The Way to a People Centered Economy

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I was very impressed when I saw the agenda for this forum. It is striking to see people looking for fundamental changes in society. We still have people looking for fundamental changes in the United States, but it is certainly much less common in the second decade of the 21st century then I was a boy growing up in the 1960s. I share in the urge to see a better society. There are many ways in which the country and the world seem to be worse today than in decades past. However, I do think there is real hope for substantive change for the better.

At the risk of disappointing people here, I think the route forward is not likely to be a radical overhaul of the existing system, but rather an evolutionary process that involves eliminating the worst features of the market system as we know it now. The path we design must build upon itself: a track record of successes builds political support and the courage to move forward with further reforms.

Before I get into specifics, I want to say that I appreciate this invitation and consider it an honor to be here. That is not only because it is an important forum, but also because I have tremendous respect for what the Korean people have been able to accomplish in a very short period of time. Like most economists, I have to be humbled by the lack of success of my profession in designing policies to make the world a better place. Most of the countries that were poor fifty years ago are still poor today.

In this context, Korea is a remarkable exception. It has gone from being among the poorest countries in the world to among the richest in the span of my lifetime. There is little doubt that the overwhelming majority of people in Korea are living far better today their parents or grandparents in the 1950s. And, as my friend Ha-Joon Chang is fond of pointing out, the country accomplished this progress largely by ignoring the development formulas offered by mainstream economists. Korea's success is an impressive accomplishment.

I am going to outline four areas in which it is important that markets be structured in a way that promotes the general welfare rather than allowing the rich to get richer. For the most part I will be discussing these areas in reference to the United States. There are two reasons. First, each of these areas raises more of an issue in the United States than in Korea at present. However in all four cases there is a real concern that Korea may follow the United States down the wrong road. Certainly there are many people in powerful positions in the United States who would like to see this outcome.

The second reason for my focus on the United States is less justifiable. I don't know enough about the details of Korea's economy to be able to comment knowledgeably on these topics with reference to the Korean economy. I am sure that my audience is better able to assess these issues in the Korean context than I am.

The four areas that I want to explore are:

1) The structure of the financial sector;

2) Institutions of corporate governance;

3) Intellectual property in the form of patent and copyright monopolies; and

4) Full employment.

Policy in these four areas will have an enormous impact on economic performance and also on the larger shape of society.

The Problems of a Bloated Financial Sector

The financial sector serves an enormously important purpose in a modern economy. It allocates capital among firms and households. It also allows people to save for future needs. No one can doubt that an economy would be seriously impaired if it did not have a well-functioning financial system. However the financial sector in many countries, certainly in the United States, has grown far beyond the size that is needed to serve its proper economic role. Measured as a share of GDP, the narrowly defined financial sector (investment banking and securities and commodities trading) has quintupled as a share of private sector GDP since the 1970s. It would be very difficult to see how this growth has been associated with the sector better serving the rest of the economy.

The difference between the current size of this sector and the 1970s size is close to 2.0 percentage points of GDP ($350 billion in 2014). This is effectively a deadweight loss from an economic perspective, if these additional resources are not associated with better service to the productive economy. It has roughly the same impact on the economy as a government department that spent 2.0 percent of GDP to do absolutely nothing.

This is not the only way in which the U.S. financial sector imposes costs on the economy. There is also a large amount of money wasted in administration and fees for various services that could be better handled either by the government sector or through a better regulated financial sector. The largest of source of this waste is in private health insurance. Administrative costs for private insurers take up between 15-20 percent of the premiums paid into the industry. This compares with administrative costs in the neighborhood of 2 percent for Medicare, the publicly run health insurance program for seniors and the disabled. While this simple comparison is not entirely fair, even if the Medicare figure is adjusted upward to make it fully comparable, we would still likely see savings in excess of 0.6 percent of GDP ($100 billion a year) if health care insurance was administered through a public sector program.[1]

There is also a large amount of unnecessary waste in the sector due to the replacement of traditional defined benefit pensions with defined contribution accounts where individuals are responsible for managing their own savings. The latter tend to have higher administrative costs in additional to also passing along the risk of bad investment decisions and poor market timing to individuals.

[1] The major difference is that Medicare patients tend to have much higher person health care expenses. This raises the denominator. Insofar as administrative expenses are fixed on a per person basis, the higher level of medical expenses per person will make Medicare seem more efficient.

