Economics After Neoliberalism

Suresh Naidu, Dani Rodrik, Gabriel Zucman, *Boston Review*, February 15, 2019

Contemporary economics is finally breaking free from its market fetishism, offering plenty of tools we can use to make society more inclusive.

We live in an age of astonishing inequality. Income and wealth disparities in the United States have risen to heights not seen since the Gilded Age and are among the highest in the developed world. Median wages for U.S. workers have stagnated for nearly fifty years. Fewer and fewer younger Americans can expect to do better than their parents. Racial disparities in wealth and well-being remain stubbornly persistent. In 2017, life expectancy in the United States declined for the third year in a row, and the allocation of healthcare looks both inefficient and unfair. Advances in automation and digitization threaten even greater labor market disruptions in the years ahead. Climate change–fueled disasters increasingly disrupt everyday life.

Economics is in a state of creative ferment—a sense of public responsibility is bringing people into the fray.

We believe that these are all solvable problems—at the very least, that we can make serious headway on them. But addressing them will require a broad and deep public discussion of new policy ideas. Social scientists have a responsibility to be part of this discussion. And economists—the kinds of economists who work in the leading academic centers of the country—have an indispensable role to play. Indeed, they have already started to play it. Economics is in a state of creative ferment that is often invisible to outsiders. While the sociology of the profession—career incentives, norms, socialization patterns—often militates against engagement with the policy world, especially by younger academic economists, a sense of public responsibility is bringing people into the fray.

The tools of economics are critical to developing a policy framework for what we call "inclusive prosperity." While prosperity is the traditional concern of economists, the "inclusive" modifier demands both that we consider the whole distribution of outcomes, not simply the average (the "middle class"), and that we consider human prosperity broadly, including non-pecuniary sources of well-being, from health to climate change to political rights. To improve the quality of public discussion around inclusive prosperity, we have organized a group of economists—the Economics for Inclusive Prosperity (EfIP) network—to make policy recommendations across a wide range of topics, including labor markets, public finance, international trade, and finance. The purpose of this nascent collective effort is not simply to offer a list of prescriptions for different domains of policy, but to provide an overall vision for economic policy that stands as a genuine alternative to the market fundamentalism that is often—and wrongly—identified with economics.

We personally saw the power of this identification in early 2018, when the three of us attended a workshop on "new thinking beyond neoliberalism." The participants—historians, political scientists, sociologists, legal scholars, and economists—agreed that the prevailing neoliberal policy framework had failed society, resulting in monumental and growing inequality. All of us were horrified by the illiberal, nativist turn in our politics, fueled in part by these chasms. There was consensus around the need for a genuine alternative—a set of policies that were both effective and inclusive, responding to legitimate grievances without sowing deeper societal divisions.

Although we fully embraced these aims, we found ourselves on the defensive. In the eyes of many, the turn towards neoliberalism is closely associated with economic ideas. Leading economists such as Friedrich Hayek and Milton Friedman were among the founders of the Mont Pelerin Society, the influential group of intellectuals whose advocacy of markets and hostility to government intervention proved highly effective in reshaping the policy landscape after 1980. Deregulation, financialization, dismantling of the welfare state, de-institutionalization of labor markets, reduction in corporate and progressive taxation, and the pursuit of hyper-globalization—the culprits behind rising inequalities—all seem to be rooted in conventional economic doctrines. The discipline's focus on markets and incentives, methodological individualism, and mathematical formalism all seem to stand in the way of meaningful, larger-scale economic and social reform. In short, neoliberalism appears to be just another name for economics.

Neoliberalism—or market fetishism—is not the consistent application of modern economics, but its primitive, simplistic perversion.

Consequently, many people view the discipline of economics with outright hostility. They believe the teaching and practice of economics has to be fundamentally reformed for the discipline to become a constructive force. There are, indeed, legitimate reasons for discontent with the way economics is too often practiced and taught. Conservative foundations and think tanks have monopolized the banner of economics in policy circles, pushing the view that there is a steep efficiency–equality trade-off and assigning priority to economic growth. Students often leave their introductory economics courses thinking that "markets always work." Conservatives tend to deploy "economics" as a justification for preferred policies, while liberals are seen as insensitive to the requirements for prosperity.

