Economic Paradigms and the New World Economy

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Outline

The plasticity of neoclassical economics
The role of policy paradigms
A good jobs, better jobs paradigm
Mainstream economics = neoliberalism?

Neoliberal policies are closely linked in the public’s mind with mainstream economic ideas
- market fundamentalism; Washington Consensus
- stabilize, deregulate, liberalize

But is neoliberalism good economics, or its misapplication?

Contemporary economic theory is remarkably flexible and admits an almost infinite variety of policy remedies
- Carlos Diaz-Alejandro: “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.” (published in 1974!)

Mainstream economics can be used to justify any number of policies and institutional arrangements

A thought experiment
The airplane economist

“Efficiency of resource allocation is a critical determinant of the economy’s performance”

“Efficiency requires aligning the incentives of households and firms with social costs and benefits”

“Growth needs a system of property rights and contract enforcement that ensures those who invest can retain the returns to their investments”

“There must be openness to ideas, innovations, and inputs from the rest of the world”

“Economies can be derailed by macroeconomic instability too; so governments must pursue a sound monetary policy and fiscal sustainability”

“And they must carry out prudential regulation of financial intermediaries to prevent the financial system from taking excessive risk”

“Economics is not just about efficiency and growth; economic principles also carry over to equity and design of social policy”

“Economics has little to say about desirable level of redistribution in society, but it does emphasize the importance of reducing the incentive distortions created by redistributive policies”
Universal principles, indeterminate policies

By the time the economist stops, it appears as if he has laid out a full-fledged neoliberal agenda
  ◦ a critic in the audience will have heard all the neoliberal scare words: efficiency, incentives, property rights, sound money, fiscal prudence

Yet the universal principles of economics enunciated by the economist are in fact quite open ended
  ◦ they presume a market-based economy – one in which economic decisions are left to individuals and firms – but not much more beyond that

They admit a surprising variety of institutional arrangements

A typical mistake is to associate the functions that good policy regimes perform with a particular type of institutional arrangements
  ◦ e.g., contract enforcement => Western legal forms, courts and third-party enforcement
  ◦ or private incentives to invest => free, deregulated markets
  ◦ or macroeconomic stability => independent central banks, currency convertibility
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<tr>
<th>OBJECTIVE</th>
<th>UNIVERSAL PRINCIPLES</th>
<th>PLAUSIBLE DIVERSITY IN INSTITUTIONAL ARRANGEMENTS</th>
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<tbody>
<tr>
<td>Productive efficiency</td>
<td><strong>Property rights</strong>: Ensure potential and current investors can retain the returns to their investments</td>
<td>What type of property rights? Private, public, cooperative?</td>
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<td>(static and dynamic)</td>
<td><strong>Incentives</strong>: Align producer incentives with social costs and benefits.</td>
<td>What type of legal regime? Common law? Civil law? Adopt or innovate?</td>
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<td><strong>Rule of law</strong>: Provide a transparent, stable and predictable set of rules.</td>
<td>What is the right balance between decentralized market competition and public intervention?</td>
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<td>Which types of financial institutions/corporate governance are most appropriate for mobilizing domestic savings?</td>
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<td>Is there a role for “industrial policy” to stimulate investment in non-traditional areas?</td>
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<td>Macroeconomic and Financial Stability</td>
<td><strong>Sound money</strong>: Do not generate liquidity beyond the increase in nominal money demand at reasonable inflation.</td>
<td>How independent should the central bank be?</td>
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<td><strong>Fiscal sustainability</strong>: Ensure public debt remains “reasonable” and stable in relation to national aggregates.</td>
<td>What is the appropriate exchange-rate regime? (dollarization, currency board, adjustable peg, controlled float, pure float)</td>
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<td><strong>Prudential regulation</strong>: Prevent financial system from taking excessive risk.</td>
<td>Should fiscal policy be rule-bound, and if so what are the appropriate rules?</td>
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<td>Size of the public economy.</td>
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<td>What is the appropriate regulatory apparatus for the financial system?</td>
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<td>What is the appropriate regulatory treatment of capital account transactions?</td>
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<td>Distributive justice and poverty alleviation</td>
<td>Targeting: Efficient redistribution entails programs targeted as closely as possible to the intended beneficiaries.</td>
<td>How progressive should the tax system be?</td>
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<td>Universality: All members of society should have universal access.</td>
<td>Should pension systems be public or private?</td>
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<td>Incentive compatibility: Efficient redistribution minimizes incentive distortions.</td>
<td>Should grant schemes be conditional?</td>
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<td>What are the appropriate points of intervention: educational system? access to health? access to credit? labor markets? tax system?</td>
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<td>What is the role of “social funds”?</td>
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<td>Redistribution of endowments? (land reform, endowments-at-birth)</td>
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<td>Organization of labor markets: decentralized or institutionalized?</td>
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<td>Modes of service delivery: NGOs, participatory arrangements., etc.</td>
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## East Asian “anomalies”

