

# Economics for Inclusive Prosperity: An Introduction

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## Background

We live in an age of astonishing inequality. Income and wealth disparities between the rich and the poor in the United States have risen to heights not seen since the gilded age in the early part of the 20<sup>th</sup> century, and are among the highest in the developed world. Median wages for American workers remain at 1970s levels. Fewer and fewer among newer generations can expect to do better than their parents. Organizational and technological changes and globalization have fueled great wealth accumulation among those able to take advantage of them, but have left large segments of the population behind. U.S. life expectancy has declined for the third year in a row in 2017, 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. Greater prosperity and inclusion both seem attainable, yet the joint target recedes ever further.

This is a time when we need new ideas for policy. We think economists, among other social scientists, have a responsibility to be part of the solution, and that mainstream economics – the kind of economics that is practiced in the leading academic centers of the country – is indispensable for generating useful policy ideas. Much of this work is already being done. In our daily grind as professional economists, we see a lot of policy ideas being discussed in seminar rooms, policy forums, and social media. There is considerable ferment in economics that is often not visible to outsiders. At the same time, the sociology of the profession – career

incentives, norms, socialization patterns – often mitigates against adequate engagement with the world of policy, especially on the part of younger academic economists.

We believe the tools of mainstream economists not only lend themselves to, but are critical to the development of 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, and that we consider prosperity broadly, including non-pecuniary sources of well-being, from health to climate change to political rights. The policy briefs that accompany this overview offer a range of policy recommendations, drawn from labor economics, public economics, international economics, financial economics, etc.<sup>2</sup> Importantly, we hope this collective effort amounts to more than a discussion of specific policy prescriptions in different domains of economics. Our claim is that there are overarching themes and commonalities that taken together provide a coherent overall vision for economic policy that stands as a genuine alternative to the market fundamentalism that is too often (and in our view, wrongly) associated with mainstream economics. We strive for a whole that is greater than the sum of the parts.

We shall discuss these broader themes and the connecting narratives that emerges later in this essay. We begin by discussing in greater detail the motivation behind the project and the role that we see economics in crafting an alternative to the status quo.

## Why we are doing this

The idea for this initiative developed following a workshop that the three of us attended during the first half of 2018. It was one of those multi-disciplinary meetings that have become increasingly common recently, on “new thinking beyond neoliberalism” and similar themes. The organizers had brought together historians, political scientists, sociologists, and legal scholars alongside economists. As is usual in such meetings, participants agreed that the prevailing policy framework had failed society, resulting in monumental and growing gaps in income and wealth. All of us were horrified by the illiberal, nativist turn our politics had taken, fueled in part by these chasms. There was consensus that we needed to develop a genuine alternative – a set of policies that were both effective and inclusive, responding to legitimate grievances without sowing deeper societal divisions.

Any economist who sits in such a meeting will eventually find himself or herself on the defensive. For in the eyes of many, the turn towards neoliberalism is closely associated with economic ideas.<sup>3</sup> 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, mathematical formalism, and passion for causal identification all seem to point towards the status quo and stand in the way of meaningful economic and social reform. In short, neoliberalism appears to be just another name for mainstream economics.

Consequently many non-economists view the discipline of economics if not with outright hostility, at least as part of the problem. They believe the teaching and practice of economics has to be fundamentally reformed for the discipline to become a constructive force.

And there are, indeed, legitimate reasons for the discontent with economics, the way it 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 normatively prioritizing economic growth. Students who do not pursue further training leave undergraduate courses thinking that economics means that “markets always work”. Conservatives tend to deploy “economics” as a justification for preferred policies, while liberals are seen to be insensitive to the requirements for prosperity.

But our own take goes beyond this common view and is substantially different from it. 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 a perversion of mainstream economics, rather than an application thereof. And contemporary economics research is rife with new ideas for creating a more inclusive society. But it is up to us economists to convince their audience about the merits of these claims. That is why we have embarked on this project. The initial set of policy briefs that accompany this introduction is our first step. We hope they will stimulate and accelerate academic economists’ sustained engagement with creative ideas for inclusive prosperity.<sup>4</sup>

## Economics is an ally of inclusive prosperity

How do we square non-economists’ perception with our claim that economics is part of the solution?