Our response is fundamentally different. Many of the dominant policy ideas of the last few decades are supported neither by sound economics nor by good evidence. Neoliberalism—or market fundamentalism, market fetishism, etc.—is not the consistent application of modern economics, but its primitive, simplistic perversion. And contemporary economics is rife with new ideas for creating a more inclusive society. But it is up to us economists to convince our audience about the merits of these claims, which is why we have embarked on this project. Below, we have outlined a set of policy briefs (full versions available here) that we hope will stimulate and accelerate academic economists' sustained engagement with creative ideas for inclusive prosperity.

Before we get to policy proposals, however, we must first address the issue of how to persuade non-economists that economics is part of the solution. To be sure, many economists' habits, especially when it comes to how they engage in public debates, are to blame for the misunderstanding of what economics is and what economists do.

Economists study markets (among other things), and we naturally feel a certain pride in explaining the way markets operate to those who lack our specialized knowledge. When markets work well, they do a good job of aggregating information and allocating scarce resources. The principle of comparative advantage, which lies behind the case for free trade, is one of the profession's crown jewels—both because it explains important aspects of the international economy and because it is, on its face, so counter-intuitive. Similarly, economists believe in the power of incentives; we have evidence that people respond to incentives, and we have seen too many well-meaning programs fail because they did not pay adequate attention to the creative ways in which people behave to realize their own goals.

Economists have a strong bias towards market-based policy solutions, but the science of economics has never produced pre-determined policy conclusions.

Yet too many economists believe their quantitative tools and theoretical lenses are the only ones that count as "scientific," leading them to dismiss disciplines that rely more on qualitative analysis and verbal theorizing. Many economists feel they need to take the side of markets because no-one else will and because doing otherwise might "provide ammunition to barbarians" (aka, self-interested pressure groups and rent-seekers). And even when some economists recognize market failures, they worry government action will make things worse and sweep many of the discipline's caveats under the rug. Economists thus get labeled as cheerleaders for free markets and hyper-globalization.

Economists also often get overly enamored with models that focus a narrow set of issues and identify first-best solutions in the circumscribed domain, at the expense of potential complications and adverse implications elsewhere. A growth economist, for example, will analyze policies that enhance technology and innovation without worrying about labor market consequences. A trade economist will recommend reducing tariffs and assume that devising compensatory mechanisms for people who lose their jobs is somebody else's responsibility. And a finance economist will design regulations to make banks safe, without considering how these may interact with macroeconomic cycles. Many policy failures—the excesses of deregulation, hyper-globalization, tax cuts, fiscal austerity—reflect such first-best reasoning. To be useful in discussions of real policies, economists have to evaluate those policies in the totality of the context in which they will be implemented and consider the robustness of policies to many possible institutional configurations and political contingencies.

But these bad habits aside, contemporary economics is hardly a paean to markets and selfishness. The typical course in microeconomics spends more time on market failures and how to fix them than on the magic of competitive markets. The typical macroeconomics course focuses on how governments can solve problems of unemployment, inflation, and instability rather than on the "classical" model where the economy is self-adjusting. The typical finance course revolves around financial crises, excessive risk-taking, and other malfunctions of financial systems. In fact, the "competitive equilibrium model" in which free markets are maximally efficient—even if they are not good for fair distribution—is the dominant framework only in introductory economics courses. Thoughtful economists (of which there are many) quickly move away from it.

Economics is still somewhat insular within social sciences because of its methodological predilections: methodological individualism, model-based abstraction, mathematical and statistical formalism. But in recent decades economists have reached out to other disciplines and have incorporated many of their insights. Economic history is experiencing a revival, behavioral economics has put homo economicus on the defensive, and the study of culture has become mainstream. At the center of the discipline, distributional considerations are making a comeback. And economists have been playing an important role in studying the growing concentration of wealth, the costs of climate change, the concentration of important markets, the stagnation of income for the working class, and the changing patterns in social mobility.

Economists still have a strong bias towards market-based policy solutions, and the policy prescriptions endorsed by economists tend to be narrowly focused on addressing precise market failures. For example, to address global warming, economists are likely to support putting a steep price on carbon. But the science of economics has never produced pre-determined policy conclusions. In fact, all predictions and conclusions in economics are contingent: if x and y conditions hold, then z outcomes follow. The answer to almost any question in economics is “it depends,” followed by an exegesis on what it depends on and why. Back in 1975, in a collected volume entitled *International Trade and Finance: Frontiers for Research,* an economist named Carlos F. Diaz-Alejandro wrote: “by now any bright graduate student, by choosing his assumptions . . . carefully, can produce a consistent model yielding just about any policy recommendation he favored at the start.” Economics has become even richer in the intervening four decades. We might say, only slightly facetiously, that today the graduate student need not even be that bright!

