Human touch emerges from dry economic theory

*Rather than just crunch numbers, three Nobel laureates studied how people actually react in the free market, writes **Justin Wolfers**.*

IS THE latest Nobel Prize for economics a victory for economic rationalists, or their foes? George Akerlof, of the University of California, Berkeley, Michael Spence, of Stanford Business School, and Joseph Stiglitz, of Columbia University, were awarded the $2 million prize for "contributions to information economics". But what does this all mean?

To the rationalists, all three have provided fundamental insights using the best tools of economic theory. All are mathematical geniuses, and all have appointments at prestigious universities that have been the torchbearers of orthodoxy. Yet the insights of each have turned economics on its head.

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Akerlof's seminal contribution introduced the concept of "adverse selection", which explains why we are all so reluctant to buy used cars. If buyers know less about the quality of a used car than sellers, then the market is said to exhibit "asymmetric information".

Who is most willing to sell their car? Naturally enough, those who own lemons are keen to offload their junk. But if buyers know this, they will be unwilling to pay as a high a price. In turn, the lower price drives more quality cars out of the market, which ultimately becomes saturated with lemons. Thus these markets may be profoundly inefficient.

This idea has applications in a range of other contexts such as health insurance: sick people want health insurance, causing higher premiums, which in turn leads healthy people to avoid insurance, further raising premiums.

Stiglitz's work has examined the implications of adverse selection in insurance, and credit markets. When banks have greater demand for loans than they can supply, a natural response may be to raise the interest rate. However, Stiglitz argues that higher interest rates discourage creditworthy customers, leaving the bank with too many risky clients.

One response is to leave the interest rate low, but with demand exceeding supply, credit must be rationed. This potentially explains why many of us find it so hard to get a loan.

Turning to insurance markets, Stiglitz noted that while insurers would prefer to force risky clients to pay higher premiums, very few clients will admit to being risky. However, by offering two contracts, insurance companies can induce potential clients to reveal their type. That is, risky clients will prefer an insurance policy with a low excess but high premium, while low-risk types will prefer a low premium at the expense of a high excess.

Finally, Spence's contribution is probably obvious to many university students but shocking to economists. While the standard view is that education is socially good, helping us to become more productive citizens, Spence proposes a radical alternative. It may be that you get a degree not to learn, but rather to signal to potential employers that you are of higher ability than the next person. Whether education is a signal, or is truly productive, is an area of ongoing debate and empirical research.

Beyond their scientific contributions, the careers of these economists represent a refreshing change from the tradition of giving the prize to inarticulate academics scrawling incomprehensible formulae on notions obscure to those outside the ivory tower. Each has engaged real and very important policy issues. Each has made fundamental contributions with far-reaching implications. And each has followed interesting and unusual career paths.

Spence has moved from a stellar career as an economic theorist into administration and, as a former dean of Stanford Business School, is widely credited for bringing that institution to international prominence. Stiglitz left the ivory tower for the realpolitik of the World Bank. Of direct relevance to Australians, he was a key figure in the Asian crisis, arguing vociferously that the traditional IMF recipe for austerity was misplaced.

Akerlof – a true feminist if ever I met one – followed his wife, Janet Yellen, to Washington DC when she was appointed the chair of Bill Clinton's council of economic advisers (a position formerly held by Stiglitz). Ever humble, Akerlof would introduce himself to dignitaries as Yellen's spouse.

Akerlof has also actively sought to engage economics with both psychology and sociology. While information economics has been one of the great revolutions in economic theory over the past 30 years, perhaps Akerlof's deepest insights – into identity, fairness, workers' motivation and behavioural economics – may form the basis for a second revolution, and even a second Nobel Prize.

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