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A POLICY MATRIX FOR INCLUSIVE PROSPERITY

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### **ABSTRACT**

One of the biggest challenges that countries face today is the very unequal distributions of opportunities, resources, income and wealth across people. Inclusive prosperity – whereby many people from different backgrounds can benefit from economic growth, new technologies, and the fruits of globalization –remains elusive. To address these issues, societies face choices among many different policies and institutional arrangements to try to ensure a proper supply of productive jobs and activities, as well as access to education, financial means, and other endowments that prepare individuals for their participation in the economy. In this paper we offer a simple, organizing framework to think about policies for inclusive prosperity. We provide a comprehensive taxonomy of policies, distinguishing among the types of inequality they address and the stages of the economy where the intervention takes place. The taxonomy clarifies the differences among contending approaches to equity and inclusion and can help analysts assess the impacts and implications of different policies and identify potential gaps.

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# A POLICY MATRIX FOR INCLUSIVE PROSPERITY

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(with the assistance of Adrien Foucault)<sup>2</sup>

## Introduction

One of the biggest challenges that countries face today is the very unequal distributions of opportunities, resources, income and wealth across people. Inclusive prosperity – whereby many people from different backgrounds can benefit from economic growth, new technologies, and the fruits of globalization – remains elusive. To address these issues, societies face choices among many different policies and institutional arrangements to try to ensure a proper supply of productive jobs and activities, as well as access to education, financial means, and other endowments that prepare individuals for their participation in the economy.

In this paper we offer a simple, organizing framework to think about policies for inclusive prosperity. We provide a comprehensive taxonomy of policies, distinguishing among the types of inequality they address and the stages of the economy where the intervention takes place. The taxonomy clarifies the differences among contending approaches to equity and inclusion and can help analysts assess the impacts and implications of different policies and identify potential gaps.

## A 3 x 3 matrix

The framework can be summarized by a 3 x 3 matrix, shown in Figure 1.<sup>3</sup> We consider that the discussion of policies can be organized around two questions or dimensions. First, which income group is the target of the policies intended to counter inequality or economic insecurity? Is it mainly the low-income households at the very bottom of the income distribution? Or is it rather the middle classes, who have traditionally had access to good jobs, but are increasingly facing reduced standards of living and growing economic insecurity in many nations? Is it instead the high-income or high wealth households at the very top that keep concentrating more economic power – as well as political power, possibly -- individually and through stocks in large corporations? Policy priorities will naturally differ depending on whether the target is the poor at the bottom, the middle classes, or the top of the income distribution. This dimension of policy is captured by the rows of the matrix in Figure 1.

The second question relates to the stage of the economy where the intervention takes place. A useful and increasingly frequently used distinction, based on Hacker (2011), is between “pre-distribution” and “redistribution” policies. In this terminology, “redistribution” policies are ex post policies, that transfer income and wealth once they have been realized (e.g., redistributive transfers, progressive taxation, and social insurance). They reshape inequalities after the economic decisions regarding employment, investments, or innovations have been made. We will use the term *post-production* policies instead to denote these policies.

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<sup>3</sup> The matrix was first used in the introduction of Blanchard and Rodrik (2021), and subsequently in Rodrik and Stantcheva (2020 ; 2021).

“Pre-distribution” policies are those that directly shape the working of and outcomes generated by markets. We find it useful to further split pre-distribution policies into two categories: *pre-production* and *production* stage policies. Pre-production policies determine the endowments that people bring to the market, such as education and skills, financial capital, social networks and social capital. Production-stage policies are those that directly shape the employment, investment, and innovation decisions of firms. Overall, the resulting classification entails a three-fold distinction between pre-production, production, and post-production policies. These are shown as the columns in Figure 1.

### **Traditional welfare states: pre- and post-production intervention**

Traditional welfare states have typically relied on the first (pre-production) and third (post-production) columns of this matrix, focusing on education and training on the one hand, and on progressive taxation and social insurance on the other hand. Production stage policies are generally considered separately, focused on market competition, physical investment, and R&D and innovation. This separation between the first and third columns on one side and the middle one on the other reflects the traditional dichotomy between social policies and economic growth or productivity policies. The former aim to correct inequality and insecurity, the latter to improve productivity, innovation, and growth.

Such a dichotomy is justifiable when the economy provides good jobs to all those with adequate education and skills and where most people can have a reasonable shot at a middle-class standard of living. But it is less justifiable in a world in which middle-class standards of living and good jobs are eroding, due to the secular trends of globalization and technological change. The disappearance of good jobs, the proliferation of bad jobs and depressed regional labor markets, as well as growing economic insecurity, would appear to be structural problems facing contemporary market economies. To address these, policy intervention in pre-production (column 1) and post-production (column 3) stages is necessary, but not nearly sufficient. It is also critical to tackle head on and directly the production stage (column 2). More precisely, it is essential to help the production stage contribute to reducing inequalities and insecurity rather than augment them.

Indeed, the production stage itself can perpetuate, dampen, or amplify existing inequalities and insecurity, through the employment, investment, and innovation decisions made by firms.

