Editor's Preface

The essays in this volume represent the work of a truly gifted economist. Arthur M. Okun, who died suddenly at the age of 51, was one of the few members of his profession who could apply technical economic analysis to difficult policy problems, devise practical solutions to these problems, and explain his results to opinion leaders and the public in language they can understand. The essays collected here include his articles in widely read periodicals as well as his contributions to the technical journals.

Arthur Okun was born in New Jersey, went to Columbia University for his undergraduate and graduate work, and received his doctorate in economics in 1956. He was elected to Phi Beta Kappa in his junior year and received the Kasher E. Green Prize for the highest scholastic average in his college class. He was the Godkin Lecturer at Harvard University in 1974 and received the 1979 Frank E. Seidman Award in political economy. He reached the rank of full professor at Yale University at the age of thirty-five.

Okun taught at Yale University from 1952 to 1960. He first came to Washington with James Tobin in 1961 when Tobin was asked to join Walter W. Heller and Kermit Gordon on President John F. Kennedy's memorable Council of Economic Advisers. Okun returned to Yale in 1963, but was soon called back by Gardner Ackley to become a member of the council in late 1964. He was appointed chairman of the council

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in February 1968. He came to the Brookings Institution in January 1969, where he remained for the remainder of his career.

Okun's major preoccupation as an economist was to devise methods of achieving economic growth with price stability. He understood that in the modern industrial economy, there is a danger that rapid economic growth stimulates inflation. He therefore supported macroeconomic policies to maintain a steady and sustainable rate of economic growth and also urged the adoption of wage-price guidelines or other forms of incomes policies to minimize inflation. In the last years of his life, Okun was grappling with stagflation—the coexistence of high inflation and high unemployment; he felt that this problem would undermine the US economy unless brought under control. The manuscript he left, *Prices and Quantities: A Macroeconomic Analysis* (Brookings, 1981), will be studied by students and policymakers alike for many years to come.

Okun's ability as a writer and phrase maker greatly added to his effectiveness as a policy analyst. Artful figures of speech adorn his articles, addresses, and congressional testimony. Among others, he invented these terms:

the discomfort index: the sum of the unemployment rate and the inflation rate;

the leaky bucket: the loss in economic efficiency accompanying programs to help low-income people;

the invisible handshake: the implicit contract between employers and workers, which is an important element in the wage-price spiral;

expensive easy money: a condition in which credit is amply available at high interest rates.

Arthur Okun was a compassionate man as well as a fine economist. His monograph *Equality and Efficiency* (Brookings, 1975), which was based on his Godkin lectures at Harvard, is a reasoned explanation of why the pursuit of too much equality can generate unacceptable efficiency losses and why the single-minded pursuit of efficiency can produce gross injustice. He believed that methods can be devised to achieve social betterment without sacrificing too much economic efficiency.

Okun was a prolific writer. The essays chosen for this volume illustrate the wide range of issues he addressed, his technical prowess in economic analysis, and his ability to communicate his thinking to lay audiences. They should be read in conjunction with his three books, *The Political*

Economy of Prosperity (Brookings, 1970), *Equality and Efficiency*, and *Prices and Quantities*, to obtain a thorough understanding of his views.

The following is a brief introduction to Okun's views on the major issues covered in this volume:

I Inflation. Unlike many economists, Okun refused to accept the proposition that inflation is essentially harmless. He believed that inflation imposes intolerable real costs on society and also undermines the usefulness of money as a yardstick in commodity, labor, and financial markets. The cost of stopping stagflation through traditional fiscal and monetary policies are enormous. Okun believed that as much as 90 percent of any reductions in gross national product resulting from a policy of disinflation could be reflected in reduced output, with as little as 10 percent in reduced prices. To cut the losses from disinflation, he urged a combination of cost-reducing measures (such as cutting sales and excise taxes and eliminating unnecessary regulations) and some form of incomes policies to slow the growth of wages and prices.

II Implicit Contracts. The onset of stagflation in the 1970s and the absence of a theory to explain it led to Okun's work on the invisible handshake. According to Okun's theory of implicit contracts, businesses enter into long-term relations with their employees and customers, thereby lowering the costs of searching incurred by workers and buyers. Such contracts, although they reduce the sensitivity of wages and prices to short-run changes in demand for labor and goods, are sensible and efficient when markets are not competitive and when uncertainty and potential surprises are brought into the picture. The idea of implicit contracts helps to explain why monetary and fiscal restraint alone has so little immediate effect on prices and wages.

