Vol. 4 No. 1 2000

Perspectives on Work is a publication of the Industrial Relations Research Association.

Editors:
Thomas A. Kochan
Hoyt N. Wheeler

Managing Editors:
Susan Cass
Paula D. Wells

Design:
Sawyer Design Associates, Inc.
Diane Sawyer, Nina Souther

Cover Illustration:
Julie Delton/Artville

Production Staff:
Lisa Narug

This project is supported by MIT Sloan School's Institute for Work and Employment Research, The Alfred P. Sloan Foundation, The William and Flora Hewlett Foundation, the IRRA and the generous support of IRRA members.

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Perspectives on Work

Voices from Our Membership
Thomas A. Kochan and Hoyt Wheeler 2

Building a New Social Contract at Work: A Call to Action
Thomas A. Kochan 3

Working Without a Social Contract—The Story of Thirty-Five Million Workers in Low-Wage Jobs
Beth Shulman 13

Work/Family and the Social Contract
Robert Drago 16

MANAGEMENT'S PERSPECTIVE

Toward a New Social Contract Around Work: The Role of Management
Lee Dyer 19

A New Social Contract at Work: Reactions of and Implications for Management
Roger E. Dahl 22

LABOR'S PERSPECTIVE

The New Economy
Amy B. Dean 25

NEW APPROACHES TO WORK

Workplace Innovations and the Social Contract: Do Workplace Innovations Work for Employees?
Paul Osterman 27

"Working" in the New Economy
Thomas A. Barocci 29

GLOBAL PERSPECTIVES

Democratic Development As the Fruits of Labor
Joseph Stiglitz 31

International Perspectives at the IRRA Meetings, January 2000
Greg J. Bamber 38

Updating Union Strategies
Malcolm Lovell 41

The Social Contract and the Future of Our Field: Doctoral Students' Perspectives
Corinne Bendersky and Sean Safford 43

DEMOCRATIC DEVELOPMENT AS THE Fruits of Labor[1]

JOSEPH STIGLITZ

Editors' Note

So far in this issue, our focus has been on the American economy and workforce. But clearly, we need to take a global perspective to the task of updating employment policies and institutions. We were very fortunate to have one of the world's leading economic theorists and policy officials Dr. Joseph Stiglitz, who was finishing up his three-year term as chief economist of the World Bank, address our Boston meeting as a distinguished speaker. Dr. Stiglitz has been the most outspoken critic of what is known as the "Washington consensus" that international financial agencies such as the IMF and the World Bank should focus narrowly on macroeconomic monetary and fiscal policies without taking into account the need for institutions that attend to the impacts of these interventions on the workforce and society. In his powerful address, which is excerpted here, Dr. Stiglitz outlines an alternative democratic development strategy.

