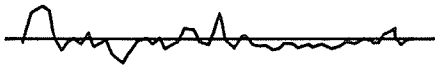


**Inflation:**

## **A RECURRING FEVER**

Economists still haggle over a proper definition of inflation, but most Americans know inflation's impact: rising prices. From Kennedy to Nixon to Carter, Washington's stop-and-go anti-inflation strategies have proved inadequate. Here the editors outline the postwar record, and economist Laurence Seidman describes the latest proposed remedy.



According to Plutarch, Athens under Solon (fl. 600 B.C.) wrestled with severe inflation after depreciation of the mina. To restore stability, the Athenian lawgiver may or may not have resorted to the "draconian" measures named after his predecessor, Draco; Plutarch does not say. In our own times, unprecedented inflation scourged Germany and Central Europe after both world wars. Prices increased a trillion-fold in Weimar Germany between 1920 and 1923, doubling between meals in the last weeks of "hyperinflation."

Inflation in the United States has historically been a shadow cast by war. During the Revolution, the Continental Congress printed reams of paper money; prices shot up 13,500 percent between 1775 and 1780. Congress had no choice: It lacked the power to tax. But even later, governments were reluctant to levy enough taxes to cover the full cost of wars. The result: Soaring prices during or after the Civil War, World Wars I and II, Korea, and Vietnam. The current inflation is largely a legacy of the late 1960s—the Vietnam War (\$135 billion) and the Great Society programs, whose costs were financed not by increased tax revenues or sales of government bonds but by deficit spending and monetary expansion. The 1.3 percent annual inflation rate of the early 1960s climbed to 4.2 percent by 1968.

While a 4.2-percent inflation rate now seems mild, it shocked pundits and bankers at the time. Nor did a belated 10-percent tax surcharge in 1968 bring it down. After Richard Nixon entered the White House, his administration applied the brakes to monetary expansion (but did not enact new taxes). Inflation dipped from its 1969 level (6.1 percent), but unemployment jumped to 6 percent and the stock market sagged.

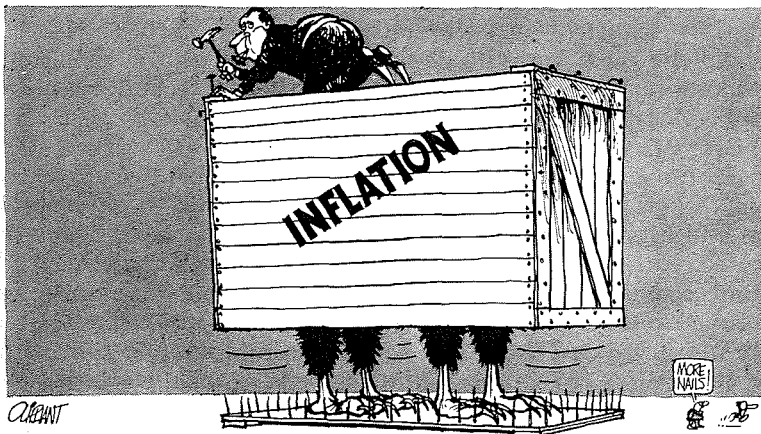
Inflation slowed when Nixon imposed the nation's first peacetime wage and price controls in 1971. As controls were lifted in mid-1972, the economy experienced a boom that lasted through the election. Inflation resumed its climb, even as boom turned to near-bust in early 1973. Then came the OPEC oil price increases, which quadrupled the price of petroleum and sent an inflationary wave throughout the world economy.

When Gerald Ford became President in 1974, he inherited a 6.5-percent unemployment rate and a 12-percent annual rate of inflation. The dollar had eroded by 50 percent since 1967. The Ford administration's tight money policies brought inflation down slightly, but unemployment remained high (8.5 percent in 1975) as a stagnant economy limped out of recession.\*

While the Carter administration has imposed a ceiling on federal pay raises, and the Federal Reserve Board has tightened the money supply by raising interest rates, the President has also sustained what Brookings economist Arthur Okun dubs "self-inflicted wounds." These were acquired as Carter and Congress attempted to help Americans cope with inflation through measures that are themselves inflationary, such as crop acreage restrictions to boost farm prices and protectionist import restrictions to help certain manufacturers. Meanwhile, the federal deficit is growing, and Washington has produced no coherent energy policy. Unemployment hovers around 6 percent.