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<tr>
<th>Institutional domain</th>
<th>Neoliberal ideal</th>
<th>“East Asian” deviations</th>
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<tr>
<td>Property rights</td>
<td>Private, enforced by the rule of law</td>
<td>Private, but govt authority occasionally overrides the law (esp. in Korea). Public in China (SOEs, TVEs)</td>
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<td>Corporate governance</td>
<td>Shareholder (“outsider”) control, protection of shareholder rights</td>
<td>Insider control</td>
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<tr>
<td>Business-government relations</td>
<td>Arms’ length, rule based</td>
<td>Close interactions</td>
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<td>Industrial organization</td>
<td>Decentralized, competitive markets, with tough anti-trust enforcement</td>
<td>Horizontal and vertical integration in production (chaebol); government-mandated “cartels”</td>
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<td>Financial system</td>
<td>Deregulated, securities based, with free entry. Prudential supervision through regulatory oversight.</td>
<td>Bank based, restricted entry, heavily controlled by government, directed lending, weak formal regulation.</td>
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<td>Labor markets</td>
<td>Decentralized, de-institutionalized, “flexible” labor markets</td>
<td>Lifetime employment in core enterprises (Japan)</td>
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<td>International capital flows</td>
<td>“prudently” free</td>
<td>Restricted (until the 1990s). Managed currencies.</td>
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<td>Public ownership</td>
<td>None in productive sectors</td>
<td>Plenty in upstream industries.</td>
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Concrete policies work only under specific conditions (that may not apply)

Why rules of thumb don’t work: an illustration from trade policy

When is trade liberalization desirable (in theory)?

• The liberalization must be complete
  – or else the reduction in import restrictions must take into account the potentially quite complicated structure of substitutability and complementarity across restricted commodities.
• There must be no microeconomic market imperfections other than the trade restrictions in question
  – or else the second-best interactions that are entailed must not be adverse
• The government must be able to undertake a compensatory devaluation of the currency
  – or else nominal wages must be downwardly flexible
• The home economy must be “small” in world markets
  – or else the liberalization must not put the economy on the wrong side of the “optimum tariff”
• The economy must be in reasonably full employment
  – or else the monetary and fiscal authorities must have effective tools of demand management at their disposal.
• The income redistributive effects of the liberalization should not be judged undesirable by society at large
  – or else there must be compensatory tax-transfer schemes with low enough excess burden.
• There must be no adverse effects on the fiscal balance
  – or else there must be alternative and expedient ways of making up for the lost fiscal revenues.
• The liberalization must be politically sustainable and hence credible
  – or else the fear of reversal must not lead to too large a consumption boom in imported durables
Why a paradigm?

Since mainstream economics comes free of policy content, rendering it useful require supplying additional content (and context). That is what policy paradigms do.

Paradigm: a “meta model” that is rarely articulated or explicitly tested, yet underlies how we think about the economy and its relation to society and the polity
  ◦ provides a general orientation for policy

In the language of contemporary economics, it is a set of maintained assumptions about
  ◦ nature/prevalence of “market failures”
  ◦ government objectives/capabilities/intentions
  ◦ possibilities of collective action in diverse spheres
  ◦ binding constraints on economic prosperity

Together with an implicit prioritization of values that may be in tension (efficiency, equity, poverty reduction, resilience, stability, personal freedom, social cohesion, …)

Neoliberalism is one such paradigm

So are mercantilism, classical liberalism, Keynesian welfare state, market socialism, developmentalism,...
Some paradigms (1)

Classical liberalism
- well-being is measured not by wealth (or gold) per se but satisfaction of individual preferences (e.g., consumption)
- the market and private initiative are the economic engine that create prosperity
- minimal state, limited to national defense, protection of property rights, and administration of justice

Keynesian welfare state
- markets are not self-creating, self-regulating, self-stabilizing, or self-legitimizing
- we need regulatory institutions, redistributive institutions, monetary and fiscal institutions, institutions of conflict management, ...
- a “thin” model of globalization (“embedded liberalism”)

Some paradigms (2)

Developmentalism
- economic policy must be in service of national developmental project (catching up)
- activist state policies required to diversify the economy and build modern industries, including state ownership, selective import protection and controls on FDI, subsidies and industrial policies
- while leveraging the world economy for foreign markets (exports), capital, and technology

Neoliberalism
- Keynesianism does not work, markets are over-regulated, and states are overextended
- must stabilize, privatize, deregulate (labor market “flexibility”; financialization; removal of price controls, trade liberalization, entry liberalization)
- a new model of globalization: “hyper-globalization”
- developing country version: “Washington Consensus”
Do we need a new paradigm?

