

Department of Treasury and Finance

Welcome address to the

The Economic Society of Australia  
Eminent Speaker Series

Professor Joseph E. Stiglitz,  
“Bailouts, Regulation or Free Markets? Business and  
Government in a Small Regional Economy”

D W Challen  
Secretary, Department of Treasury and Finance, Tasmania

Monday 2 August 2010

To make even a small contribution in the field of economics is quite an achievement. There is only a very small group of economists whose contribution has been so significant that it has helped economics further evolve as a discipline, improved our fundamental understanding of how economies work, made economics accessible to the broader community, or helped make a paradigm shift in the literature and teaching of economics.

If there is anyone that can be said to belong to this elite group, it is our guest today, Professor Joseph Stiglitz. It is my pleasure to introduce him to you.

Joseph Stiglitz was born in 1943 in Gary, Indiana. Gary, Indiana has other claims to fame – it is also the hometown of another great economist Paul Samuelson, of Robert Kearns the inventor of the intermittent windshield wiper, and of the Jackson Five. Its economic base was closely aligned with industrial activity and at one time it was an important steel producing city. Gary has been afflicted over time by poverty, cyclical unemployment and racial segregation.

Being surrounded by poverty as he grew up had a big impact on the young Joseph Stiglitz. In his later studies of economics, he counted this early exposure to hardship as a distinct advantage. It meant that, in contrast to his colleagues from more affluent suburbs, he was not as accepting of economic models that suggested that unemployment or discrimination could not exist, or that income distribution didn't matter much. This ensured that his later work was always grounded in reality.

During his school years, Joseph Stiglitz was a keen debater. Part of the attraction of debating was the fact that participants were randomly assigned to one side or the other of any debate. It was a constant reminder that there was always another side to any issue and that to successfully explore an issue, one had to see it from all sides and be able to accept that the 'right answer' didn't command a monopoly of the supporting arguments.

Professor Stiglitz's first years of university education were at Amherst College, Massachusetts. After a broad education at Amherst, he eventually settled on economics as the subject that, in his words, '*seemed to have it all*'.

Having decided to specialise in economics, Professor Stiglitz moved to the Massachusetts Institute of Technology. Here he was exposed to exceptional teachers, including several Nobel Prize winners. While he enjoyed the economic models taught at MIT, an awareness began to emerge of problems in reconciling these models with what he observed in the real world.

In 1965, he commenced a Fulbright fellowship to Cambridge, after which he returned to MIT, as an assistant professor. A long career in academia followed, with appointments at Yale; University College in Nairobi; Oxford; Stanford; and Princeton, among others.

Professor Stiglitz's contribution to economics over the past four and a half decades has been vast, with major contributions to macro-economics and monetary theory, public sector economics, growth theory, development economics, industrial organisation, welfare economics and income and wealth distribution.

However, Professor Stiglitz's most important contribution has been his lead role founding an entirely new branch of economics: the economics of information.

From very early in his career he noted shortcomings in the predictive power of economic models. The most maddening example was the persistence of unemployment – the failure of labour markets to clear as the models suggested they should.

But there were others. During a stay in Kenya in 1969 – one of the earliest of many visits to the developing world – Professor Stiglitz observed not just extreme poverty and mass unemployment, but also the practice of sharecropping. Sharecropping, an arrangement in which a tenant-farmer pays a share of the value of his crop to the landlord, ran counter to the prevailing economic models of the time. It typically involved the tenant surrendering about half of the value of his output to the landlord. But to the young Stiglitz this practice seemed to be highly inefficient, equivalent to a 50 per cent tax on workers' labour. He realised these arrangements were attempting to solve an information problem. The landlord did not opt to pay the farmer to work the land, because the incentives for an employee to get the most from the land could be driven very low; plus it would be difficult and time costly to monitor the employee's level of effort. The landlord had less information about the worker's efforts than the worker. Sharecropping appeared to be one way, however inefficient, of overcoming this information problem.

Thanks to the work of Professor Stiglitz and others, we have seen multitudes of these types of practices studied and re-framed through a different lens. We now have the term *information asymmetry* to describe situations in which parties to a transaction have unequal levels of information. Not only do information asymmetries exist, they are pervasive throughout the economy. They are present between the employer and the employee, the insurer and the insured, the lender and the borrower, the politician and the constituent, the salesman and the customer.

The concept of imperfect information is so well integrated into economics these days that it is easy to overlook just how extraordinarily significant this new body of work was, and how it has advanced our thinking. This new way of seeing things implied that free markets would rarely operate at optimal efficiency. It challenged the long-held belief in the 'invisible hand'. It suggested that well constructed government intervention could improve markets.

Professor Stiglitz's discoveries set in motion a stream of related work on the consequences of imperfect information, such as adverse selection and moral hazard, as well as means to overcome or take advantage of imperfect information, through screening and signalling.

Crucially, the economics of information helped Professor Stiglitz develop models that could explain a range of previously unexplained behaviour and market shortcomings. The problem of imperfect information helped to explain the existence of unemployment, recessions and depressions. It had fundamental policy implications.

In 2001 Professor Stiglitz was awarded the Nobel Prize, along with George Akerlof and Michael Spence, 'for their analyses of markets with asymmetric information'.

