RE: Policy Memo on new public investment bank, working draft

America has an investment problem. That was true even before the current coronavirus crisis, and it's even more true after the pandemic has damaged the economy and made clear the need for large-scale efforts at rebuilding and adaptation. The institutions that are supposed to manage our investment decisions are failing to translate our national wealth into investment in sustainable, equitable, and environmentally responsible growth and the creation of good jobs for American communities.

The good news is that our national investment problem is now becoming a major focus among political decisionmakers, on a bipartisan basis. Republicans like Senator Marco Rubio have called for government leadership in coordinating long-term productive investment, and House Republicans have introduced legislation that would establish a publicly sponsored (but privately financed) infrastructure bank. On the Democratic side, the Biden campaign has advocated numerous investment initiatives in areas ranging from green technology and infrastructure to reshoring manufacturing, and influential Democratic legislators like Rose DeLauro have introduced detailed legislative proposals for public infrastructure banks. There has been a renewed interest in historical examples of public investment leadership like the Reconstruction Finance Corporation (RFC), and academics like Saule Omarova at Cornell and James K. Galbraith at the University of Texas have advocated for new public investment authorities.

A public investment authority can help shape markets, catalyze new industries, and raise environmental and labor standards at the leading edge of the economy. But the new profusion of calls for public leadership in restoring national investment raises many questions – starting with the details of how a public investment authority should operate and what its goals should be.

Existing models of public support for investment are flawed in many ways. After several decades of neoliberal market ideology, public investment mechanisms often follow the lead of the private sector, effectively passing along public subsidies to private market investors who take the leadership role in shaping the investment. For years, too many public-private partnerships have left private actors in the driver's seat, with risks borne by the public and rewards reserved for private investors. Since they grant key control rights to private entities, such public-private partnerships have tended to prioritize maximizing private returns over public purpose, or even served as vehicles for privatization of public assets. Other large-scale public financing interventions such as government-sponsored housing enterprises and, more recently, Federal Reserve credit interventions have also functioned by channeling public subsidies to private actors who played the critical role in determining how funds were used.

A public investment bank which is large, autonomous, and has both a clear mandate and its own resource base with which to pursue public purposes could bring much more fundamental change to investment practices. But the design details of such an authority are critical in determining whether it will succeed in creating more just and sustainable investment practices, or will simply subsidize current private market investment trends that have led to under-investment in long term growth, poor job quality, and increasing racial and economic inequality. Below we lay out several broad goals for a public investment authority, and then describe the specific design mechanisms that will assist in accomplishing those goals.

Goals

1) **Shape investment policy and direction around public purposes.** Rather than taking the lead from the private sector, a modern Federal investment authority should be a leader in shaping and directing investment priorities for the nation. This requires a large, robust organization with substantial autonomy in its funding mechanisms. It should have a mandate to plan, prioritize, manage, and evaluate investment in pursuit of public goals across a wide range of infrastructure areas, from transportation and energy to housing, while still respecting the need to be economically sustainable.

2) **Be a catalyst for "high road" growth.** Too often, private investment markets have pursued gains that depend on stripping assets from workers and communities, or using financial engineering strategies to extract wealth from productive companies rather than investing in their future productivity. A modern RFC should be a standard setter for high standards in labor practices, environmental standards, equitable growth, and community development.

3) **Be a capacity builder for existing Federal, state, and local government investment.** It would be a mistake to see a National Investment Authority as somehow the sole provider of public investment, as opposed to one entity within a broader network. Public investment needs much greater than could be served by a single entity, and many forms of public investment are addressed through straightforward fiscal investments. But a large and robust public investment authority could be a mechanism to coordinate investment strategies and provide strategic assistance across a whole range of government entities, including both states and localities and Federal agencies.

4) **Take a key facilitation and leadership role in response to economic crises –** The Federal Reserve is currently becoming a kind of de facto emergency manager of financial crises. But it is extremely poorly designed for this role. Both by statute and institutional design, the Federal Reserve's role is not to manage productive investment or engage in emergency response spending, but to provide a liquidity or credit backstop to ensure that private financial markets continue to function. A public investment authority would be a far better lead entity for this role – as indeed the historical Reconstruction Finance Corporation was during the Great Depression.

