40 Years Later—The Relevance of Okun's "Equality and Efficiency: The Big Tradeoff"

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The following are opening remarks written and prepared by Lawrence Summers, Charles W. Eliot University Professor of Harvard University for a Brookings even held on May 4, 2015: 40 Years Later—The Relevance of Okun's "Equality and Efficiency: The Big Tradeoff. In Dr. Summers' absence his remarks were read aloud by Ted Gayer, Vice President and Director of Economic Studies and Joseph A. Pechman Senior Fellow at the Brookings Institution.

I am told that I first met Art Okun days after my birth though I confess to not remembering. I do remember calling him "Uncle Art" and playing baseball with his sons, my brothers, Art and my father at the playground near the house where I grew up. And I remember as a 14 year old hearing his Fels lectures on stabilization policy at Penn and finding the idea that scientific analysis could lead to better policies which would prevent people from being unemployed to be incredibly exciting. Not long after I started pressuring my parents to teach me economics—and was lucky to have parents who could do a splendid job of it.

I'll talk in just a moment about the great book that we are here to discuss. But first I want to say to say something about Art was part of the highlight and one of the lowest lights of the early part of my career. The first significant paper I wrote was my paper with Kim Clark on Labor Market Dynamics published in the BPEA in 1979. We were graduate students and Art was a leader of the profession but he and George Perry put tens of hours into getting our paper right, relevant and clear. Never before or since have I received a critique of my work that was as penetrating or as constructive. It was an immense gift and one that established standards I have tried to live up to ever since.

That was the highlight. The low light came a year or two later when not too long after Art died, I propounded a somewhat half baked argument at the MIT economics department lunch table.

Skepticism was expressed. I persisted. Finally Paul Samuelson ended the conversation by remarking in words I have never forgotten—"Larry, I recently wrote a eulogy for Art Okun. In it, I observed that I had never heard him say a stupid thing. Well Larry, it looks now like I will not be able to say that about you." I learned something from Paul's putdown and even more from Art's example. The stakes in economic policy making are enormous. Economics is not physics—economic theories do not just describe the world—they can change it. Rigorous modeling, effective polemic, or elegant mathematics can be very dangerous when they are not informed by wisdom and good sense and a willingness to learn from experience.

Art's capacity for well-rounded wisdom regarding the most important issues of the day was nowhere better illustrated than in Equality and Efficiency: The Big Tradeoff, the book whose 40th anniversary we celebrate today. I still remember the excitement with which I read it as a first year graduate student. It was the antithesis of the first year economic theory sequence in which I was mired: a thoughtful engaging rigorously logical analysis of real issues that were crucial to the wellbeing of the American people.

Rereading the book in preparation for writing a new forward for it, I was struck at one level by how well it reads today. If a very bright student or policymaker or expert in another field was seeking an understanding of how economists think about the role of markets and issues of fairness, I would even today recommend Okun's book. While recognizing the many virtues of markets, he anticipates the arguments of subsequent critics like my Harvard colleague Michael Sandel when he discusses why it would be wrong to allow citizens to buy their way out of jury duty or sell themselves into bondage.

Okun is acute on the philosophical questions. I suspect he would have rejected the terms of the debate slated to follow these remarks. He would have said of course there are opportunities starting from where America is today to take measures like increasing access to higher education which would promote both efficiency and equity. And he would have had many more examples that likely would have included closing tax shelters, attacking monopolies and fostering international economic cooperation. At the same time, he would have recognized that there were likely limits on the amount of inequality reduction that could be achieved with policies that also accelerated growth. And so he would have recognized that as usual in economics there are tradeoffs. The more of one objective you achieve, the less you are likely to achieve of some other objective. Substantial increases in redistribution are likely to come at some debatable cost in terms of economic efficiency. So his balanced advice would have been to first implement policies that increase growth while increasing equality, and then consider those measures that involve trading off efficiency and equality.