Development Objectives

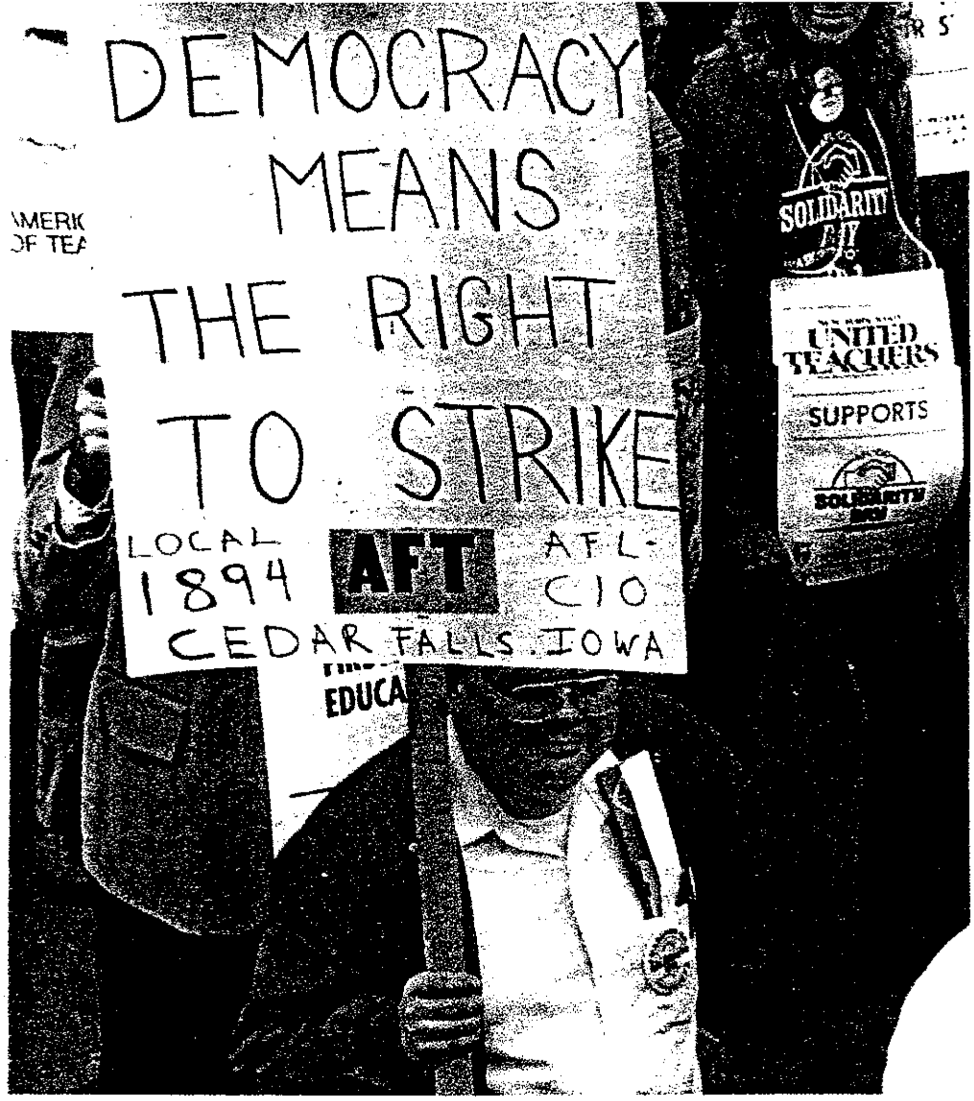
Today there is growing recognition that the objectives of development go beyond simply an increase in GDP: we are concerned with promoting democratic, equitable, sustainable development.[2] If that is our objective, then it is natural that we should pay particular attention to the issue of how the plight of workers changes in the course of development; and we should look not only at their incomes but at broader measures—their health and safety and even their democratic participation, both at the workplace and within the broader political arena. Workers' rights should be a central focus of a development institution such as the World Bank.

I am just completing three years of service as chief economist of the World Bank. During that time, labor market issues did arise but, all too frequently, mainly from a narrow economics focus and, even then, looked at even more narrowly through the lens of neoclassical economics. Wage rigidities—often the fruits of hard-fought bargaining—were thought to be part of the problem facing many countries, contributing to their high unemployment. A standard message was to increase labor market flexibility; the not so subtle subtext was to lower wages and lay off unneeded workers. Even when labor market problems are not the core of the problem facing the country, all too often workers are asked to bear the brunt of the costs of adjustment. In East Asia, it was reckless lending by international banks and other financial institutions, combined with reckless borrowing by domestic financial institutions, combined with fickle investor expectations that may have precipitated the crises. But the costs, in terms of soaring unemployment and plummeting wages, were borne by workers. Workers were asked to listen to sermons about "bearing pain" just a short while after hearing, from the same preachers, sermons about how globalization and opening up capital markets would bring them unprecedented growth. And nowhere, in all of these discussions, did issues of workers' rights, including the right to participate in the decisions which would affect their lives in so many ways, get raised.