Finally, the United States allows financial firms to engage in behavior that can only be described as predatory. Banks and other financial firms routinely apply a fee structure that can often extract substantial amounts of money from those who can least afford it. For example, it is a common practice for banks to charge fees of $30-$40 for overdrawing an account. Since low and moderate income households generally have little by way of cash buffer, they can often find themselves in this situation. In many cases they may have to pay a fee of $30 or $40 because they were a dollar or two short in their account for a day.

These rents in the financial sector all come at the direct expense of the productive economy. For example, an algorithm that allows traders to discover major buy or sell orders, and then trade ahead of these orders, may generate hundreds of millions or even billions of dollars for its creator. Yet, this action will provide zero information to the market. Similarly, large amounts of money can be earned by designing mechanisms that trick customers into actions that impose bank fees. As a result of its potential for generating large fortunes, many of the country's most highly educated workers go into the financial sector. This is also one of the economy's major generators of inequality.

The simple and obvious point is that policy must be designed to contain the growth of the financial sector and ensure that it fulfills its purpose in the most efficient possible way. There are several obvious policies for accomplishing this task.

First, banks should not be allowed to grow to a size where they benefit from implicit too big to fail (TBTF) insurance. The logic here is that if investors come to believe that a bank will not be allowed to fail because it is too important to the economy, then it will be able to borrow at a lower interest rate than its competitors. This can amount to a substantial subsidy. The I.M.F. recently estimated the size of the subsidy to large banks in the United States at $50 billion a year. It estimated the size of the subsidy to large banks in the euro zone at $300 billion a year.[2] Some of these subsidies would go to shareholders but a substantial portion of the subsidies would go into the pockets of the top management at the TBTF banks.

There is no reason for governments to be providing subsidies to large banks. It is a simple matter to impose punitive fees on large banks that would offset the value of these subsidies and force TBTF to downsize to the point where their collapse would not impose a large cost on the economy.

The second mechanism for discouraging bloat in the financial sector is a tax directly on the sources of the bloat, specifically a tax on financial transactions. A few years ago I designed a scaled financial transaction tax with my friend Bob Pollin, which was designed to roughly double the transactions costs that prevailed in financial markets at the time. [3] We estimated our tax would raise an amount of revenue that was roughly equal to 1.0 percent of GDP.

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[2] International Monetary Fund, 2014. Global Financial Stability Report, Chapter 3.

[3] Baker, D, R. Pollin, T. McArthur, and M. Sherman, 2009. "The Potential Revenue from Financial Transactions Taxes," Washington DC: Center for Economic and Policy Research.

While raising revenue for the government was one motive for the tax, it would also have the effect of reducing the volume of transactions in the financial sector. If the elasticity of trading is close to one, which is the assessment of much of the research on the topic, then the reduction in trading volume would be roughly equivalent to the amount of revenue generated through the tax. If our calculations were correct, then our scaled tax would reduce the amount of resources consumed by the sector by an amount equal to 1.0 percent of GDP (@$175 billion in 2014.) This would both eliminate an enormous source of waste in the economy and drastically reduce many of the top incomes.

Finally, to rein in the financial sector, we should insist that the government provide services in areas where it is more efficient than the private sector. As noted before, the government-run Medicare system has much lower administrative costs than private insurers. This is a strong argument for extending Medicare to the population as a whole. This should be possible to achieve through a market process, whereby a government plan is allowed to compete on an equal footing with plans offered by the private sector. If the government plan is in fact more efficient it should be able to win out over time through a process of competition.

Similarly, the government could offer low-cost banking services through the postal system, as it used to do in the United States and still does in Korea and many other countries. Such a service would be designed to cover its costs, without engaging the sort of predatory practices that are common in the private banking system. The government could also offer a low-cost defined contribution pension system, similar to the one that federal employers now use. This would allow middle income workers to save an enormous amount in fees over their working lifetimes.[4] Their savings would come directly out of the earnings of the financial sector.

All of the measures listed above are consistent with making the economy more efficient – making markets work better. Yet, they would have the impact of reducing a major source of inequality in the economy today. The financial sector would be serving the productive economy at least as well as it does at present, while imposing a much smaller cost on the economy.

Corporate Governance

The corporate governance structure in the United States has been corrupted so that it is now largely a story whereby top corporate management picks the directors who ostensibly control the company. These directors receive payments that are typically several hundred thousand dollars a year. This is in exchange for attending a small number of meeting (usually 4-8). This creates a situation where directors often feel indebted to the top management that arranged their selection. They return the favor when it comes time to determine the compensation for the chief executive officer (CEO) and other top

[4] A middle income worker who put $3,000 a year into this account for 30 years could easily save more than $20,000 in fees over the course of their working career. The ability to turn an accumulation into an annuity at low cost could save another $10,000 to $20,000.

management, approving pay packages that are far larger than would be warranted by market considerations.