At another level rereading Okun's book reminds one of how much the economy has changed since the 1970s or even since the 1990s and as a consequence how much a sensible progressive policy agenda today is different than the one that was appropriate in the 1970s or 1990s. In my forward to the reprinting of <u>Equality and Efficiency</u> I describe the major changes in the economy, and speculate about what Art would be recommending if he were with us today. Rather than reprising that discussion here, let me conclude by noting how in areas relating to equity and efficiency my thinking has changed in response to a changing economy over the last 40 years. This is not I believe because my values have changed but is rather because of changes in the economy and our understanding of it.

When Okun wrote and for some years afterwards economists believed that the distribution of income as reflected either in the profit share or the share of income going to different quintiles of the population was relatively constant. It followed that the dominant determinant of the growth rate of middle income families was the overall economic growth rate or essentially equivalently that average wages would track productivity growth. This led to great emphasis on measures that could be expected to raise productivity or productivity growth.

For many years now, it has been the case that the income distribution has been growing much more unequal. In particular, the share of income going to the top 1% has risen rapidly from about 8% of income in the late 1970s to around 20 percent today. And the share of capital income in total income continues to rise. Updating a calculation performed a few years ago by Jason Furman and me, I recently calculated that if the income distribution were the same as it was in 1979, about $1 trillion more would be going to the bottom 80 percent of the population increasing their income by almost 25 percent and that about $1 trillion less would be going to the top 1 percent reducing their incomes about in half.

In this context unlike the one in which Okun wrote, it is clear that influencing the distribution of income and its trend has the potential to have a major impact on the well being of the middle class. How? With inequality higher and progressivity lower the case for progressive reform is strong. Certainly because of what has happened in the economy, I would in thinking about tax policy put much more emphasis on distributional issues relative to efficiency issues than I would have during much of my career. Similarly, I believe that concern with issues relating to the cost of capital and the adverse effects of taxes in increasing it has been very legitimate at points in the past. At present, when zero interest rates make capital costs as low as they have ever been but corporate profits are at record levels, there needs to be much less concern with capital costs and more concern with the distributional aspects of capital taxation.

The same basic idea that rising inequality tips the balance between fairness and efficiency applies in other areas of policy as well. So also does the emergence of deflation or lowflation as a threat to the American economy. Okun recognizes the minimum wage can be dangerously high and excessively strong unions can do damage if jobs are taken away and inflation is promoted. These risks are remote today. Indeed, more income for workers would likely contribute to more spending which would in turn increase employment. When the minimum wage is actually lower in real terms than it was when Okun wrote, and when only 6.6 percent of private sector workers are covered by unions, I would judge that he benefit cost ratio seems tilted towards minimum wage increases and towards relaxation of the rules regarding the rights of private sector workers to bargain with management.

Another area where conditions have changed over the years is with respect to policy directed at the financial sector and corporate governance. The financial sector has shown itself to be less of a source of diversification and stability and more of a source of instability than most judged a generation ago. At the same time compensation levels in the sector, and in firms engaged with the sector has gone up rapidly. The simultaneous emergence of high profits and low interest rates raises the question of whether monopoly power is on the increase. So the question of regulatory actions looms much larger than it has for many years.

I could go on and talk about the equity benefits of a high pressure economy, mandated paid leave for those with family responsibilities and a range of issues. I will though have made my point if I have whetted your curiosity with respect to Art Okun's most influential book and made the case that in economic policy with regard to issues of equity, Abraham Lincoln had it right when he said “As our case is new, so we think anew, and act anew”.

Lawrence Summers is the Charles W. Eliot University Professor at Harvard Kennedy School; President Emeritus, Harvard University; Former Secretary of the Treasury and Former Director, National Economic Council, The White House and co-chair of the Hutchins Center Advisor Council at the Brookings Institution. He is also a member of the Advisory Council for The Hamilton Project at Brookings.