIB program, particularly those that are most successful (generate positive returns) and mission-oriented, respectively. This, too, would help to establish best-practices.

State investment banks are not uniform in their size, scope, and structure; they differ along many dimensions such as: funding source and cost; ownership type; direct or indirect funding (via private agents); activities, program, portfolio of investments, and financing tools; regulatory environment and specific bylaws; priorities; performance; among other aspects.²⁰ Thus, future research could seek to address more specific questions such as:

- Is the investment in low-risk, big players always warranted? When should SIBs pull out?
- Does it matter and what are the implications to be funded by the treasury/budget, central bank or the market?
- What are the implications of directly providing finance and of operating through private agents? What are the upsides and downsides?
- How to appraise for the uncertainty of technological projects? How to structure portfolios of investments? And when to discard failed cases and what to do with them?
- Related to the previous question, what is the economically and socially acceptable number of failures that SIBs might afford to bear?²¹ Should SIBs engage in 'martingale'-like strategy, whereby they increase their investments (and potential pay-off) in order to cover for past failures?

¹⁹ This is not to say that private banks do not have a place to play in market economies—the opposite is true. But for private finance to achieve a productive, non-speculative role, appropriate regulations (including segmentation of activities) need to be in place, such as happened during the post-World War II 'golden age'. Indeed, public banking and regulated private finance are the two sides of Minsky's policy recommendation for a well-functioning financial system.

²⁰ Luna-Martinez and Vicente (2012) carried out a survey of 90 SIBs and offer a snapshot of the SIB population.

²¹ We thank one of the anonymous referees for raising this important question.

We believe this represents a fruitful research agenda that could improve our understanding of the degree to which the activities of states investment banks are opening up new technological landscapes and economic opportunities—*making things happen that otherwise would not*—shaping and creating markets not only fixing them.

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