Design Mechanisms

Goals are general, but the critical question is the specific design elements which allow those goals to be achieved. We suggest the following design elements in support of an effective public investment authority:

- It should be made proactive and autonomous through an independent equity base.
- It should be general purpose, not single purpose
- It should be a hub to coordinate strategic investment planning and build capacity
- It should be a learning organization
- It should be empowered to take a leadership role in addressing economic crises

Below, we describe each of these criteria in detail and the arguments for them.

It should be made proactive and autonomous through an independent equity base – A public investment authority must have the autonomy to design, lead, and pursue its own projects. That doesn't mean that government should not co-invest with private capital or draw on private capital markets for financing, but it does mean that it should have a core financing base that is not dependent on private investors taking the lead.

The financing mechanism that most effectively empowers a public investment authority to pursue public purposes is a government provided equity base, which the bank is responsible for managing, investing, and maintaining. This was the financing mechanism used for the Reconstruction Finance Corporation. This kind of equity grant permits the bank to be an autonomous agent in selecting and financing projects, while still accepting private capital for co-investment in numerous ways. Ownership of its own equity would also allow the bank flexibility to tailor its financing strategies in a wide variety of ways as appropriate for each project, including through loans, equity investments, loan guarantees, supporting pools of private sector financing, and other mechanisms used by sophisticated investment banks.

A public bank financed with public equity would in effect have the power and financing abilities of a giant private bank, except it would turn that power to public purposes. Providing such a grant of equity would hardly be unaffordable. Matching the current Goldman Sachs equity of $100 billion would cost less than one-quarter of the $454 billion in equity provided to the Federal Reserve in the recent Covid-19 legislation to finance short-term lending and liquidity assistance alone. At a conservative 10% leverage ratio, $100 billion in equity would support $1 trillion in bank financing. A grant of the currently unused equity from the CARES Act would finance a $250 billion bank, roughly the size of JP Morgan, the nation's largest bank, and finance $2.5 trillion in financing at a 10% leverage ratio.

Another advantage of an investment authority empowered with its own equity base would be that the responsibility of stewardship for this equity base would ensure some level of market discipline. Unlike private banks, a public investment authority would be charged with a public purpose and not with maximizing short term profit – indeed, earning high profits at times of national need could be a sign that the bank is not performing its purpose. But the general need to meet a long-term break-even constraint on a portfolio basis would help to discipline the bank's decision-making. The case of the RFC, which made a long-term profit on its grant of public equity, is instructive in this case. Crucially, this mandate would be to break even (not earn a profit), over a long period of time (not just one year), thus distinguishing it from the private sector model of short-term profit maximization.

Further, a mandate of equity stewardship would mean that under Federal budgetary rules the costs of the entity would be low – the CARES Act grant of hundreds of billion of dollars in equity to the Federal Reserve was scored as having no budgetary cost based on the likely preservation of the equity.

We should seek a large general purpose strategic investment authority, rather than a multitude of limited purpose investment entities – The level and extent of interest in public investment has led to a situation where there are a multitude of different proposals in circulation for public investment entities, many of them narrow-purpose or even single purpose. For example, there are specialized proposals for infrastructure banks, for green investment, for investment aimed at reshoring manufacturing, for community development, and so forth. One way in which this debate could move is having multiple different public investment authorities or banks, each specialized to a particular purpose. This is attractive from the standpoint of the division of political authorities within Congress, and also because it could give each specialized expert community its own financing entity.

However, there are many advantages to having a general purpose investment authority. Such a general purpose authority would carry significantly greater authority, financial muscle, and weight, than a multitude of smaller entities. It could more easily emerge as a strategic center of gravity for providing investment leadership in the economy, and would be less easily captured by particular interest groups. Even more important, a single large investment authority would be much better placed to take advantage of complementarities that exist between different investment purposes. For example, green investment may involve re-shoring manufacturing capacity, providing jobs to historically disadvantaged communities, energy-efficient design of affordable housing, encouraging technological innovation, and so forth. A single entity that contains within it a variety of expert divisions would be better placed to plan around and exploit these complementarities.