Economics' recent empirical bent makes it more difficult to idolize markets because it makes it more difficult to ignore inconvenient facts.

Moreover, economics research has become significantly more applied and empirical since the 1990s. The share of academic publications that use data and carry out empirical analysis has increased substantially in all sub-fields within economics and currently exceeds 60 percent in labor economics, development economics, international economics, public finance, and macroeconomics. This is important because systematic empirical evidence is a disciplining device against ideological policy prescriptions. The recent empirical bent makes it more difficult to idolize markets because it makes it more difficult to ignore inconvenient facts. Recent empirical findings, for example, have found that international trade produces large adverse effects on some local communities; minimum wages do not reduce employment; and financial liberalization produces crises rather than faster economic growth.

Economics does have its universals, of course, such as market-based incentives, clear property rights, contract enforcement, macroeconomic stability, and prudential regulation. These higher-order principles are associated with efficiency and are generally presumed to be conducive to superior economic performance. But these principles are compatible with an almost infinite variety of institutional arrangements with each arrangement producing a different distributional outcome and a different contribution to overall prosperity. The recipe thus calls for comparative institutional analysis of economic performance—not glib “markets work” slogans. The abstraction with which economists perceive complex bundles of institutions also gives practitioners tools to help design large scale alternatives—from precision tweaks to the tax code to full-blown visions of post-capitalist societies.

Consider even the simplest economic setting of a perfectly competitive market economy. When an economist draws a supply-and-demand diagram on the black board, she may not list all the institutional prerequisites that lie behind the two curves. Firms have property rights over their assets and can enforce their contracts with suppliers. They have access to credit, can rely on public infrastructure such as transportation and power, and are protected from thieves and bandits. Their employees accept the terms of employment and show up at work each day. Consumers have all the information they need to make reasonable choices. They are reasonably confident that firms do not cheat them. There is a stable unit of value and means of exchange for buying and selling goods.

Economics does not necessarily have definite answers, but it does supply the tools needed to lay out the tradeoffs, thus contributing to a more informed democratic debate.

Clearly markets rely on a wide range of institutions; they are “embedded” in institutions, as Karl Polanyi would say. But how should those institutions be designed? Take property rights as an example. The Coase theorem suggests it does not matter for efficiency how property rights are allocated as long as transaction costs are zero. But the caveat does a lot of work here: transactions costs matter greatly. So, we must make choices. Should a job belong to a company, a worker, or a combination? Perhaps the company itself should be owned by a third party—a local government entity, say—and simply ensure incentive compatibility for managers and workers. That might sound crazy to most Americans, but China has eked unprecedented rates of economic growth out of such a property-rights regime. Perhaps employers should have property rights (for a fixed period) only over new assets they create, with existing assets distributed among other claimants. That too sounds crazy, unless we realize that is exactly what the patent system does, giving innovators temporary ownership over new “intellectual property.” Perhaps the government, on behalf of the general public, should retain part ownership of new technologies since so much of innovation relies on public infrastructure (public R&D and subsidies, higher education, the legal regime, etc.). The choices that need to be made must consider distributional concerns and depend both on our ultimate objectives and the potential fit with local context.

As we grapple with new realities created by digitization, demographics, and their impacts on labor markets, such questions about the allocation of property rights among different claimants become crucial. Economics does not necessarily have definite answers here. Nor does it provide the appropriate distributional weights (how to weigh the returns to workers, employers, and the government, and what procedural and deontological constraints should be respected). But it does supply the tools needed to lay out the tradeoffs, thus contributing to a more informed democratic debate.

The same kind of institutional indeterminacy pervades all other policy domains. Which labor market institutions minimize job insecurity without jeopardizing employment creation? How do we best provide social protection without blunting economic incentives? What kind of financial regulations ensure financial stability without blocking financial innovation? What kind of monetary and fiscal rules are best for an open economy? Economics does not provide a fixed answer to these questions. Instead, it highlights the potential consequences of different arrangements.