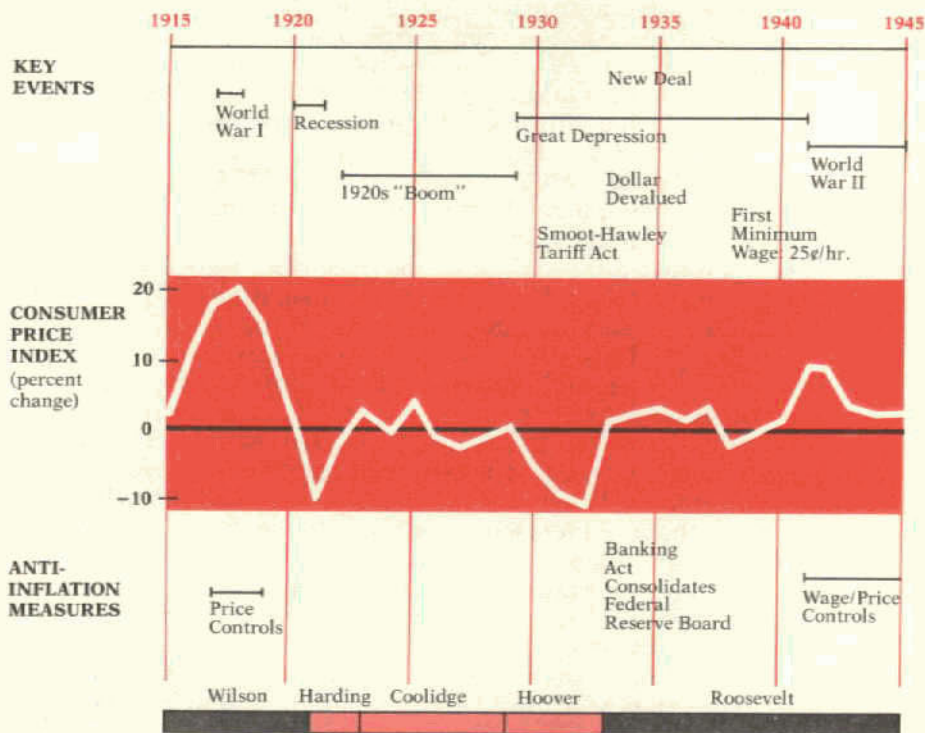
The country's problems are due as much to the complex, anomalous nature of the current inflation (the projected 1978

\*A recession is now generally defined as a decline in real Gross National Product (GNP) over two successive quarters. GNP is the value of all goods and services produced in the nation.



© 1971 The Denver Post. Reprinted with permission of the Los Angeles Times Syndicate.