I often felt myself to be the lone voice in these discussions, suggesting that basic democratic principles recommended that not only should the workers' voices be heard but they should actually have a seat at the table. To be sure, increasing attention did get focused on safety nets. But was it simply an attempt to assuage feelings of guilt, providing too little too late or, even worse, an attempt to moderate public criticism of "globalization without a human face"? Suspicion of the international institutions evidenced in Seattle was perhaps the, not unsurprising, outcome of the attitudes and policies of recent decades.

As chief economist, I faced several problems. I simply could not ignore the standard arguments about the adverse effects of inflexible labor markets, and, while I agreed with some of the arguments, there were others that left me unconvinced. I had to tackle those issues on terms that the economists themselves—viewing the world from their particular perspective—could understand. But there was a more positive agenda: improving labor relations, including promoting core labor standards.

These perspectives bring me back to two themes that I have been stressing over the last three years. The first is that not only was the Washington consensus too narrow in its objectives, in its focus on GDP, but also in what it saw as the *instruments* of development, the improvement of resource allocation through trade liberalization, privatization, and stabilization. The second related theme is that development needed to be seen as a transformation of society, a change in mind-sets. If that is the case, then workers have to be at the center of the development transformation, and workers' organizations can be key institutions in the development process.



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Labor As a Stakeholder in Corporate Governance

A central theme of the literature on corporate governance is that there are differences in interests among the various stakeholders in the firm. One strand of literature has argued that there is a variety of mechanisms by which a greater congruence can be obtained, e.g., by making workers partial owners, as under employee stock option plans, or by making banks also equity holders. Unfortunately, these same practices often lead to conflicts of interest. A bank that is also an equity holder may have an incentive to make an excessively risky loan, partially at the public expense (as a result of the government guarantee to depositors).

There are several advantages to bringing workers within the fold of corporate governance, beyond enhancing this congruence of interests. First, the sharing of information may lead to less conflict. Under some theories, strikes are a result of imperfections of information; they are a costly way of conveying information between the parties. If firms have to disclose the same information to workers as they do to other board members, then the credibility of that information is enhanced; workers are more willing to accept a firm's claim that it cannot pay higher wages without threatening the viability of the firm.

There are also arguments that worker participation in decision making, even if only through representatives, may increase the sense of "fairness" of any decisions made, and fairness in turn can affect worker morale and productivity (See Akerlof and Yellen 1986).

Second, workers are often in a better position to monitor the firm than are creditors, because they are continuously on the spot. They can verify, or challenge, management claims about what is actually happening within the firm. It is for this very reason that management may resist having worker participation. It may limit the power that management exerts (and its rents) by reducing the asymmetries in information.

In 1990, David Levine and Laura Tyson (1990) surveyed forty-three empirical studies on the connection between participation and productivity. They found that the effect of worker participation on productivity was usually positive, though sometimes small or statistically insignificant, but almost never negative. The effect improves the more the participation was close to the shop floor or office.

Several dozen new studies have been conducted since then, several of which have particularly strong research designs and data quality. Their conclusions reinforce the earlier findings: a small-scale employee involvement plan, just as a small amount of training or a modest change in pay systems, may have some beneficial effects, particularly in the short run. Furthermore, a system of high involvement, strong rewards, and high levels of skill and information, integrated with a corporate strategy that relies on frontline employees' ideas and creativity, is capable of impressive improvements in organizational performance (Levine 1995, 81).

The literature on ESOPs and other forms of employee ownership has generally, but not always, found a positive relationship between ownership and performance. But when the ownership is coupled with genuine participation, the positive relationship is quite clear.

Two Industrial Relations Systems: The Low Road and the High Road

The contrasts between the low- and high-involvement workplaces are part of a larger story about the interlocking attributes of different types of systems (see Aoki 1994). Indeed, one way to look at the East Asian crisis is like the turmoil that occurs at the interface between two systems, just as an earthquake is produced by the collision and rubbing of tectonic plates. In a system of information-rich and stable but highly leveraged relationships between firms and financiers, distress is handled with understanding and leniency on the part of the lenders. The high trust in the firm-financier relationship pairs together with the high leverage as part of a workable system.