There is already a considerable variety of institutional arrangements in existence today. Welfare and labor-market arrangements, for example, differ greatly across the developed world, and the United States can learn a lot from experiments elsewhere. But plausible institutional diversity is not limited to existing practices. We can— and will need to—develop new institutions. Nothing in *laissez-faire* guarantees that growth will be equitable or globalization sustainable. We need to design policies and institutions that make inclusive prosperity possible and globalization sustainable—politically and economically. With a powerful theoretical machinery that allows them to think in abstract terms about such matters, economists’ imagination is crucial to the task.

All of the participants in our inclusive prosperity project are tenured academic economists, working in broadly mainstream subfields. Some have worked in government; most have not. Some have engaged in writing broadly for a non-academic audience; most have not. They are researchers who believe sound scholarship is indispensable to showing the way to inclusive prosperity. They are all economists of the real world, who understand that we live in a second-best world rife with market imperfections and in which power matters enormously in shaping market outcomes.

Taking contemporary economics seriously is consistent with recommending fairly dramatic structural changes in American economic life.

In such a world the competitive model is rarely the right benchmark for understanding the problems and suggesting solutions. We must instead search for alternative models. This requires an empirical orientation, an experimental mind set, and a good dose of humility to recognize the limits of our knowledge.

The policy proposals put forth reflect economic reasoning and contemporary evidence on a variety of market failures, from international trade to insurance to capital and labor markets. Throughout the proposals is the sense that economies are operating well inside the justice-efficiency frontier, and that there are numerous policy "free-lunches" that could push us towards an economy that is morally better without sacrificing (and indeed possibly enhancing) prosperity. Taking contemporary economics seriously is consistent with recommending fairly dramatic structural changes in American economic life.

Many of the proposals involve efficiency-and-equality enhancing interventions in markets well known to be rife with market failure, such as labor markets, credit markets, insurance markets, and markets for innovation. While the theoretical basis for market failures in these domains has been apparent for some time, the empirical importance of the various failures has been made only recently.

For example, while the minimum wage debate continues, few would claim that it is an effective tool for intervening in labor markets with wages higher than a certain level. Other labor market institutions are needed to take advantage of free lunches created by monopsony and other labor market failures in the segment of the labor market where most workers find themselves. Arindrajit Dube proposes a system of wage boards, similar to the Australian system, where either administrators or tripartite boards negotiate wages at the industry-occupation-region level, thus setting minimum wages throughout the distribution. He finds that wage inequality would significantly fall as a result. Suresh Naidu discusses the more traditional U.S. labor movement, and how mechanism design, experiments, and behavioral economics can be mobilized to ease the pervasive collective action problem facing unions.

In the domain of capital markets, both Anat Admati and Atif Mian stress the systemic risk produced by the current system. Mian discusses the role that inequality, together with capital flows from oil-rich countries and Asia, has played in generating a "glut" of U.S. savings, pushing down the real interest rate and increasing systemic risk. He shows how inequality generates instability in financial markets, but also how private macro-prudential contracting is thwarted because of externalities that contractors are not paying attention to and of specific tax and regulatory structures (e.g., Basel III risk weighting). Exploring the banking sector, Admati shows how banks, uniquely among financial institutions, are overexposed to debt, making them more vulnerable to bankruptcy and a threat to stability. Both authors point to a variety of good regulatory options, with Mian emphasizing credit contract repayments that are contingent on the aggregate state of the economy, and Admati favoring capital requirements and tax reforms that make debt look less attractive.

Some of the proposals speak directly to how the size of the government can be increased in a sustainable and prosperity-enhancing way. Gabriel Zucman's proposal shows an ingeniously simple path out of international tax competition, where countries no longer have to bid for multinational investment by slashing corporate taxes. Zucman proposes taxing multinationals by allocating their global profits proportionally to where they make their sales. While companies can easily relocate profits or production to low-tax jurisdictions today, sales are much harder to manipulate. His reform would thus make it possible to tax the winners of globalization, which seems like a necessary condition for globalization to be sustainable in the long run.

Sandra Black and Jesse Rothstein use the best modern economics to provide a contemporary restatement of an old idea: government should provide public goods and social insurance. Social insurance mitigates the widespread and well-known failures in insurance markets, in the form of unemployment insurance, social security, and health insurance. And education requires government provision because children are generally in school before the peak income of their parents and because parents cannot borrow against the earnings of their children. The benefits of education are also in the far future and are associated with externalities in crime, citizenship, and innovation. All this militates in favor of government provision of education and social insurance.

These proposals all show a willingness to subordinate textbook economic efficiency to other values such as democratic rule and egalitarian relationships among citizens.