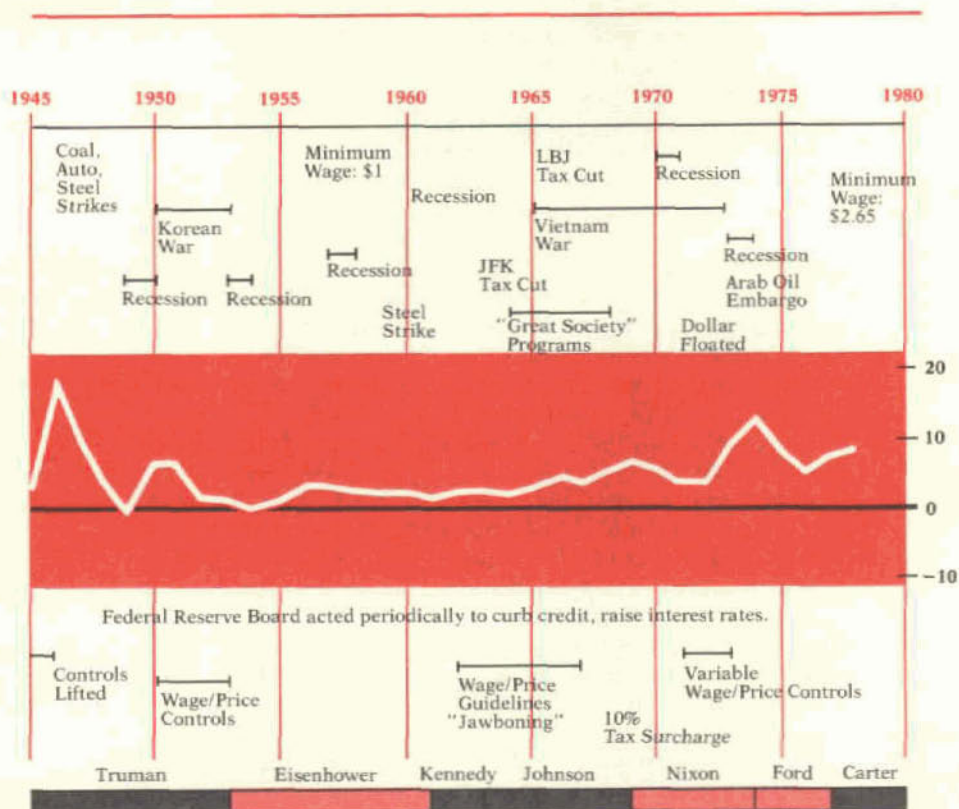
INFLATION: 1915-1978



rate: 9.7 percent) as to any lack of government will. Today's inflation is part of an uninterrupted post-World War II price rise. In the past, periodic depressions and resulting deflations kept long-term prices fairly stable. But the U.S. economy is now more or less depression-proof; there has been no *deflation* since the Great Depression.

Moreover, since 1973, the United States has been infected with "stagflation," a rogue strain characterized by high inflation and high unemployment at the same time. In the past, an inverse relationship was thought to exist between the two: High unemployment would dampen inflation, while high inflation would curb unemployment. Today, the rules seem to be flexible only in an upward direction: Lower unemployment, for example, still seems to increase inflation, but higher unemployment exerts little downward pressure on prices.

This makes inflation very hard to treat. Indeed, painful as



inflation is, it is not so painful as the cure. Nor do all Americans feel it when the economy is quite ill. It is the nature of a cost-price spiral that, *on average*, wages keep up with prices, a situation that, *on average*, tends to soften inflation's punch.\*

Life is not played by averages, however. As Nixon's economic adviser, Herbert Stein, has noted, "the most significant fact about inflation is that some prices [and wages] rise more than others, and some do not rise at all." Who benefits? During inflation, "creditors" generally lose and "debtors" generally gain. A banker who made a 10-year, \$1,000 loan in 1968 will receive back less than \$1,000 in 1968 dollars, even at an extraordinarily high interest rate, when the loan is repaid in 1978. This applies to all fixed-value assets: bank deposits, mortgages,

\*Since the onset of stagflation in 1973, *money* wages have increased by an average of 50 percent. However, the increase is illusory; *real* (inflation-adjusted) wages have increased by an average of only 8.4 percent.

---

bonds, life insurance, pensions, and, of course, currency. (Between 1946 and 1971, inflation wiped out an estimated \$1.2 trillion worth of debt in the United States.) Thus, those on fixed incomes, such as elderly people who rely on pensions, have much to lose by inflation. Others have much to gain. Real estate agents do quite well, for example, since they receive a percentage commission on rising real estate prices. Yet, winners aside, inflation is inherently destabilizing. It renders corporate plans uncertain. Psychologically, it makes everyone try to "stay ahead." Inflation also increases the federal tax bite as incomes are boosted into higher tax brackets. The federal income tax share of the GNP will rise from the 1976 level of about 11 percent to a projected 13 percent in 1981. According to Walter Heller, a former Kennedy administration economist, this will amount to an unlegislated tax increase next year of \$18 billion.