The downside of paradigms

◦ by the time they become conventional wisdom, they turn into cookie cutter solutions and develop blind spots that render them inappropriate to specific contexts

Navigating among paradigms may be a better approach to policy than adherence to single one

◦ paradigms that economists explicitly reject today hold certain truths
◦ what worked here does not work there
  ◦ large dispersion in effects of similar interventions (Vivalt, 2020)
  ◦ different contexts require different remedies

So beware economists bearing policy paradigms!

But still need an animating vision for policy
New challenges require new approaches

The challenges of public health and geopolitics (Ukraine, Russia, US-China) merely exacerbate ongoing problems

The challenge of climate transition
- requires new approaches, with “market-based” policies at best part of the solution

Existing models of global economy, welfare state, and development were unsustainable and inadequate
- “hyper-globalization”: undermined by distributional struggles, new emphasis on social cohesion, resilience, and geopolitics
- welfare state not adequate to address labor market polarization (inadequate demand for middle skills)
- development: growth through integration in global economy no longer works when tradable activities become highly skill- and capital-intensive (of which premature de-industrialization is a symptom)

A change in course is inevitable
Re-integrating domestic economies

New policies for domestic economic & social cohesion and for climate transition
- primacy of domestic economic, social, environmental agenda
- emphasis on “good jobs”
- from cost-saving to “resilience”
- public investment in skills, health, green transition
- “new industrial policies” connecting advanced firms/technologies with rest of economy

New responsibilities for business elites: from globalism to social solidarity
- quid pro quo: investment in local suppliers, communities, and workforce in return for public goods

A thinner but more sustainable globalization
- “peaceful economic co-existence”
- right to protect own standards/regulations/tax regimes/national security
  - but not to impose those standards on other countries
A good jobs (or better jobs) strategy

Development and prosperity require not just improved productivity, but more productive jobs for the bulk of the labor force
- addressing inequality where it is created -- in the productive sphere – rather than indirectly through transfers and social support

Jobs are not only a source of income, but also of personal dignity and fulfillment

Disappearance of good jobs (through trade, automation, and austerity shocks) has been linked to a variety of social and political ills
- rising rates of crime, addiction, broken families, suicide
- support for right-wing nativist political movements
- increase in authoritarian values

From distributive justice to “contributive justice” (M. Sandel)
“Industrial policies” for services

Customized assistance to firms with soft conditionality on job creation
  ◦ instead of subsidies and tax incentives

Collaborative and iterative relationship with firms
  ◦ instead of top-down, arms’-length, ex-ante rules

Focused on services, and mostly smaller and mid-sized firms
  ◦ instead of export champions and most productive segments of the economy

Based on quid-pro-quo:
  ◦ firms need access to stable, skilled workforce, reliable horizontal and vertical networks (w/out holdup, informational problems), technology, contractual and property rights enforcement
  ◦ governments need firms to internalize “good jobs” externalities in employment, training, investment, and technological choices
  ◦ deep uncertainty precludes simple remedies (such as Pigovian employment subsidies) (Rodrik and Sabel, 2019)
How the good jobs strategy differs

From neoliberalism
◦ less focus on the magic of markets; more focus on cross-sector collaboration

From Keynesian welfare state
◦ no presumption that adequate numbers of good jobs will be available, even with investments in education and full employment
◦ less focus on aggregate demand management and income supports; more focus on dissemination of productive employment opportunities on the supply side of the economy

Growth will be lower, but its quality might be higher
◦ more inclusive and focused on building the middle class

Convergence between social and growth policies
Would prioritizing the domestic agenda hurt the global economy?

Prioritizing domestic equity and social cohesion not inimical to open economy
   In fact, essential to it

Christine Lagarde (2019): “Bretton Woods launched a new era of global economic cooperation, in which countries helped themselves by helping each other.”

In fact, the truth was closer to the opposite of this. The genius of BW was that countries were allowed to help themselves first.

The success of any future global regime rests on the idea that countries help each other by helping themselves.
An important pre-requisite: managing geopolitical competition

US must accept multipolarity, accept China as a major power, not oppose giving it greater voice in global economic governance, and not try to undermine its technological development

- In other words, US must accommodate China rather than continue to seek primacy over it

China must stop bullying its neighbors militarily, limit cyber-espionage, and accept status quo over Taiwan (and avoid military takeover)

The greatest threat to a healthy global economy is not the new domestic economic agendas in US and elsewhere, but the mismanagement of geopolitical competition
The indeterminacy of neoclassical economics: the good and the bad

Indeterminacy of economics has

- disadvantages: no clear cut policy remedies
- advantages: flexibility and invitation to institutional imaginations