Economists study markets (among other things) and they naturally feel a certain pride in explaining the way they operate to those who lack their 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 the face of it, so counter-intuitive. Similarly, economists believe in the power of incentives, because they have evidence people respond to incentives and they have seen too many well-meaning programs fail on account of not having paid adequate attention to the creative ways in which people behave to realize their own goals.

At the same time, 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 standard competitive equilibrium model in which free markets are maximally efficient (even if still not necessarily socially optimal, in view of distributional concerns) is the dominant framework only in introductory economics courses. Serious students of economics quickly move away from it.

Economics remains 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. Distributional considerations are making a comeback at the center of the discipline. Economists have been at the forefront of studying the growing concentration of wealth, the costs of climate change, concentration of important markets, the stagnation of income for the working class, and the changing patterns in social mobility.

Economists often have a bias towards market-based policy solutions, sustained by a demand for identifying precise market failures as a precondition for policy interventions. But the science of economics has never produced pre-determined policy conclusions. In fact, all predictions and conclusions in economics are contingent: if these and these conditions hold, then these outcomes follow. The answer to almost any question in economics is “it depends,” followed by an exegesis on what it depends on and why.<sup>5</sup> Back in 1975, in a collected volume titled *International Trade and Finance: Frontiers for Research* an economist 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” (Diaz Alejandro, 1975). 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!

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 (Angrist et al., 2017). This is important because systematic empirical evidence is a disciplining device against ideological policy prescriptions embedded in preconceived theorizing. The empirical bent of economics makes it more difficult to ignore inconvenient facts, when real world markets do not behave like textbook ones. It is harder to idolize markets when research finds international trade produces large adverse effects on some local communities, minimum wages do not reduce employment, or financial liberalization produces crises rather than faster economic growth – just to point out a few empirical findings from the recent economic literature.

Economics does have its universals, a set of higher-order principles associated with efficiency and generally presumed to be conducive to superior economic performance: market-based incentives, clear property rights, contract enforcement, macroeconomic stability, prudential regulation, and so on. But these principles are compatible with an almost infinite variety of institutional arrangements. Each of these institutional arrangements – rules of the game — produces a different distributional outcome. And how it contributes to overall prosperity depends on the suitability to the specific context at hand. This is a recipe for comparative institutional analysis of economic performance, and no glib “markets work” slogans follow from it. 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 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.

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, for 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, even if we focus only on efficiency: clearly 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. You might think this is crazy, but China has eked unprecedented rates of economic growth out of such a property-rights regime. We can think of many other variants. 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 government should retain part ownership of new technologies, on behalf of the general public, since so much of innovation relies on public infrastructure (public R&D and subsidies, higher education, the legal regime, etc.). Distributional concerns add to the choices that need to be made. Which among these (and other) possibilities we should favor depends 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 do weight the returns to workers, employers, and the government, and what procedural and deontological constraints should be respected). But it supplies 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? Once again, economics does not provide a fixed answer to these questions. Instead, it highlights the potential consequences of different arrangements.

Economists have a powerful theoretical machinery that allows them to think in abstract terms about such matters. So they are well positioned to develop innovative institutional arrangements that go beyond the already considerable variety that exists in the world today. Welfare or labor-markets arrangements, say, differ greatly across the developed world. There is much that the U.S. can learn from experiments elsewhere. But plausible institutional diversity is not limited to existing practices. We can – and will need to – to develop new institutions. Nothing in free markets guarantees that growth will be equitable or globalization sustainable. There’s always a need to design policies and institutions to make inclusive prosperity possible and globalization sustainable politically and economically. Economists’ imagination is crucial to the task.

