Balancing market, state, and community

Joseph E. Stiglitz

Dar es Salaam

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I. Stockholm Statement representing a rethinking of development strategies

1. GDP growth is not an end in itself
2. Development has to be inclusive
3. Environmental sustainability is a requirement, not an option
4. The need to balance market, state, and community
5. Providing macroeconomic stability

But this does not just mean balancing budgets or focusing exclusively on inflation

Stockholm Statement

6. Attending to the impact of global technology and inequality
    - Key issue is not developed vs. less developed countries, but appropriate treatment of labor, in both developed and developing countries
    - Requires investment in human capital
    - Creating new instruments of redistributions within and between countries
7. Social norms and mindsets matter
    - Bringing the insights of modern behavioral economics to bear in development economics
    - Effective ways of altering behavior (savings, fertility, etc.)

Stockholm Statement

8. Global policies and the responsibility of the international community
   - Recognizing the interdependence of countries
     - That the policies of the large rich countries have large externalities on the rest of the world, which they often don't take into account (including their monetary, regulatory, trade, and migration policies)
     - But tax havens affect all countries
   - International agreements cover only part of these arenas
     - Climate change agreements do not go far enough
     - Do not cover cost of adaptation by poor countries
   - Developed countries have not lived up to their commitments of 0.7% of GDP in aid

Marked change from the Washington Consensus

- With its primary emphasis on markets
- With its inadequate treatment of market failures
- With its narrow view of macro stability
- With its narrow conception of the goals of development
    - More instruments
        - More instruments for monetary policy (now embraced even by advanced countries, e.g. in QE and macro-prudential regulation)
        - More instruments for macro-stability (now embraced in new Institutional View of IMF, on capital controls)
        - More instruments for developmental transformation—notably industrial policies, including for agriculture and services (so more accurately labeled as learning, industrial and trade (LIT) policies)
    - Broader goals

Broader goals to reflect challenges of the 21st century

- Climate change
- Inclusive growth
  - Trickle down economics doesn't work
  - Greater inclusivity can lead to more robust growth
  - More attention to employment generation, especially where labor force growth is rapid (as in Tanzania)
  - There are policies that can simultaneously increase equality and growth
  - Seeing equality and growth as complements rather than substitutes is major change in development thinking
- There may be further challenges: Is Trump ushering in a new era of global protectionism?
  - Underlying social and political forces go beyond Trump

Clearer distinctions between means and goals

- Privatization, markets are not ends in themselves—they are only (possibly) *means* to the broader goals described earlier
- Other variables too need to be looked at through this lens
  - Inflation, budget deficits, current account deficits
- But not attending to some of these variables in a timely way may make it difficult to achieve our goals

Greater participation: a balance between markets, government, and society

- Not just markets, but government and civil society
  - Systems of checks and balances critical
  - Media and civil society can play a pivotal role
- This lecture will focus on new understandings of the appropriate balance of markets, government, and society, based on our new understandings of the determinants of success in the development process and general understandings of market economies

II. The strengths and limits of markets

- One of most important insights in economics was that of Adam Smith:
  - Pursuit of self-interest leads, as if by an invisible hand, to the well-being of society
    - Not even Adam Smith believed in invisible hand—arguing for government intervention to prevent monopolies, to foster education, to reduce poverty

“People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices”

- He understood many of the limitations of markets

Advances in modern economics have enhanced our understanding of the limits of markets

- The reason that the invisible hand often seems invisible is that it's not there
  - Whenever there are information perfections and incomplete risk markets—that is always, and especially in developing countries—markets are not efficient
- Central to development is societal transformation and learning
  - With important spillovers from one firm or individual to another
- Unfettered markets on their own accordingly won't promote development as well as they should

Market failures are pervasive and important

- Imperfections of credit markets
  - Poor individuals can't borrow the funds they need, even if the investments they would finance have a high return
- Imperfections of risk markets
  - Individuals can't buy insurance against many of the risks that they face, and this discourages some high return activities
  - Highlights important role of government in social protection
    - And this is true even in advanced countries, with "good" markets
- Theories of imperfect information explain why these imperfections are *inevitable*
- Washington Consensus policies ignored these
- Government policies can help make markets work better, and can help deal with the consequences of these market imperfections