As a result, of this insider arrangement median compensation for CEOs in the United States has soared relative to the pay of ordinary workers and the pay of CEOs in other wealthy countries. The median pay of a CEO at a Fortune 500 company is now over $12 million a year, more than 300 times the pay of the median worker. It is not uncommon for CEOs to get pay packages that exceed $25 or $30 million.

The bloated pay of CEOs also has spillover effects on the pay of other top executives and the pay for top management outside of the corporate world. Presidents of major universities often receive pay packages that exceed $1 million a year as do the CEOs of major charities or other non-profit institutions. They can argue, with some justification, they would be paid far more if they were working in the corporate sector with comparable responsibilities. This is again a major source of inequality in the economy as these pay packages put these top executives in the top 0.1 percent or even top 0.01 percent of wage earners.

The key for preventing these sorts of bloated pay packages is to ensure that the shareholders can maintain effective control over CEO pay. It may not in general be desirable to give power to corporate shareholders, but when the alternative is outrageous pay packages for top management, the goal should be to empower the shareholders.

Most other countries are well ahead of the United States in this area in part because they have a practice of bank ownership of corporate stock. The banks act as long-term shareholders who can effectively police the practices of top management. In this capacity they can impose a break on outlandish pay packages.

In the United States, where banks do not hold shares of stock, there is no institutional structure now in place to rein in CEO pay. There are some major companies where the founder's descendants still have a controlling interest, but these are the exceptions.[5] This means that is necessary to create a new institutional structure to change the incentives in corporate governance.

On possibility comes out of the "say on pay" provision that was included in the Dodd-Frank financial reform bill that was passed following the economic crisis. This provision requires that CEO pay be submitted for a non-binding vote of the shareholders. In the three years that this provision has been in effect the overwhelming majority of pay packages have been easily approved, with less than 3.0 percent having been voted down. It is extremely difficult to organize among shareholders and since the vote is non-binding, the potential benefits from a successful campaign are limited.

It would not be difficult, however, to make these say on pay votes more meaningful. If the directors were required to forfeit their stipends if a pay package was defeated by shareholders, it would radically alter the incentives they now face in deciding on CEO pay. As it stands now, there is a strong incentive to

[5] Ford and Walmart would be examples of two such companies. However, even if the families were motivated to try to limit CEO pay they would likely find it difficult to do so in a context where bloated pay packages were the norm at other companies.

simply go along. All the people involved in the process are friends (CEOs sometimes actually sit on corporate boards), there would be little reason for a director to make a point of disrupting the process by insisting that a CEO pay package was more in line with the market. This logic shifts completely if the directors know that they may forfeit their stipends entirely by approving an overly generous pay package. They would now have a strong incentive to ensure that they had structured the pay package in a way that was sufficient to attract and keep highly competent managers, but at the same time did not reward unnecessarily reward them.[6]

Bringing pay packages for CEOs back in line with their levels of three decades ago would be an important step toward reducing inequality in the U.S. economy. Bloated CEO pay is certainly not the sort of problem in Korea as it is the United States. Hopefully the country will maintain a structure of corporate governance that ensures it never will be.

Patents and Copyrights

Patents and copyrights are one way in which to finance innovation and creative work. In effect, the government enforces a monopoly for a limited period of time as a prize. While nearly all countries now have some form of patent and copyright protection as a result of the inclusion of the TRIPS provision in the last WTO round, the United States goes much further in enforcing these monopolies than any other countries. On the patent side, its inspection of patents is notoriously lax. In one famous case the patent office actually approved a patent for a peanut butter and jelly sandwich.[7] On the copyright side, the U.S. Congress has repeatedly extended the copyright period and applied the extensions retroactively. While this has enriched a small number of companies that own valuable copyrights that would have otherwise expired, it is obviously not possible to provide incentives that would affect peoples' past behavior. This is the nature of patent and copyright law in the United States.