Professor Stiglitz's career has by no means been restricted to academia. In 1993 he moved to Washington to serve as a member and later Chair of President Clinton's

Council of Economic Advisers. During his time at the Council he also became involved in environmental issues and served on the Intergovernmental Panel for Climate Change.

In 1997 Professor Stiglitz joined the World Bank as chief economist and senior vice president for development policy. He became known for his concerns about the policy prescriptions that the International Monetary Fund imposed on the developing countries it was helping. These policies, he argued, were not only less than ideal, but had the potential to do damage and cause unnecessary levels of pain.

To his astonishment, Professor Stiglitz found that open debate within these institutions was discouraged and that the standard policy prescribed for developing countries was rarely if ever considered against alternative options. Exasperated by the lack of internal debate, he began to speak publicly about such issues.

This was an extraordinary development for its time. The IMF and the World Bank had long had their critics, but here was a distinguished economist and an insider openly criticising what were the prevailing international development policies of the time. His comments raised the ire of the IMF, the US Treasury and other proponents of globalisation.

Professor Stiglitz has made clear his belief that globalisation has the potential to improve the lives of many, particularly the poor. However, he has argued that its management is critical and that notions of sound economics, equity and transparency have often been overlooked.

Professor Stiglitz left the World Bank in 2000 and took up an appointment at Columbia University in New York, where he has remained since. He retains his interest in policy – at Columbia he founded the Initiative for Policy Dialogue, bringing together economists to help developing countries explore policy alternatives, and to encourage wider civic participation in economic policy making.

Professor Stiglitz's output includes dozens of books, hundreds of technical papers and countless articles for the mainstream press. Like other great economists, Professor Stiglitz writes extensively for the layman as well as the academic. He has written on subjects ranging from the global financial crisis to globalisation, from the true cost of the Iraq conflict to the inadequacies of gross domestic product as a measure of well-being.

The evolution of economics as a discipline during the career of Professor Stiglitz is a reminder that it is still a relatively young discipline. Our understanding of the way the economy works has improved vastly over the years thanks to his efforts.

We, here, would also do well to look through the Stiglitz lens when viewing our own patch of the world; to be aware that just like the debating contest, the prospect of a better understanding lies in looking at things from many angles; to test our thinking about what we expect against what we observe; to consider the possibility that information gaps may be greater than they appear; to judge our policy responses against carefully thought out alternatives; and to promote the benefits of open, candid and well informed debate.

For most of its history Tasmania's economy has trailed the national economy. We can generally explain this: as a small, regional island economy, our industries do not

enjoy the economies of scale of the larger states. Physically, Tasmania is separated from national markets and its isolation increases transportation costs. Our small domestic market often yields less domestic competition. But developments in transport, communications and the free flow of financing have all brought Tasmania into a world of globalised economic activity. No longer are we immune from the effects of national and international trade, labour mobility or policy decisions made elsewhere.

More difficult is explaining why Tasmania's economic performance diverged so sharply from the national economy in the 1980s and 1990s, why the State took a lot longer to recover from the national recession of the early 1990s, or why unemployment has remained persistently higher than in the rest of the country for most of the past few decades. Or, more positively, how in recent years Tasmania's economy turned around so noticeably.

One can be confident that the role of government here has always been important. Professor Stiglitz has written extensively on the capacity of government intervention to improve the performance of markets. But he has also stressed that this intervention needs to be carefully selected and targeted. For policy-makers, this is unnerving – we have to live with the knowledge that our policies have the potential to improve people's lives, but that our intervention can create unintended consequences. We must also educate the community to understand the extent to which government can and should intervene. For every problem there is not necessarily a good government solution – for every failure there is not necessarily good government compensation – and for every bad incentive there is not necessarily a good government correction.

Governments in a small regional economy like Tasmania face three major challenges in keeping our economy healthy and robust.

The first is that Australian states have fairly limited influence over their own economies. The states have no control over interest rates or exchange rates, and they have limited capacity to influence economic activity through public spending. Their tax bases are restricted by the Constitution, and the taxation policies of one state are constrained by tax competition from others.

The second challenge is to design and implement policies that make good economic sense. A good understanding of the economy is not sufficient; we also need to be able to apply this to sound policy action. As the controversy surrounding much of Professor Stiglitz's work highlights, there is still disagreement among economists about appropriate policies, even when they can agree on the theoretical understanding of the issue at hand. Here, as Professor Stiglitz has consistently advocated, we need to be dispassionate and look at the evidence.

The third challenge, perhaps the hardest, is turning policy ideas into actions. This is rarely easy. The voice of community interests are too often drowned out by the megaphones of vested interests. Reversing previously implemented bad policies can be a particularly ghoulish task.

But the business of government should be about pursuing the broader community interest, even if this means making hard decisions. It will be about taking from some to give to others; about facing the reality of past decisions that have not proven to be the best judgement; about canvassing widely and thinking carefully before taking

action; about reaching to achieve the aspirations of a community; and about keeping an open mind to its role as an economic manager.

We have with us today someone who has pushed the boundaries of this thinking – someone who has not just studied but been a party to these difficult decision making processes of government. From his life of learning and inquiry we can make our own advances in the way we deal with new problems, as well as re-thinking the old problems.

It is with a great pleasure that I introduce our distinguished speaker. Speaking on the topic of *'Bailouts, regulation or free markets? Business and government in a small regional economy'*, could you all please join me in giving a very warm welcome to Professor Joseph Stiglitz.