Macroeconomic externalities and financial market imperfections

- Greenwald-Stiglitz had shown that whenever there was imperfect/asymmetric information and imperfect risk markets (that is, always), markets are not Pareto efficient
  - Reversing presumption about the efficiency of markets
  - Not just a few isolated market failures (like environmental externalities)
- These imperfections often manifest themselves as pecuniary externalities that matter
- We now know they have pervasive macroeconomic consequences—and macroeconomic policy has to be designed to take them into account

Important implications for the role of the state

- Market, on its own, will lead to excessive borrowing, especially in foreign-denominated debt
- Market on its own will lead to too big and too intertwined financial institutions
- Need for strong financial sector regulations
  - Including macro-prudential regulations
  - Including regulations on cross border flows (capital controls)

Exploitation

- Profits can be enhanced as much by exploiting others as by providing cheaper and better products
- Akerlof and Shiller: "Phishing for Phools"
- Exploitation exists because of imperfections of information and presence of market power—both ignored by WC
- Government has an important role in preventing this kind of exploitation

Imposing costs on others (negative externalities)

- Firms don’t take into account the costs they impose on others
  - The financial sectors’ reckless lending imposed an enormous cost on the global economy
  - Polluting firms fail to take into account the social cost of their pollution
- Government can regulate and punish such activities
- True not just of firms but of individuals
  - Large costs of urban congestion
  - Large costs of increasing population

Public goods

- Markets on their own won't supply an adequate amount of public goods—education, health, infrastructure, knowledge—from which all benefit
  - Such goods are of increasing importance in a modern society
- Providing these goods is one of central functions of government

Markets, even when they are efficient, pay no attention to distribution

- Trickle down economics doesn't work
- One of reasons that government should not focus just on maximizing GDP
- Objective of development is to enhance well-being of all citizens
  - But market driven GDP growth may only benefit a few
  - And there won't be a societal transformation
- Differences among countries showed that it was not just a matter of economies, but of policies

New thinking about relationship between distribution and economic performance

- Used to be thought that there was a trade-off: one could only get more equal outcomes by sacrificing growth and efficiency
- Now we realize that they are complementary: societies with greater equality perform better
  - Faster and more stable growth
- Multiple mechanisms
  - Inequality implies many poor don't live up to their potential—wasting society's most important resource, its human resource
  - More divided societies have less social and political cohesion, hard to get support for vital

Major message of my book *The Price of Inequality*

Perspective now strongly supported by research at the IMF

Important implication: GDP is not a good measure of well-being

- GDP is a measure of market income
- But with market failures market income is not a good measure of societal well-being
  - Especially important in a resource economy
    - GDP could go up, but the income of citizens could go down—most of benefits go abroad
    - And standards of living deteriorate even more, as a result of pollution
  - Doesn't reflect whether growth is sustainable
  - Doesn't reflect resource depletion and environmental degradation
  - Or even build up of unsustainable debts
  - Increased conflict could give rise to increased spending on security—GDP would go up but welfare decrease
  - Doesn't reflect how the benefits are shared
- Important to bear in mind: what we measure affects what we do; if we measure the wrong thing, we may be led to do the wrong thing

Major message of Report of International Commission on the Measurement of Economic Performance and Social Progress, *Mismeasuring Our Lives: Why GDP Doesn't Add Up*

Summary: important roles of government

- Regulation: preventing exploitation and negative externalities
- Providing public goods and promoting activities with positive externalities
- Correcting other market failures and dealing with other consequences of market failures
  - Social protection
- Overall: promoting growth—including through industrial policies
  - Under Washington Consensus, these were discouraged
  - Now recognize that all countries have industrial policies and they are relevant for all sectors, and well designed industrial policies are central to successful development
- Ensuring inclusive growth

Basic function: **establishing and enforcing the rules of the game, the basic legal framework, the institutional infrastructure**

These affect not only the efficiency of the economy, but how the fruits are shared

- Ensuring competition

In all societies government has central role

- In promoting macro-stability and economic growth

But in developing countries, its role in promoting development is pivotal

- Sometimes referred to as the **development state**

No country has been successful without government playing an important role

- The developmental state was central to the success of East Asia
- Ideas are now being applied in Africa
- Development state does not arrive like manna from heaven nor is it perfect– has to be constructed. And it has to be constructed in such a way as that it improves performance over time and changes with changing times and circumstances. This is an important area for public policy.