III Output, Employment, and Unemployment. Early in his career, Okun observed that the economy grew by about 3 percentage points as the unemployment rate was reduced by 1 percentage point. This relation, which became known as Okun's law, held for many years; numerous scholars are trying to explain why it broke down in the late 1970s. Okun emphasized repeatedly that it would be difficult to achieve the conflicting goals of high employment and price stability and spent much of his career trying to develop methods of improving the trade-off between them.

IV Fiscal and Monetary Policy. Okun believed in the efficacy of both monetary policy and fiscal policy for stabilization purposes, but he did not have any ideological preconceptions about which was the preferred instrument. He felt that the unresolved policy debates dividing the economics profession were essentially quantitative. He made considerable efforts to estimate the effect of particular policy actions on spending, saving, investment, and interest rates. He argued that economic policy should be based on an eclectic theory of macroeconomics and that to be effective, economic policy should be activist and flexible. He opposed slavish adherence to a fixed growth path for the money stock and urged instead that officials be guided by use of interest rates as well as the money supply in seeking to achieve their macroeconomic objectives.

V Economic Performance, 1960–1980. Okun was a careful observer of the economic scene, and his analysis was invariably insightful and illuminating. In examining the impact of the 1964 tax cut, he found confirmation of the effectiveness of fiscal policy in stimulating economic activity. He attributed the long and uninterrupted economic expansion of the 1960s to the active and consistent use of the tools of economic policy. He blamed the poor economic performance of 1969–1971 on the adoption of what he called a policy of "decisive inaction" and argued that monetary and fiscal actions were needed to moderate the impact on the economy of the oil shocks and other surprises in the mid- and late 1970s. In his assessment of economic performance, he concluded that countercyclical policy since the end of World War II had been on the whole successful but that insufficient attention had been paid to the problem of chronic inflation.

VI Economic Forecasting. Okun was himself an excellent forecaster. He did his work with a blend of analytical relations and judgments rather than a large-scale econometric model. He was nonetheless sympathetic to the development of models and was always ready to assist those engaged in this work. He used relatively simple but effective criteria for appraising the predictive value of economic forecasts. For example, he would compare the performance of a forecast with forecasts derived from various naive models and used the number of forecast months with the wrong sign to judge predictions of cyclical turning points. To make large-scale models more useful for analysis and policy formulation, he urged modelers to analyze the accuracy of individual equations as well as the overall performance of the models, to formalize decision rules on when to use judgment and to refit or update equations, and to make available enough information to permit others to reproduce the forecasts.

VII Economic Policy Formulation. Okun had definite views about the role of the economist and the economics profession in the policymaking process. He believed that the economist must deal with social values, assess and make judgments about trade-offs, and set priorities. Yet he also believed that the president's economic adviser, to be effective, must be sensitive to the president's aims and values and exhibit a considerable degree of loyalty, particularly in public statements. Though a presidential adviser cannot be a spokesman for the economics profession as well as the incumbent administration, Okun believed that the adviser can represent the views of the profession *within* the administration. He also believed that the public and Congress should be made aware of the profession's view when a consensus on a particular issue exists.

VIII Equality and Efficiency. Although his primary professional interest was macroeconomics, Okun wandered from this familiar turf to examine the socioeconomic trade-off between equality and efficiency. Okun saw contemporary America as a split-level society, one of equal rights but unequal incomes. He believed that this system is sensible and beneficial, but recognized that there is a trade-off between the objectives of equality and productive efficiency. Okun valued the market as a decentralizer and regarded it as an efficient economic institution, but he insisted that the results produced by the market need to be modified to protect the poor and the disadvantaged. Ideally, remedial measures would be taken to the point where the costs of inefficiency equal the benefits of equality. He believed that the shortcomings of the system could best be remedied from within the system by such means as progressive taxation, transfer payments, job programs, improved equality of opportunity, elimination of racial and sexual discrimination, and lowering barriers to access to capital. Okun was convinced that democracy and capitalism need each other "to put some reality into equality and some humanity into efficiency."

As this summary suggests, Arthur Okun was not an ivory-tower economist. He was interested in not only solving economic problems but also improving economic welfare. In *The Political Economy of Prosperity*, he explained why it is difficult to be a successful political economist: "To convey the professional view effectively requires the talents of a missionary, an outstanding pedagogue, and a supersalesman; it also takes skillful and sympathetic understanding of the opposition views and, especially, of noneconomic considerations in policy choices." Okun himself possessed these qualifications, and they enabled him to make major contributions to economic analysis and policy.

The US economy would now be better off if policymakers had paid more attention to what Arthur Okun was saying. It is still not too late to benefit from his insights and wisdom.