### **Why should we care about the middle? the costs of the middle-class squeeze**

“Good jobs” are traditionally defined as providing high enough a wage to afford decent living conditions, social benefits, and opportunities for career progression. A survey of French and U.S. citizens undertaken in Rodrik and Stantcheva (2021) shows that the most frequent terms which come to the minds of the respondents when asked to define good jobs are “good salary”, “a good environment/good feeling,” “good work conditions,” and “family life.” In short, good jobs are what allows citizens to live a typical middle-class life.

The availability of good jobs in adequate numbers is important not only for the workers themselves, but also for the broader impacts and spillovers it has on society (Rodrik and Sabel, 2019). A lack of good jobs and the hollowing-out of the middle class can have adverse social consequences: family breakdowns, crime, drug and opioid abuse. It can also have political costs in the form of a rise in authoritarian, ethno-nationalist populism and political polarization. Finally, as the productivity benefits of new technologies (e.g., automation, the knowledge economy, digital advances) remain bottled up in a few firms and sectors, and among some groups of workers in metropolitan areas, the concentration of good jobs reduces aggregate productivity growth in the economy as a whole.

This array of potential economic, political, and social costs is not necessarily taken into account when firms make their production and investment decisions. This opens up scope for public intervention to internalize these spillovers, for which our 3x3 matrix can be an organizing framework.

### **Acting on all columns, an integrative approach**

While production-stage policies are not a substitute for education, progressive taxation, or social protection policies, they are critical complements that more directly target the inequality and insecurity that arise in the course of production. Intervening there has the potential to ease the burden on overstretched social spending budgets.

Moreover, citizens and governments in many countries generally perceive that they are facing an undesirable trade-off between the quality and quantity of jobs, i.e., between having more good jobs and facing higher unemployment. Many countries take the stance of allowing dualistic labor markets to become entrenched (Temin, 2017): Small enclaves of productive, highly paid activities exist amidst many low-paying jobs and pockets of unemployment. There is fear that higher standards on overall working conditions would ineluctably come with higher unemployment and reduced work hours for those who remain employed. In countries where minimum wages and labor regulations prevent incomes from falling too low, as is the case in many Western European economies, unemployment ends up hitting young workers and new jobseekers who want to enter the labor market.

This tension is a real one, but it could be alleviated by increasing the supply of productive good jobs to include those who would otherwise be excluded. Historically, a growth in good jobs available was achieved thanks to economy-wide rises in productivity, which narrowed the gap between opportunities available for insiders and outsiders of the labor market. For instance, the mechanization of agriculture during the 19<sup>th</sup> and early 20<sup>th</sup> centuries created unemployment in rural areas, but surplus workers found employment in urban centers, in the manufacturing and related services sectors, with higher productivity and wages. This does not happen mechanically though: During the second half of the 20<sup>th</sup> century, de-industrialization from labor productivity growth in manufacturing and import competition led to declines in production jobs available and to a shift towards employment in services, where wages and employment conditions were usually worse. The current technological trends are not automatically leading to more, highly paid good jobs either. Hence, action on column 2 is needed.

Importantly, good jobs and good firms can be complementary: Good firms produce good jobs – and perhaps vice versa. This provides a further clear argument for also targeting column 2 of the matrix and for looking at policies across columns in an integrated way. The productivity of low-wage, low-productivity firms has to be improved in order for them to be able to offer good, sufficiently high-paying jobs. Similarly, it is not sufficient to simply train or re-train workers, firms must also upgrade their capabilities. Such an approach – if successful – can enhance productivity and economic growth as well. Instead of having large unproductive and lagging sectors and groups of workers, these would join and contribute to the productive areas of the economy, benefitting from advances and technologies. To some extent, it can alleviate the tension between higher productivity and growth and more equal distribution of income and opportunities.

The largely separate tracks of social policies and economic productivity, competitiveness, and growth policies have thus to merge to some extent. The columns of the matrix have to be addressed in an integrated way, with employment policies that look more like innovation and industrial policies, and industrial and innovation policies that look more like labor market policies.

### **Filling the matrix: policy examples**

We now give examples from various countries about the types of policies that fit into each cell of this matrix, denoted by a letter. Obviously, when we use this matrix to characterize the policy landscape in different countries, we need to bear in mind that the scope and degree of intervention within each cell might vary.

**Bottom incomes, pre-production stage (top left cell)**

Early childhood interventions:

- Compulsory early childhood education (France)
- Childcare subsidies for low-income families (U.S.)

Primary education policies

- Compulsory education in primary and lower secondary schools (OECD countries)
- Schools funded and managed by local authorities (Finland)

**Bottom incomes, production stage (top center cell)**

Minimum wage regulations

- Minimum wage set in national law (U.S., Most EU countries)
- Minimum wage set under collective bargaining agreements (Austria, Belgium, Norway, Switzerland)

Apprenticeships

- National frameworks to regulate and promote apprenticeships (most UE countries)
- Public funding to support apprenticeships, either to firms or apprentices (most UE countries)
- National standards to identify high-quality apprenticeships (U.S.)