But when the same firms start to become indebted with arm's-length, short-term borrowing, there is little slack in the face of distress, and the high leverage may lead to crisis. Low-trust and arm's-length finance relationships need to be paired with lower debt-equity ratios to provide more flexibility under distress. The point is not that one system or the other is "better" but that an unwise mixture of the two systems may be prone to crisis.

High trust is developed between workers and managers by managers exercising the self-restraint to not use their power to enrich themselves or to take advantage of the workers. On their side, the workers choose to be cooperative, without feeling that they are exposing themselves to being opportunistically exploited by self-aggrandizing managers. That mutual cooperativeness in the high-trust management-labor relationship is the basis for high "X-efficiency." In a high-trust and high-involvement environment, the genuine participation of the workers leads to their increased buy-in to the goals of the immediate work group, if not to some goals of the broader enterprise. As a result of this socialization into the enterprise, the worker tends to identify with and to affect the goals of the whole effort. Instead of better threats and monitoring to reduce opportunistic behavior in the agency relation, the high-trust/high-involvement system strives toward identification of principals and agents. In a 1991 symposium on "Organizations and Economics," Herbert Simon emphasized the importance of identification.

> Although economic rewards play an important part in securing adherence to organizational goals and management authority, they are limited in their effectiveness. Organizations would be far less effective systems than they actually are if such rewards were the only means, or even the principal means, of motivation available. In fact, observation of behavior in organizations reveals other powerful motivations that induce employees to accept organizational goals and authority as bases for their actions. [The] most important of these mechanisms . . . [is] organizational identification. (Simon 1991, 34)

Moreover, the greater congruence between the goals of the agents and the goals of the firm can be achieved by adjusting both instead of only the former.

> The body of employees is, together with the body of shareholders, explicitly or implicitly recognized as a constituent of the firm, and its interests are considered in the formation of managerial policy. (Aoki 1987, 283-284)

We have thus seen how the system tries to generalize to larger enterprises the virtues of the family farmer, small producer, or shopkeeper who is self-employed. In doing so, we have seen several different levels of analysis:

1. Implicit contracts—reputational relationships with incomplete contracts with adjustments in response to changing circumstances, based on voice and trust—may be more effective than explicit contracts with, say, one side having all "residual" rights to control and all residual income.
2. Adaptations in workers' preferences—identification—may be more effective in eliciting desired behavior of workers than incentive-based contracts; how to achieve such identification is one of the major challenges facing management. Profit sharing, which in terms of standard incentive theories may be fairly ineffective, may still be effective because of its effects in facilitating identification.
3. Identification can also be facilitated by firms convincingly changing their stated objectives, going beyond simply profit maximizing, to include the welfare of their workers not only as means to ends but as ends themselves.

The following table concisely gives the flavor of the two systems and how their internal interlocks might be played out in different markets.[3]

The Low and High Roads in Industrial Relations

Enterprise characteristic	Low road	High road
Labor market		
Inducement to high effort	High unemployment and efficiency wage	Induces effort even with low unemployment
Compensation	Contractual wages	Wages plus profit sharing
Wage differentials	High differentials as incentive for individual advancement	Low differentials for increased group solidarity and cohesiveness
Employment security	Dismissal is credible threat for discipline	High security to promote identification with enterprise
Training costs	Paid by individual to increase marketability	Paid by firm as long-term human capital investment
Macroenvironment	Can adjust to and contribute to larger recessions with layoffs	Works better with and contributes to fewer and smaller recessions by avoiding layoffs
Product & factor markets		
Relationship	Arm's length, market-oriented, and competitive	Long-term relation based on commitment, trust, and loyalty
Product	Standardized (to foster competition)	Customized to buyer or seller
Curb to opportunism	Exit and competition	Voice, commitment, and trust
Capital market		
Relationship	Arm's length and market-oriented finance	Long-term relational finance
Time perspective	Short-term, since hard to monitor; human capital investments downplayed	Long-term and patient to reap return to human capital investments
Debt/equity ratios	Need low ratio to provide flexibility in face of unforgiving market	Can have higher ratios with patient relationship to financial sources and with involved, more flexible workers
Low costs of equity	Low costs, since no sharing of income or control rights with workers	Lower costs for internal equity, since workers already share some income and control rights