## **Economists’ habits are to blame too**

The misunderstanding of what economics is (and what economists do) is compounded by the way economists frequently engage in public debates. 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 do so and because doing otherwise might “provide ammunition to barbarians.” And even when they recognize market failures, they worry government action will make things worse. As a result, many of the discipline’s caveats are swept under the rug. And economists get labeled as cheerleaders for free markets and hyper-globalization.

There is often a naïve political economy at play here,

with the implicit assumption that self-interested pressure groups and rent-seekers – the so-called barbarians -- are represented only on one side of a policy question.<sup>6</sup> In reality, every market equilibrium, with or without public action, creates winners and losers. These groups necessarily try to bend outcomes to their liking. Neoliberalism certainly has had its own powerful lobbies. Free-market oriented policies since the 1980s have been hijacked by their own special interests, as we can see in corporate taxation or trade agreements for example. Good policy cannot be abstracted from politics and has to be designed by taking its likely effects into account. This is as true for policies that purportedly try to take the government out of the market as it is for policies that broaden the government's role.

Economists often get too enamored of first-best benchmarks within a model tailored to study a narrow set of issues. This leads them to focus on the direct efficiency consequences in the area under focus, at the expense of potential complications and adverse implications elsewhere. A growth economist 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 the losers is somebody else's job. 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 – can be traced to such first-best reasoning. To be useful, economists have to evaluate 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. As Avinash Dixit (2009) puts it, “the world is second-best at best.”

## Some common themes in the policy essays

All of the participants in this project are 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 show 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.

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 in these essays reflect economic reasoning and contemporary evidence on a variety of market failures, from international trade to insurance to capital and labor markets. Shot through 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 accords with our moral intuitions 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 (Dube and Naidu), credit markets (Admati and Mian), insurance markets (Black and Rothstein), and markets for innovation (Korinek). 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, there is a consensus that it is not an effective tool for intervening in labor markets with wages higher than say, the 30<sup>th</sup> percentile. 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. 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. Naidu discusses the more traditional American labor movement, and possibilities for economics to help organized labor overcome some of the limitations of the current U.S. industrial relations institutions.

In the domain of capital markets, both Admati and 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 savings, pushing down the real interest rate and increasing systemic risk. Admati looks at the banking sector, showing how banks, uniquely among financial institutions, are overexposed to debt, making them more vulnerable to bankruptcy and again, a threat to stability. Both authors point to a variety of macroprudential 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.

Two of the proposals speak directly to how the size for government can be increased in a sustainable and prosperity-enhancing way. 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 very winners of globalization—probably a necessary condition for globalization to be sustainable in the long run.

Black and Rothstein provide a contemporary restatement of an old idea: government should provide public goods and social insurance, and root this argument in the best modern economics. For example, education requires government provision because parents cannot borrow against the earnings of their children (and children happen generally before the peak income of the parents). 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. Social insurance mitigates the widespread and well-known failures in insurance markets, in the form of unemployment insurance, social security, and health insurance.

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 over-estimate the social cost of labor, investing too much in technologies that replace labor. Governments routinely intervene in the process of innovation, for example to encourage green technologies. Korinek proposes that they similarly steer technology in the direction of innovations that have desirable distributive properties. Promoting AI systems that complement and augment the cognitive abilities of workers – along with mechanisms that ensure workers retain substantial part of the surplus generated – would be an example. 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 inequalitarian, as it transfers income from consumers to owners of firms.

Another way to look at a slice of the proposals is via Karl Polanyi: to work well, crucial markets (e.g. the “fictitious commodities” of labor, land, and capital) must be embedded in non-market institutions, the “rules of the game” supplied by government. Rodrik, for example, shows that trade agreements ought to include clauses that prevent competition on “unjust” margins; and Dube shows that wage boards setting market-specific minima could compress wages a lot, with much more refined targeting than a blunt, economy-wide minimum wage. Mian shows how inequality generates instability in financial markets, but also how private macro-prudential contracting is thwarted both because there is an aggregate externality as well as specific tax and regulatory structures (e.g. Basel III risk weighting). 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. Rodrik’s “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.