Reduced social contributions for firms on low-income employees

- Very low employer contributions on minimum wage employees (Ireland)
- Tax breaks for recruiting unemployed workers (*Hiring Incentives to Restore Employment Act*, U.S)

In-work subsidies

- Earned Income Tax Credit* (EITC, U.S.)
- Prime pour l'emploi* (PPE, France)

**Bottom incomes, post-production stage (top right cell)**

Social transfers

- Housing, family, child benefits (OECD countries)

Guaranteed minimum income

- Monthly transfer (*Revenu de solidarité active*, France)
- Monthly transfer for the elderly and disabled (*Supplemental Security Income*, U.S.)

**Middle incomes, pre-production stage (middle left cell)**

Investments in higher education

- Public spending on tertiary institutions (1.0% of GDP in OECD countries on average)
- Higher education as a legal right (France)
- Pell Grants* (U.S.)

Schemes for adult learning and training

- European Agenda for Adult Learning* (EU)
- Tax allowance for higher education expenses (*American Opportunity Tax Credit*, U.S.)
- Adult education allowance (Finland)

**Middle incomes, production-stage (middle center cell)**

Cluster policies to generate and disseminate innovation

- Silicon Valley (USA), Toyota Cluster (Japan), Cambridge Technopole (UK), Sophia Antipolis (France)

SME support entities

- KfW Mittelstandsbank*, the SME arm of Germany's public investment bank (17.2Bn€ of funding in 2018)

- Small Business Administration (U.S.)*
- Occupational licensing
  - Legal norms to determine job categories requiring government licensing (OECD countries)
- On- the job training
  - Personal activity account (*Compte formation*, France)
  - Workforce Innovation and Opportunity Act (U.S.)*
- Collective bargaining and wage council
  - Swedish Jobs Council
  - Office of Labor-Management Standards (U.S.)
- Trade policies
  - U.S. tariffs in Chinese-made goods
  - EU free-trade agreements

**Middle incomes, post-production stage (middle right cell)**

- Unemployment benefits
  - National unemployment insurance (EU countries)
  - Unemployment benefits provided by local governments (U.S.)
- Pensions
  - Public pension system (France)
  - Tax exemptions for pension contributions (U.S.)

**Top incomes, pre-production stage (bottom left cell)**

- Inheritance taxation
  - Taxing any amount inherited or gift received during lifetime (*Lifetime Beneficiary-based wealth transfer taxation*, Ireland))
  - Differentiated tax rates based on relationship with the deceased (most EU countries)
  - Abolition of inheritance taxation (Norway, Sweden)
- Estate taxation
  - Based on estate of the deceased (UK, U.S.)
- Gift taxation
  - Gifts taxed using income rates (Lithuania)
  - Flat taxation of monetary gifts, progressive taxation of non-monetary ones (Greece)

**Top incomes, production-stage (bottom center cell)**

- R&D tax credits
  - Credit for Increasing Research Activities (U.S.)
  - Differentiated tax credit for SMEs and. large firms (Netherlands)
- R&D grants
  - European Innovation Fund (EU)*
  - Grant to encourage SMEs to invest in R&D (*Small Business Innovation Research Program*, U.S)
- Antitrust policies
  - Investigation into abuse of market power for digital platforms (U.S., EU)
  - Regulation of mergers (e.g., Alstom-Siemens failed merger) (EU)
- Corporate Income taxation
  - Reduced Corporate income tax rates for SMEs (France, Belgium, Portugal)
  - Taxation of some of domestic firms' foreign profits - (*Global intangible low-taxed income*, U.S.)

**Top incomes, post-production stage (bottom right cell)**

- Top income tax rates

- Progressive income taxation (U.S., EU)
- Flat tax on incomes (Hungary, Romania)
- Tax treatment of pass-through corporations (U.S.)

#### Capital gains taxation

- Differentiated tax rates depending on duration of asset ownership (U.S.)
- No taxes on capital gains (Belgium, Luxembourg, Slovakia)

#### Wealth taxes

- Proceeds of the wealth tax flowing to local governments (Norway)
- Wealth tax on specific asset classes (*Impôt sur la fortune immobilière*, France)

### **Conclusion**

The policy matrix is an organizing framework. It does not *per se* determine what the right policies are, but highlights that there are opportunities at each of the three stages of the economic process and at different segments of the income distribution. It can help streamline policy discussions, identify areas for intervention, reveal how different parts of an overall policy system fit together, and allow useful comparisons across policy regimes in different countries.



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**Figure 1: The policy matrix**

		<b>At what stage of the economy does policy intervene?</b>		
		pre-production stage	production stage	post-production stage
<b>Which income segment do we care about?</b>	bottom incomes	primary education and early-childhood programs; vocational training	minimum wage; apprenticeships; reduced social security contributions by firms; in-work benefits	social transfers (housing, family, child benefits); guaranteed minimum income; Earned income tax credit
	middle class	public higher education; adult retraining programs	Industrial policies; occupational licensing; on-the-job training; collective bargaining & work councils; trade policies	unemployment insurance; pensions
	top incomes	Inheritance, gift & estate taxes	R&D tax credits; competition and anti-trust policies.	top income tax rates; wealth taxes; corporate taxes.