Development Strategy for Labor: From the Low Road to the High Road

Until the East Asian crisis struck, there was, at least among some circles, the view that the high road had distinct advantages over the low road: macrostability would be greater, productivity growth higher, worker morale stronger. I worry that one of the more adverse consequences of the East Asian crisis may be the abandonment of the high road, as firms are being encouraged to break long-standing implicit contracts with workers to downsize in response to the new economic realities, even if downsizing implies forcing long-term workers into unemployment. Such long-standing relationships are viewed as contributing to market rigidities, impeding the quick adjustments needed in the nimble world of modern globalization.

To be sure, *excessive labor market rigidities* (almost tautologically) can have adverse effects. But long-term social contracts between firms and their workers may make the firms more accepting of, and more promoting of, change and progress. Indeed, the breaking of the social contract and the undermining of social capital are increasingly being given credit for the huge decreases in productivity in the former Soviet Union. But given imperfections of information (e.g., between workers and firms), arm's-length market-based relationships will lead to an underinvestment in firm-specific human capital (relative to the first-best optimum) and higher labor turnover.

The Need for and Limitations of Collective Action

I have stressed these market failures, often implicit in the discussions of labor relations, for an important reason. In the absence of the kinds of imperfections noted earlier, firms would have an incentive to have the "optimal" amount of worker participation in decision making; there would be no need for government intervention in governance. If the evidence that the high road is as compelling as many seem to believe, firms will move in that direction.

But the market failures depicted earlier explain why these firms may not move as much or as fast as is socially desirable and provide a clear rationale for collective action. There is at least the possibility that government interventions in the labor market, through regulations affecting working conditions, collective bargaining, and more broadly workers' rights, will bring about redistributions that might not otherwise be achieved. Such interventions may, under certain circumstances, actually be Pareto improvements.

But I hasten to add that there is a delicate balance: excessively strong unions can, through collective action, hold up the rest of the economy, reduce product market competition, and interfere in other ways with the efficiency of the economy. This is particularly problematic in areas in which there is a natural monopoly or a government-created monopoly or near monopoly. Wage increases can be passed on to consumers, and workers in these industries have in country after country been able to use their market power to extract wages far in excess of their opportunity costs. When the service is publicly provided, such as education, market discipline may too be limited. Though eventually voters may raise concerns about public employees being paid wages considerably in excess of market wages, the process is a slow one; and, before the political process responds, considerable rents may be extracted from the public. Of particular concern are those instances in which, in order to maintain their rents, unions attempt to suppress competition, as many would argue has been happening in the United States with unions' vehement opposition to vouchers.

Development As Democratic Transformation

Finally, I would like to view this developmental strategy for labor within a broader framework for development. In my Prebisch Lecture (1998b), I emphasized the concept of development as transformation.