Finally, some of the proposals propose fixing non-market institutions with ideas from economics. Importantly for any policy proposals in 2018, democratic political economy must be considered, where people’s influence on policy is roughly equal and political preferences are arrived at through open, well-informed public debate.

Too many policy ideas break on the rock of government capture by special interests or systematically distorted presentations in the media. Ethan Kaplan's proposal 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. Suresh Naidu's proposal hints at ways mechanism design and behavioral economics can be mobilized to ease the pervasive collective action problem facing unions.

Ethan Kaplan's 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, suggesting that politicians, behaving somewhat rationally, trade-off responsiveness across pecuniary and popular constituencies.

A theme running through many of the essays is the power asymmetries that shape the functioning of our contemporary economy. Many economists dismiss the role of power because, as Naidu puts it in his essay, "under conditions of perfect competition and information, there is no scope for power." Talk about power is viewed as non-rigorous, or at least as belonging outside economics. 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 traditionally political imbalances; others are power imbalances that naturally occur in the market due to informational asymmetries or barriers to entry.

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); restricting campaign contributions and making it easier for poorer people to vote can increase the accountability of the political system (Kaplan).

## Final words

The policy briefs that accompany this introduction range over a wide swathe of policy domains – social policy, taxation, labor markets, financial regulation, trade agreements, technology, and electoral rules. But their coverage is certainly not exhaustive; there are many important policy areas that remain untouched or are mentioned only briefly, and we have more contributions promised. The essays themselves are intended as first cuts, rather than definitive statements. We think of them as a modest beginning: a demonstration that mainstream 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 serve inclusive prosperity, and help build a society that is both fairer and does better job of living up to its productive potential.

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## Endnotes

1 This is an introduction to the inaugural series of policy briefs prepared under the auspices of the Economics for Inclusive Prosperity (EfiP) network. The policy briefs and founding members of EfiP are listed at the end. We are grateful to the Hewlett Foundation for financial support. Special thanks to Margaret Levi and the Stanford Center for Advanced Study in Behavioral Sciences (CASBS) for stimulating the conversation that instigated this project.

2 A list of these initial policy briefs is at the end of this document.

3 We will not go into a detailed discussion of neoliberalism, a term that is commonly used by non-economists but not so much by economists. For standard treatments, see Brown (2006) and Harvey (2007). For a discussion from one of us, see Rodrik (2017).

4 There are many think tanks which rely on economists' ideas and engage them in thinking about policy issues. However, we are not aware of any *academic* network of economists focused on turning research and scholarship to policy use in the broad domain that we have called "inclusive prosperity."

5 Rodrik (2015) argues that the scientific nature of economics resides precisely in this ability to generate conditional hypotheses that can be confronted with evidence (even if not decisively tested).

6 Ash, Chen, and Naidu (2018) show that a teaching program on law and economics for judges, funded by a conservative donor, produced harsher prison sentences in criminal trials. Rodrik (2018) argues that investor and pharma lobbies distort the agenda of trade agreements towards clauses with high private gains but doubtful social benefits.



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## Inaugural EfIP Policy Briefs

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1. Suresh Naidu, Dani Rodrik, and Gabriel Zucman, “Economics for Inclusive Prosperity: An Introduction”
2. Anat R. Admati, “Towards a Better Financial System”
3. Sandra E. Black and Jesse Rothstein, “An Expanded View of Government’s Role”
4. Arindrajit Dube, “Using Wage Boards to Raise Pay”
5. Ethan Kaplan, “Election Law and Political Economy”
6. Anton Korinek, “Labor in the Age of Automation and Artificial Intelligence”
7. Suresh Naidu, “Worker Collective Action in the mid-21st Century Labor Market”
8. Atif Mian, “How to Think About Finance”
9. Dani Rodrik, “Towards a More Inclusive Globalization: An Anti-Social Dumping Scheme”
10. Gabriel Zucman, “Taxing Multinational Corporations in the 21st Century?”