Anton Korinek takes up the increasingly important question of how new technologies affect labor markets and the distribution of income. The direction of technological change is not exogenous, he argues, and it depends on the incentives set both by markets and by governments. In particular, innovators may overestimate the social cost of labor, investing too much in technologies that replace labor. Governments routinely intervene in the process of innovation—to encourage green technologies, for example. Korinek proposes that they similarly steer technology in the direction of innovations that have desirable distributive properties. They could, for example, promote AI systems that complement and augment the cognitive abilities of workers—along with mechanisms that ensure workers retain a substantial part of the surplus generated. Korinek also discusses how inelastic, complementary factors such as land or specialized skills might be taxed in response to technological change, and how the value of monopolies granted by the patent system is intrinsically inegalitarian since it transfers income from consumers to owners of firms.

Rodrik's proposal is distinctive in that it gives an explicitly pro-social justification for restrictions on trade, not trying to clothe the protectionism in terms of ameliorating some other externality or market failure. He shows that trade agreements ought to include clauses that prevent competition on "unjust" margins, and his "social safeguards" would give countries a claim, justified by broad social support, on trade authorities that a restriction on trade is necessary to maintain the domestic social contract. This proposal is indicative of the commitments of many of the members of EfIP: a willingness to subordinate textbook economic efficiency to other values such as democratic rule and egalitarian relationships among citizens. These proposals take Polanyi's words to heart: to work well, crucial markets (including markets for labor, land, and capital) must be embedded in non-market institutions, and the "rules of the game" must be supplied by government.

Finally, some of the proposals propose fixing non-market institutions with ideas from economics. Democratic political economy—where people's influence on policy is roughly equal and political preferences are arrived at through open, well-informed public debate—must be considered for any policy proposals in 2019. Too many policy ideas break on the rock of government capture by special interests or systematically distorted presentations in the media. Ethan Kaplan draws on a few decades of empirical political economy to suggest policies that could drastically alter the balance of political influence in the United States. His proposal exemplifies the strengths of empirical political economy as practiced in economics departments. The evidence cited is all carefully identified from naturally occurring variation and suggests a number of policies that could equalize political representation and increase turnout. Some of these suggestions highlight margins that are more likely to be thought of by an economist rather than a political scientist: for example, the increased influence of money when media coverage of politics is low suggests that politicians, behaving somewhat rationally, trade-off responsiveness across pecuniary and popular constituencies.

Many of the essays share the theme of how power asymmetries shape our contemporary economy. Many economists dismiss the role of power because they think it cannot be studied rigorously or belongs outside economics. As Naidu puts it in his essay, "under conditions of perfect competition and information, there is no scope for power." But asymmetries between different groups abound: who has the upper hand in bargaining for wages and employment; who has market power and who gets to compete; who can move across borders and who is stuck at home; who can evade taxation and who cannot; who gets to set the agenda of trade agreements and who is excluded; who can vote and who is effectively disenfranchised. Some of these asymmetries are traditional political imbalances; others are power imbalances that naturally occur in the market due to informational asymmetries or barriers to entry.

Many economists dismiss the role of power, but these proposals tackle power asymmetries frontally and suggest ways of rebalancing power for economic ends.

Policies that counter such asymmetries make sense not only from a distributional standpoint but also for improving aggregate economic performance. The policy essays tackle these asymmetries frontally and suggest ways of rebalancing power for economic ends. Unions and wage boards can rein monopsony power in labor markets (Naidu and Dube); putting sand in the wheels of financial globalization can enhance the fiscal capacity of the state (Zucman); regulating private finance can prevent crises (Admati and Mian); giving labor a greater say in trade agreements can improve the design of trade agreements (Rodrik); and restricting campaign contributions and making it easier for poorer people to vote can increase the accountability of the political system (Kaplan).

But while these policy briefs range over a wide swathe of policy domains—social policy, taxation, labor markets, financial regulation, trade agreements, technology, and electoral rules—their coverage is certainly not exhaustive. Many important policy areas remain untouched or are mentioned only briefly, and we still have much work to do. These essays (with more promised) are intended as first cuts, rather than definitive statements: we offer them as evidence that economics produces relevant and imaginative policy ideas and an encouragement to other economists to contribute in the same vein. They are a proof-of-concept for the claim that economics can help build a society that is both fairer and does more to live up to its productive potential—that economics can serve inclusive prosperity.