> *Development represents a transformation of society, a movement from traditional relations, traditional ways of thinking, traditional ways of dealing with health and education, traditional methods of production, to more "modern" ways. For instance, a characteristic of traditional societies is the acceptance of the world as it is; the modern perspective recognizes change, it recognizes that we, as individuals and societies, can take actions that, for instance, reduce infant mortality, increase lifespans, and increase productivity.*

We should be clear: workers in much of the world have grounds for suspicion. Capital market liberalization in East Asia did not bring the benefits that were promised, except to a few wealthy individuals. It did impoverish many, both through lower wages and increased unemployment. Worse still, workers have seen decisions that affect their lives and livelihoods being seemingly forced on their countries, with hardly a nod toward the concerns of the workers, apart from sermons about the virtues of bearing pain. I believe, for instance, that there is some chance that some of the disastrous economic decisions that were made in responding to the East Asian economic crisis would not have occurred had workers had a voice (let alone a voice commensurate with their stake in the outcome) in the decision making. And even if similar decisions had been made, at least workers would have felt that they had had their say.

Thus, I would argue that economic democracy is essential to effect the systemic change in mind-set associated with the democratic transformation and to engender policies that make change—which is at the center of development—more acceptable. And because labor and other affected social groups have had a voice in shaping the changes, in making them more acceptable, change is likely to be accepted or even embraced rather than reversed at the first opportunity.

Toward Economic Democracy

So far, I have largely cast the analysis in traditional economic terms. But I want to put forward a stronger hypothesis. We care about the kind of society we live in. We believe in democracy, regardless of whether it increases economic efficiency or not.[4]

Democratic processes must entail open dialogue and broadly active civic engagement, and they require that individuals have a voice in the decisions that affect them, including economic decisions. Thus, we can speak of industrial or economic democracy in the workplace, where unions play a key role, and local democracy at the community level as well as democracy at the national level.

Economic democracy is thus an essential part of a democratic society. The limits and bounds of economic democracy are evolving, just as democracy itself is changing. Though democracy has a long tradition—in the West, it dates back at least to the Greek city-states—even political democracy has been slow to evolve. It was only in the century just ended that universal political suffrage became the norm. Many countries have been slow to grant those basic rights—of a free press, free speech, the right to organize to pursue common objectives (both in general and for workers in particular)—that are so necessary for an effective democracy. Many governments continue not to recognize the people's fundamental "right to know," pursuing secrecy well beyond the domain where it is needed for national security.

Democratic processes must entail open dialogue and broadly active civic engagement, and they require that individuals have a voice in the decisions that affect them, including economic decisions.

There have been comparably great strides in economic democracy. Today management is more willing to listen to the concerns of workers; they do not view this as an intrusion into managerial prerogatives. Even language is changing, as one speaks of partnerships, teams, community. One need not be Pollyannaish, believing that there is complete congruence of interests, to believe that such a change in language represents a fundamental shift in mind-set, a move toward greater openness, to delineating more clearly the sources of conflict, clarifying the asymmetries of bargaining power that arise from costs of labor mobility, limited worker resources, and asymmetries of information.

Democracy is also fragile. Repeatedly, we have seen high levels of social disorder lead to calls for strong (read "antidemocratic") government to restore the basic foundations of law and order, without which individuals cannot live and work together. We have seen how economic policies and the manner in which they are adopted can either contribute to social cohesion or to social disorder. The world has experienced economic crises of increasing frequency and severity. There is a growing consensus on the causes of the crises and on the policies that must be adopted to reduce their frequency and severity and to mitigate the consequences, e.g., by developing stronger safety nets. But there is no safety net that can fully replace the security provided by an economy running at full employment. No welfare system will ever restore the dignity that comes from work. It is imperative that countries not only work to put into place policies that prevent crises and minimize their magnitude and adverse consequences but respond to these crises in ways that maintain as high a level of employment as possible. Too often, in advising countries on policies that they should pursue, the focus has been too narrow. While potential efficiency benefits were stressed, the downside risks were given short shrift; worse still, little attention was put on sequencing—ensuring that the country had in place the institutions that would enable the country (and especially the most vulnerable workers within it) to bear the risks.[5] And in exposing the country and its workers to these risks, we not only put at risk the lives and livelihoods of the workers but, more fundamentally, the systems of economic and political democracy.

As we end the millennium and begin another, it is time to view the issues of labor relations through new lenses and to begin a shift in the prevailing paradigm.