The abuses of the patent system are most glaring in the case of prescription drugs and the tech sector. In the former case, since the United States does not regulate drug prices, drug companies are able to charge prices in the tens or even hundreds of thousands of dollars for their drugs. In a case that has garnered considerable attention in the United States and around the world; Gilead Sciences is charging $84,000 for a round of treatment of Sovaldi, a new drug for treating Hepatitis C. This drug can be profitably sold as a generic for less than $1,000 for a round of treatment. Even in a country as wealthy as the United States, paying $84,000 for a treatment creates enormous problems which would not exist

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[6] It is common for CEOs in the United States to be paid in stock options. These options are generally not indexed in any way. This means that the CEOs can profit simple because the stock market goes up and their company's stock rises along with everyone else's. It also means that the CEO can profit enormously if the company's stock price went up because of an event for which they were in no way responsible. For example, the CEO of Exxon-Mobil in the last decade made an enormous fortune because the price of oil more than tripled during his tenure. The caused the company's share price to soar as well. The simple way to avoid this problem is to index options to the performance of a related group of companies. This would make it far less likely that top management would benefit due to (or suffer from) events that were beyond their control.

[7] Wikipedia provides a brief description of the patent [http://www.google.com/patents/US6004596].

if the drug were selling for its free market price. Insurers and the government will be very resistant to paying this much for a drug. Several new treatments for cancer and other diseases present comparable problems.

In addition to the difficulties associated with paying these prices, the huge gap between the patent protected price and the cost of production leads to exactly the sort of corruption and abuses that textbook economics predicts. Drug companies have enormous incentive to promote their drugs as widely as possible, even if it means using them for purposes where it is not the most effective treatment. Drug companies also have incentive to conceal evidence that their drug may not be effective or could even be harmful. This is a very serious risk when the company has access to test data that is not available to the larger scientific community.

As a result of this incentive structure it is a common to read about scandals involving drug companies concealing or misrepresenting their test data. In most cases it means that patients may not be getting the best possible treatment for their conditions or may be paying for drugs that provide them little benefit. In more extreme cases, the drugs they are taking may be causing them serious harm or even lead to fatalities. In one such case, the pharmaceutical giant Merck, agreed to pay out $6 billion in damages over accusations that its arthritis drug could cause heart attacks or strokes in people with heart disease. It was alleged that the company had test results showing this is as possible side-effect, but concealed this evidence so as not to damage sales. While this is an extreme case, given the incentives created by patent monopolies in prescription drugs, it would be surprising if drug companies did not misrepresent the safety and effectiveness of their drugs in order to promote sales.[8]

The patent system in the drug industry is also likely to lead to poorer research outcomes. Since research is being done in pursuit of patent rents, companies will be secretive in their work and disclose as little information as possible when filing a patent. This secrecy impedes scientific progress since science advances most quickly when research results are broadly shared. This will also lead to much duplicative research as companies seek to cash in on their competitors' patent rents. This often results in the development of multiple drugs to treat the same condition. In the context of a system in which a company had a patent monopoly on a drug to treat a harmful condition, more competition is generally better, but if the drug was selling at the free market price, no one would spend large amounts of money to develop a drug for a condition that can already be effectively treated.[9]

In addition, the patent system provides no incentive to pursue treatments that don't involve patentable drugs. This means that research into environmental or dietary factors that may cause health problems, or even research into possible cures involving old off-patent drugs will not be pursued. Ideally, publicly

[8] The New York Times recently had an article detailing billions of dollars that drug companies had paid out to doctors and other health care providers over the prior three years. Such payments raise obvious conflict of interest issues, since their purpose may be to persuade these providers to promote the use of their drugs (???).
[9] There will typically be value to follow on drugs , since some people may react poorly to the initial drug, but from a social standpoint, resources would be better deployed developing drugs for conditions for which there are no effective treatments.

financed research can look into these areas, but the patent system creates a divide that may not correspond in any natural way to research expertise.

There are alternatives to patent-financed research, most of which involve publicly funding through various mechanisms. There are good reasons for believing that these would be far more efficient than the current patent system.[10] It is worth noting that the United States already spends more than $30 billion a year on bio-medical research through the National Institutes of Health. This funding enjoys support from across the political spectrum, so the idea that the government can usefully fund research should not be far-fetched even in the United States.

While the replacement of the system of patent financing for prescription drugs is not likely in the immediate future, it is important to warn of the increasing abuses of the system. It is a bipartisan policy of the U.S. government to push for stronger and longer protection, not just in the United States, but around the world. We have made this a central issue in all bilateral and multilateral trade agreements over the last quarter century. Countries like South Korea have every reason in the world to resist this effort.

This drive has nothing to do with free market economics; it is crony capitalism at its worst. It is about redistributing money upwards. Not only do these protections slow growth and worsen the distribution of income, they do it in a way that jeopardizes public health.