Many key government activities can be seen as response to multiple problems

Example 1: Education

- In sufficient investments in education because of imperfect capital and risk markets
- Important spillovers—a more educated labor force makes a country more attractive to foreign investors
- Providing free high quality education (including, where possible, pre-K education) is central creating inclusive growth

Example 2: Macro-stability

Markets on their own are not stable

Everyone benefits from a more stable economy

- Individuals cannot insure themselves against the risk of market fluctuations
- Instability discourages investment and lowers economic growth

Even conservatives now recognize that government has an important role to play

- But often attempt to constrain both the instruments that the government can use and the precise nature of stability to be promoted (e.g. price stability, rather than overall stability)

III. Importance of getting balance right

- Washington Consensus policies didn't get balance right
- In right balance, government and markets are complementary
  - Based on understanding of (dynamic and static) comparative advantage
  - Recognizing that there is much learning and improvement in efficiency and efficacy in both
    - Large disparities in productivities among private firms
    - Large disparities in productivities of private and public sectors across countries
    - Providing evidence of ample opportunities for learning, including institutional learning

Mistakes of Washington Consensus were very costly

- In Africa, structural adjustment led to a lost quarter century and deindustrialization
  - Growth recovered, partly as a result of China's involvement (infrastructure, buying commodities and natural resources) in this century
    - Will it be sustained as China slows?
- Policies focused on limiting the role of the state, limiting the ability of the state to increase its capacities
  - The countries that achieved macro stability and "good governance" didn't see a flow of foreign investment except in natural resources

Events in the Rest of The World

- The 2008 crisis showed that markets on their own were neither efficient nor stable
  - Huge losses from inadequate regulation
  - Economy only saved through massive government intervention
    - Irony: attempt to reduce role of government led to increased role
  - Major deficiencies in "governance" even in US

More than just markets and government

- Older theories paid little attention to many things that we now know are important
  - Held that institutions don’t matter: what drives the economy are underlying economic forces (supply and demand)
- But institutions *do* matter—such as sharecropping
- Sometimes, these institutions can be *explained* (e.g. responses to imperfections of information)
- But there is no presumption that these institutional responses are efficient
  - And institutions often persist when circumstances change, leaving dysfunctional institutions in place
  - Many institutions exist to preserve power structures

A variety of institutional arrangements

- Not just for-profit institutions and government
- In US, some of the most successful institutions are not-for-profit foundations (e.g. universities)
- Many examples of successful cooperatives
- TVE’s were among important institutional innovations in China

The public good is a public good

- So there will be an undersupply of efforts to make sure that the public sector is run well (just as there is an undersupply of efforts to make sure large corporations with wide share ownership are run well)
- Government can subsidize the institutions that can strengthen monitoring and participation—media, think tanks, education
- Important role for civil society and other forms of voluntary collective action

Other ways of preventing government failure and capture

- Systems of checks and balances
  - But if not well designed, and if society is too divided, can lead to gridlock, entrenching existing elites
- What is needed is more than checks and balances within government, but within society—and that can only be achieved if the extent of economic inequality is limited, and if there is a break in the transmission of economic advantage across generations.

Rule of law

- Importance has rightly been emphasized in modern discussions of development
- But there has often been confusion about meaning
- What matters is what kind of “rule of law”
- The wrong kind of rule of law can be used by the powerful to take advantage of ordinary citizens and maintain and extend inequalities
  - US bankruptcy law
- What most mean by a rule of law is a legal system that protects ordinary citizens against the powerful

Successful development is more than just projects and policies

- There has to be social cohesion
- Social cohesion requires and facilitates inclusive growth (fortunate that Tanzania widely hailed as amongst the most socially cohesive societies in Africa)
  - Inclusive in outcomes
  - Inclusive in process, participation
- Most likely path to ensure success of people-centered developmental strategies