Classic ("demand-pull") inflation generally begins, according to the famous formulation, with too much money chasing too few goods: As demand rises, prices are bid up. This can result from a major tax cut. It can also happen when a government prints money to pay its bills, or when it steps into the market as a major buyer of goods and services, bidding prices up to secure what it needs, then leaving everyone else to bid up prices even further as they fight for what remains. (Hence wartime inflation, when the money supply expands even as production of consumer goods declines.) Demand-pull inflation can quickly turn into "cost-push" inflation. That is, after the initial spurt of inflation sends wages and costs higher, the wages and costs themselves will begin to send inflation higher.

If inflation begins with monetary expansion, monetary contraction can stop it in its tracks. "There is no technical problem about how to end inflation," Nobel economist Milton Friedman has pointed out. "The real obstacles are political." Cutting back the money supply is ruthlessly effective: The Confederacy's rampant inflation came to an abrupt halt when Union troops burned the South's Treasury Note Bureau in South Carolina in early 1865; no more paper notes could be circulated.

The Federal Reserve Board can tighten and loosen the money supply through its open market operations (buying or selling bonds), and by setting the interest at which banks may borrow from the federal government. Such short-term fine-tuning can cope with simple demand-pull inflation. Only if the tightening is applied long and drastically, however, can it cope with cost-push inflation as well. And in terms of unemployment, the side effects are sobering.

Because monetary policy, in politically acceptable doses,

---

does not seem to work, many economists have lately urged Washington to consider some form of "incomes" policy. The latest proposal: a tax-based strategy. Widely discussed in Congress and the White House, it is examined below.

## A TAX-BASED INCOMES POLICY

*by Laurence S. Seidman*

Last May, a new approach to inflation made its debut in Congress when Senator William Proxmire's (D.-Wis.) Banking Committee held hearings on a "tax-based incomes policy" (TIP). When first proposed in 1971 by University of Pennsylvania economist Sidney Weintraub and Federal Reserve Governor Henry Wallich, TIP received little attention. However, it has gradually gained support from other economists; some, like Arthur Okun of the Brookings Institution, have designed their own versions. In essence, the aim of TIP is not to place the blame for inflation on labor or business, but to restructure incentives to restrain wage and price increases so that the outcome is best for labor, business, and the public.

In early 1978, the average annual wage increase was 8 percent. But because the average growth rate of productivity (industry output per man-hour) is only 2 percent annually and varies little, the average unit labor cost increase was 6 percent. Not surprisingly, the inflation rate was also 6 percent. The best way to predict the inflation rate is to observe the average wage settlement and subtract 2 percent. This rule of thumb is one of the most stable relationships in economics.

Nor is there any mystery about why. Every business must cover an increase in its unit labor cost by raising prices. The degree of competition in each industry establishes a specific relationship between unit cost and price; they move together. Both theory and history suggest that sustained price increases cannot occur without increases in unit labor costs. Instead, research suggests that a smaller wage increase—and therefore a smaller unit cost increase—will result in a smaller price increase. The only way to bring the inflation rate down to zero is to stop the advance of unit labor costs by gradually reducing the growth rate of wages and salaries (including executive pay and benefits) down to the growth rate of productivity.

The traditional cure for inflation is monetary and fiscal dis-

---

cipline. Such discipline must be one element in any successful anti-inflation strategy; but it cannot be the only element. There is only one way monetary and fiscal discipline can bring down the growth in wages: by causing a severe enough recession. This is precisely the policy that was tried in 1974 and early 1975, with dismal results. To be sure, if "tight" monetary and fiscal policy is applied long enough, and severely enough, it will eventually cause high unemployment and low profits, which in turn will reduce wage increases, unit cost increases, and therefore price increases. Those who advocate a balanced budget and slow monetary growth, however, seldom mention the painful aspects of this process. They leave the impression that there is a mysterious link between such discipline and the prices firms set. But firms will raise prices as long as unit costs increase; and unit costs will increase as long as wage increases exceed productivity increases.

Because monetary and fiscal discipline reduces wage inflation only indirectly, "incomes policy"—attempts to influence directly the growth rate of wages and salaries—was conceived as an essential complement to such discipline. Unfortunately, thus far incomes policy has relied on either persuasion or controls. Each strategy has serious shortcomings.