There is a similar, albeit less consequential story with copyrights. Copyrights are an archaic and incredibly inefficient mechanism for supporting creative work. Furthermore, with the spread of the Internet they are becoming ever harder to enforce. Rather than adjusting to developments in technology, the U.S. government's position is to go the route of increased repression with harsher penalties for violating copyright law. A woman recently completed a 16-month prison term for allowing people to download copyrighted material off her computer.[11] South Korea should feel no qualms about standing up for free market capitalism and resisting U.S. efforts to use increased repression and surveillance to sustain copyrights in the 21st century.

Full Employment and Two Percent Inflation Targets

I recently wrote a book with a friend, Jared Bernstein, on the benefits of full employment in the United States.[12] We were highlighting the importance of full employment not just because we think that the unemployed should be able to get jobs, but also because of its impact on the bargaining power of tens of millions of workers who are already employed.

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[10] Some of these alternatives are outlined in Baker, D. 2004, "Financing Drug Research: What Are the Issues?"
[11] "The Unrepentant Bootlegger," New York Times, September 27, 2014.
[12] Getting Back to Full Employment: A Better Bargain for Working People, 2013. Washington, DC: Center for Economic and Policy Research.

We used several different methodologies and data sets and consistently found the same relationship. When the unemployment gets down to low levels, as it did in the United States in the late 1990s, those at the middle and bottom get a disproportionate share of the benefits. The logic of this is straightforward. In a period of rising unemployment, firms will not typically lay off their managers or people in highly skilled positions. Rather they look to make reductions in employment of the workers near the bottom of the pay scale. This means that the ones most likely to lose their jobs are dishwashers and custodians in restaurants, clerks in retail stores, and housekeepers in hotels. The supervisors and more highly educated workers are likely to keep their jobs unless demand falls off much more sharply. As a result, the demand for more highly educated workers is likely to be considerably less cyclical than the demand for less educated workers.

The implication of this point is that the overall level of employment and unemployment matters hugely for income distribution. And, this is very much a policy choice. Many central banks, including now the Federal Reserve Board in the United States, have set an explicit inflation target (usually 2.0 percent). In many cases, this has meant being willing to keep substantial numbers of workers unemployed in order to meet this 2.0 percent target. While this is portrayed as a simple technical decision (the desire to have a stable inflation rate), it is actually a political choice with enormous consequences.

While there may be no simple long-run trade-off between inflation and unemployment, there is undeniable a trade-off between unemployment and the risk of higher inflation. In other words, at lower rates of unemployment we have a greater risk of accelerating inflation. The decision on how much risk of inflation we should tolerate in order to let more workers have jobs is a political question, not one to be decided by technocrats.

The United States is currently seeing a battle between those who argue that the risks of inflation are already too great and that the Fed should start raising interest rates, even though employment is still at least 3 million below trend levels and possibly as much as 6 million. If these people carry the day, millions of unemployed workers and their families would be subjected to a near poverty level existence. Almost as important, most workers would continue to lack the bargaining power to secure real wage gains. Income would continue to be redistributed upward.

Note that this outcome has nothing to do with the free market. It is a story where an agency of the government, the central bank, deliberately acts to keep most workers from sharing in the gains of growth. The free market doesn't require this outcome. The opposition here is people who insist that inflation has to be a more important concern than unemployment, not people who believe in a free market.

The Best Path Forward

I realize that I have mostly outlined a "don't go here" story, which is obviously not a description of a forward direction. Part of my reason is that I would not be so presumptuous as to tell a Korean audience

about the path they should look to take their economy and their country. However I do think there are a couple of points that can be made.

First, the social insurance programs in the United States and most of the rest of developed world have been enormous success stories. The public provision of health care, old age pensions, and education has both been successful in accomplishing its goal virtually everywhere, and almost always is more efficient than private sector alternatives. These programs can be defended on grounds of social justice, but also on economic efficiency. Progressives should never be shy about making the latter point. Advocates of privatizing these services are not going to save the public money; they are going to raise costs while often profiting well-connected businesses.

The second point is that progressives should never set themselves out as opponents of the market. The market is a tool like the wheel. By itself it is never good or bad. The right may often use the market for pernicious purposes, most importantly redistributing income upward.

Our response should never be to lash out at the market. We have to be equally creative in figuring out how to structure the market to better achieve progressive goals – broadly shared prosperity and a sustainable economy. This is possible, if we are prepared to do the hard work of thinking things through.