IV. Globalization, technology and inequality

- Increase in productivity (including through robotization, artificial intelligence) could make everyone better off
  - But there can be large distributional consequences, in the absence of government intervention
  - Market equilibrium could result in some groups being worse off ("labor saving innovations")
- Within a country, there are (imperfect) mechanisms to ensure that everyone is better off
  - But globally, there are effectively no such mechanisms
  - Highlighting the importance of addressing demographic and educational issues within Africa
  - And the need for reforms in our system of global governance

Well-known deficiencies in global governance

- Have been exacerbated by changes in global economy
  - With increasing share of global economic activity in emerging markets
- We live in a highly interdependent world, where collective action is needed
  - We have a system of global governance without global government
  - Requires leadership and good will
  - America used to provide that leadership, even if it tried to shape globalization towards its corporate interests
  - Now, it is attacking even the principle of an international rule of law

Global trade

- Global trade agreements advantage advanced countries over developing countries (they are thus unfair)
  - Developed countries kept their agricultural subsidies
    - Leading to lower global agricultural prices
    - Hurting farmers in poorest countries
  - Escalating tariffs discouraged production of value-added products in developing countries, shifting production to advanced countries
- Now Trump claims that trade agreements are unfair to US
  - He is wrong
  - American negotiators got almost everything they wanted
  - The problem was they wanted the wrong things
  - They were advancing corporate interests
  - At the expense of workers in both the United States and developing countries

American workers have been hurt by international trade

- Even though most of their plight is due to technological change
- Conservative advocates of free trade refused to support assistance for those who were displaced
  - They wanted to weaken bargaining position of workers
  - Consistent with their stance on investment agreements
  - Which provide greater protection for American investors investing abroad than investing at home
- The real battle is not between developed and developing countries, but between corporate interests and those of workers

Investment agreements

- Developing countries should be wary of signing investment agreements
- South Africa withdrawing from its agreements
- Protection of property rights should be the same for foreign investors and domestic investors
  - And should be protected by the overall legal framework
- Investment agreements go beyond protecting against expropriation—they inhibit desirable regulatory and tax policies and prevent renegotiation of “odious” or unfair resource contracts
  - Enforced by unfair, non-transparent dispute resolution mechanisms
- Recent agreements move in the right direction—but still not far enough

V. Marked changes in our understandings in last 30 years

- Then, the neoclassical model predominated
- Now we understand its limitations, the importance of imperfections of competition, information, and markets, the lack of robustness of that model, the importance of second best
  - Now there is a focus on behavioral economics, endogenous technology, learning
  - These are all especially important for developing countries

Marked changes in our understandings in last 30 years

- Then, there was a presumption that markets were efficient, with the exception of certain well-defined problems, like environmental pollution.

- Now, there is a presumption that markets are not efficient or stable
  - That there are not just environmental externalities, but also information and learning externalities and macroeconomic externalities
  - Giving rise to multiple needs for government intervention—not just macro-stabilization, but also industrial and trade policies, etc.

Marked changes in our understandings in last 30 years

- Then, it was thought that one could separate issues of distribution from efficiency

- Now, we realize that the issues of distribution and efficiency cannot be separated.

Marked changes in our understandings in last 30 years

- Then, we paid little attention to how markets are structured by the legal system. Economists would simply refer generally to a rule of law, with strong property rights, rigorously enforced.
- Now we realize that markets don't exist in a vacuum, that they are structured by our legal frameworks, that there are many alternative legal frameworks (rules governing bankruptcy, corporate governance, etc) and the choices a society makes make a great deal of difference, for development and distribution.
  - Inevitably, these are decisions made by the political system

Marked changes in our understandings in last 30 years

- Then, the focus was on limiting the role of the government—getting it out of the way
- Now we realize that government is essential, and a central part of development policy is improving the performance of the public sector
- While the Washington Consensus policies and the theories on which they have been based have been widely discredited, their influence still lingers, often masqueraded using different language
- The most successful countries built a developmental state, and figured out how to correctly balance the market, the state, and the community (albeit often by trial and error)