Persuasion is the current policy of the Carter administration;\* business and labor are simply urged to restrain wage increases. When the policy is pursued aggressively, it is called "jawboning." When it is pursued prayerfully, it is called "wishboning." Its fundamental weakness is that it fails to recognize that in our market economy, business and labor respond primarily to financial incentives, not exhortation.

The other method, controls, was tried during the Nixon administration in 1971–72. The problem with controls is that they are rigid and interfere with the freedom of business and labor to make their own decisions. They prevent changes in relative wages and prices that are vital to efficient resource allocation—one of the great social virtues of a market economy. Under Nixon's Phase II, for example, all firms were required to limit wage increases to 5.5 percent, although firms seeking an excep-

---

\*It was also the cornerstone of the Kennedy administration's "guideposts" policy.

---

*Laurence S. Seidman, 31, is assistant professor of economics at the University of Pennsylvania. Born in New York City, he received his B.A. from Harvard (1968) and his Ph.D. in economics from the University of California at Berkeley (1974). He is the author of The Design of Federal Employment Programs (1975).*

### THE INFLATION-UNEMPLOYMENT TRADEOFF

In the mid-1960s, most economics textbooks taught that there was a tradeoff between the unemployment rate and the inflation rate; if one was high, the other would be low. It was thought that we could have either high unemployment, or high inflation, but not both.

The lessons of the past decade, however, have prompted some rethinking. Under the new view, the tradeoff is between the unemployment rate and the *change* in the inflation rate: Thus, a low unemployment rate will cause the inflation rate to increase; a high unemployment rate will cause the inflation rate to decrease.

The new view attributes a powerful role to inertia. If wage increases and therefore price increases have been high, a high unemployment rate cannot immediately be expected to achieve a low wage (and therefore price) inflation rate; it can only be expected to cause workers to accept somewhat smaller wage *increases* than they received in the previous year.

The 1974–76 recession contradicts the old view but is consistent with the new view. Although unemployment averaged 8 percent for over two years, the inflation rate remained above 5 percent throughout the recession. However, it did decline—from about 10 percent in 1974 to under 6 percent in 1976—even if it remained high.

Under the new view, there is a specific unemployment rate—the nonaccelerating-inflation rate of unemployment (NAIRU)—that will keep the inflation rate constant (not necessarily zero). The NAIRU has been estimated to be approximately 6 percent. My own research suggests that TIP may be able to lower it, perhaps to 4 percent, because the downward push of TIP on wages should counter the upward push on wages generated by a low unemployment rate and the accompanying labor shortage. When TIP is introduced, if monetary and fiscal policy holds the unemployment rate above 4 percent, then the inflation rate should decline. When it reaches zero, adjustments in monetary and fiscal policy can lower the unemployment rate to 4 percent. (Without TIP, a 4-percent unemployment rate would cause inflation to accelerate gradually.) The economy could then be run permanently at an unemployment rate of 4 percent, and an inflation rate of zero.

—L.S.S.

tion could appeal to the Pay Board. Yet when consumers increase their demand for product X, firms making X should be able to grant an above-average wage increase to attract more labor, without undergoing a costly, time-consuming appeal process. Consumers are harmed if they cannot.

If persuasion is too weak, and controls are too rigid, why not use financial incentives? This is the strategy embodied in a tax-



based incomes policy. Advocates of TIP have not yet agreed on the best design, but for illustration, one might consider a package that combines elements from Okun's "tax-carrot" proposal and Weintraub and Wallich's original "tax-stick" proposal.

In early 1978, as noted, wage increases averaged 8 percent; productivity increases, 2 percent; and price increases, 6 percent. Suppose that the initial TIP goals are a wage inflation rate of 6 percent and a price inflation rate of 4 percent. Then TIP might consist of the following incentives:

*Employer Incentive.* A firm that grants a wage increase in excess of 6 percent would incur a surcharge on its income tax in proportion to the size of the excess; if it grants less than 6 percent, it would enjoy a corresponding tax cut; if it grants 6 percent, its tax rate would remain at the base (48 percent of profits for many corporations).<sup>\*</sup> Thus, if a firm grants a 7-percent wage increase, and the TIP multiplier (surcharge on each percent of excess) is 6, its tax rate would rise to 54 percent; if it grants 8 percent, its tax rate would rise 12 points to 60 percent.