In addition, a general purpose investment authority would be more likely to have the financial scale necessary to be truly independent, since it would not have to compete for private capital in order to gain scale. A multitude of public investment bodies would likely create a landscape where each entity was too small to play a decisive leadership role in public investment strategy. A general purpose investment authority would also be more likely to draw the kind of bipartisan political support that would help to ensure that it maintained continuity and influence over time. All parts of the political spectrum have investment goals, and an authority with a range of investment purposes could more easily build support across the political spectrum.

It should be a hub to coordinate strategic investment planning across governments – Even if one seeks a large, well financed, general purpose public investment authority, it would be a mistake to suppose that such an entity would replace other government bodies concerned with public investment and regulation and spending connected to such investment. The Federal government already has numerous investment and investment-related programs across the Department of Defense, the Department of Energy, the Commerce Department, the Department of Transportation, Housing and Urban Development, Health and Human Services, etc. The situation today is very different from when the RFC was created during the Great Depression – at that time the RFC served functions that today are performed by banking regulators, the Department of Energy, the Department of Transportation, housing finance agencies, and so on. States and localities also play a critical leadership role in infrastructure investment, and are responsive to local conditions in a way that a Federal body is not.

Instead of replacing other investment initiatives, a new public investment authority should provide a hub for assisting in planning and financing a coordinated public investment strategy, which can also influence the direction of private sector investment.

Currently, investment initiatives across the Federal government are often obscure, underfunded, limited to a single sector, and are not conceived of or prioritized as part of a strategic whole. They are also disconnected from Federal regulatory and procurement rules that have a deep impact on how investment takes place within the economy. A powerful and well financed national investment authority dedicated to a national investment strategy as a whole could change that, while leaving in place the many specialized investment entities that exist across all the agencies of the Federal government.

At the state and local level, a national investment financing agency could play a critical role in providing a Federal insurance guarantee for state and local infrastructure financing, and otherwise subsidizing state and local investment efforts directly. It could also help to coordinate state and local spending at the regional level and with Federal efforts.

The organizational structure of a new investment authority should also be designed from the start to facilitate coordination and capacity building across Federal, state, and local government investment activities. A requirement for the investment authority to consult with and employee detailees from other Federal agencies could strengthen this coordination at the Federal level. Creating an entity with strong regional and state subdivisions, and provisions for representation for state and local political leaders in the oversight of the investment authority, would increase capacity to coordinate with and assist state and local investment initiatives. And requirements that a range of substantive expertise, from engineering and technology to community development for underprivileged groups, be represented within the divisions and executive structure of the authority would also assist in allowing the investment authority to play a coordinating and capacity building role.

It should be a learning organization: For many decades American has not had the kind of pro-active approach to national investment advocated in this memo, and which it seems clear we need today. Bringing a new pro-active approach up to scale will involve a great deal of trial and error.

A national investment authority that was charged with consistently evaluating both the social and financial return of all of its projects would create a powerful knowledge base. This would both improve the financing effectiveness of the authority over time, and serve as a critical base of information for other investment efforts in the Federal, state and local, and private sectors.

Mandating that the authority play a strong role in oversight and evaluation of its projects, rather than simply handing over those duties to private actors, would help to build the internal knowledge base and institutional memory needed for the investment authority to play a leadership role.

It should be empowered to take a leadership role in responding to economic crisis: Like the Reconstruction Finance Corporation in the Depression, a public investment entity should be able to take a leadership role in recovery from economic downturns and crises. A public investment authority would be a more effective first responder to economic crises than the Federal Reserve, which is oriented to liquidity provision and not investment.

In order to do this, there should be a mechanism by which a public investment bank could “surge” its capacity in response to an economic downturn. This could be done by increasing the capacity of the bank to leverage its equity base. For example, if a public investment entity with $100 billion in capital cut its leverage ratio from 10% to 5%, during an economic emergency this would free up $1 trillion in additional financing to support economic recovery and enhance any other fiscal response made by other parts of government.

The investment authority could publicly declare emergency and exigent circumstances necessitating a change in its leverage ratio. Such a declaration could include planning for specific uses of additional financing to support economic recovery investments, as well as a plan for deleveraging the bank and returning to the “base” level of 10% leverage after the economic crisis had passed. Congress could be given the ability to veto such a determination through a vote of disapproval.