Concluding Remarks

As we end the millennium and begin another, it is time to view the issues of labor relations through new lenses and to begin a shift in the prevailing paradigm. Few people writing a history of capitalism in the United States would venture that organized labor did not play an important role, not only in restructuring the relationships between workers and firms, partially redressing an imbalance of power, but also in improving living standards. Critics who say that these changes would have come on their own, simply as a result of higher GNP, are simply not credible.

But the world today is markedly different from the world seventy-five or fifty years ago. The statistics suggest that unions are playing a far less important role within the private sector than they did in the years immediately following World War II. Yet that does not mean that issues of labor relations have disappeared. Rather, the grounds have shifted, for instance, to issues concerning the role of workers in ownership and governance. There may be a need for government to facilitate this shift in economic organization, just as it did earlier in the century, in facilitating the growth of unions. Many of the developing countries—some of which are just emerging from a history of feudal relations—face more traditional problems of redressing fundamental imbalances of power. Those of us in the business of dispensing development advice must be aware of the social, political, economic, and historical context in which that advice is given: advising countries to have more flexible labor markets may be tantamount to telling them to give up hard-won advances in labor standards. And even the welfare gains may be problematic, once the social costs of the risks imposed and the adverse macroeconomic effects described earlier are taken into account. The streets of Seattle bear testimony to the sense of frustration that many within the developing world feel about how the international community has addressed their concerns.

But even more fundamental than the issues of economic efficiency are those concerning economic democracy: the kind of society we are attempting to create. There is more that we can do than just follow the dictum of "do no harm," though some might argue that that would, by itself, be going a long way. While globalization provides new challenges for sustainable democratic development, it also offers new opportunities to loosen the fetters of the past and to promote the democratic processes essential for long-run success. By becoming advocates of stronger workers' rights and representation at every level—from the workplace to the local, regional, and national level to the international level—I believe we can achieve much more than improvements in efficiency. Labor unions and other genuine forms of popular self-organization are key to democratic economic development. That is why today the World Bank supports the labor standards of the ILO, including the rights to organize and collectively bargain.

NOTES

This is an abridged version. The full text will appear in the *Proceedings*.

1. The findings, interpretations, and conclusions expressed in this paper are entirely those of the author and should not be attributed in any manner to the World Bank, to its affiliated organizations, or to the members of its board of directors or the countries they represent.
2. See, e.g., Stiglitz 1998a.
3. See Levine and Tyson 1990 and Levine 1995 for many of the same points, and see Clark 1979 or Dore 1987 for similar tables comparing Anglo-American-type and Japanese-type firms.
4. Within the development literature, there is a large and controversial literature addressing the issue of the two-way relationship between growth and democracy. See, e.g., Knack and Keefer (1997), World Bank (1997), Stiglitz (1999d).
5. Thus, a large literature now bears testimony to capital and financial market liberalization, whatever the efficiency benefits that might be derived from them and some recent literature has even questioned that; see Stiglitz [1999e] See Demirgüç-Kunt and Detragiache (1997).

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Joseph E. Stiglitz

Joseph E. Stiglitz, senior vice president, development economics and former chief economist for the World Bank, was the distinguished speaker at the 52nd IRRA meetings in Boston, January 8, 2000. Dr. Stiglitz previously served as chairman and member of the U.S. Council of Economic Advisers and was an active member of President Clinton's economic team since 1993. He is on leave from Stanford University where he is a professor of economics. Previously, Dr. Stiglitz was a professor of economics at Princeton, Yale, and All Souls College, Oxford.

As an academic, Dr. Stiglitz helped create a new branch of economics, the "Economics of Information," which has received widespread application. In the late 1970s and early 1980s, he helped revive interest in the economics of technical change and other factors that contribute to long-run increases in productivity and living standards. Dr. Stiglitz is a leading scholar of the economics of the public sector.