*Employee Incentive.* Employees at a firm that grants an average wage increase in excess of 6 percent would receive a tax increase for that year in proportion to the size of the excess; if the firm grants less than 6 percent, they would enjoy a proportionate tax cut; if it grants 6 percent, their tax rate would remain unchanged. (Thus, if the TIP excess wage tax is, say, 50 percent, and an employee's 7-percent raise gives him \$150 more per year than he would have received from a 6-percent raise, this \$150 difference would be subject to a \$75 tax.) The penalty or reward would depend only on the *average* wage increase at the firm, so that individual promotion is not discouraged.

Such incentives differ fundamentally from controls. For both employer and employee, the tax penalty would be stiff, but not prohibitive. Where market forces or special industry conditions call for a relative wage increase, it is essential that the firm be able to exceed 6 percent, though by less than it would have without TIP.<sup>†</sup> Like other tax incentives, TIP merely changes the profitability of particular decisions. Each firm remains free to do as it wishes, without the approval of regulators. TIP would, of

<sup>\*</sup>Some advocates of TIP suggest limiting coverage to large firms, thereby keeping administrative costs down; others believe broader coverage would be more effective.

<sup>†</sup>For example, suppose firm A faces a sharp rise in product demand, and thus a labor shortage, while firm B faces a decline in demand, and thus a labor surplus. Without TIP, firm A might grant 9 percent, and firm B, 7 percent, for an average wage increase of 8 percent. With TIP, firm A might grant 7 percent, and firm B, 5 percent, for an average of 6 percent. TIP would not replace the market forces working on each firm, and would not prevent the relative wage increase required by firm A to attract additional labor.

---

course, complicate the tax code. But so do other tax incentives—such as the investment tax credit and accelerated depreciation—which businessmen clearly do not regard as controls.

If the TIP package, together with monetary and fiscal restraint, succeeds in reducing wage inflation to 6 percent and price inflation to 4 percent, then the dividing line between penalty and reward should be lowered to 4 percent, and ultimately (after several years) to 2 percent, the growth rate of productivity—the rate required to keep the inflation rate near zero.

Although TIP focuses its incentives on wages and salaries, price inflation should automatically decline with wage inflation. Tax incentives to restrain prices or profits are thus unnecessary (and almost certainly unfeasible). Nevertheless, labor deserves protection against the unlikely event that wage increases decline further than price increases. Under Arthur Okun's "real wage insurance" proposal, Congress would authorize in advance tax cuts for employees to make up the difference. A second proposal, from Lawrence Klein and Vijaya Duggal of the University of Pennsylvania, would protect workers from any adverse shift in the ratio of after-tax profits to payroll. If the ratio for the whole corporate sector rises above a certain threshold while wage inflation declines, the base corporate tax rate would be raised equally for all firms to keep the ratio at the threshold. In my view, both proposals should be integrated into TIP.

A permanent reduction in the inflation rate would, of course, be a central benefit of TIP. But it would not be the only benefit. TIP may also be able to reduce permanently the *nonaccelerating-inflation rate of unemployment* (the unemployment rate that will keep the inflation rate constant) from 6 percent to about 4 percent. This would yield large social benefits. According to Okun's Law (a 1-percent reduction in unemployment yields a 3-percent increase in real GNP), if the economy can be run at a 4-percent unemployment rate, *real* (inflation-adjusted) GNP, labor income, private investment, and profits will all be 6 percent higher each year than if the unemployment rate were 6 percent. Given these potential benefits, it is not surprising that a growing number of economists and policymakers are concluding that despite its initial administrative cost, TIP is a policy worth adopting.

---

EDITOR'S NOTE. *For added background, readers may wish to consult Robert Solow's "The Intelligent Citizen's Guide to Inflation" (The Public Interest, Winter 1975); and "Tax-Based Income Policies" by Lawrence S. Seidman, in Brookings Papers on Economic Activity (1978).*