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An Efficient Strategy To Combat Inflation

Arthur M. Okun

CHRONIC INFLATION has been the outstanding feature of the American economy in the seventies, and it is our foremost economic ill as we approach the decade of the eighties. In the following assessment and prescription, I emphasize three propositions:

- That the chronic inflation of the seventies is a new and different phenomenon that cannot be diagnosed correctly with old theories or treated effectively with old prescriptions.
- If left untreated, the syndrome of chronic inflation is likely to become more severe and to impose even greater economic and social costs in the eighties.
- An efficient anti-inflationary program must be diversified. It needs three major elements: enough fiscal-monetary discipline to provide a safety margin against excess demand; a coordinated federal initiative to reduce private costs; and constructive measures to obtain price-wage restraint.

Diagnosing Stagflation

The recent era of inflation began in the mid-sixties with excess demand. That initial episode of inflation fit the traditional definition of too much money chasing too few goods. In 1966–68, the federal budget was an engine of inflation, and it was not effectively offset by monetary restraint. Employment, production, capital spending, and real incomes soared—but so did prices. Serious mistakes of economic policy were made in the pursuit of guns and butter during the Vietnam war. Yet it must be remembered that every previous wartime period in U.S. history was marked by more rapid inflation. The big difference this time was that the end of the war did not bring the end of the inflation. On the contrary, it ratcheted up further.

For the years 1968 through 1978, the inflation rate of our GNP averaged 6.1 percent, and at its lowest was 4.1 percent in 1972. In contrast, for the years 1952 through 1967, inflation averaged 2 percent and at its worst was 3.4 percent in 1957. Thus, *every* year since 1968 has had a higher inflation rate than *any* year between 1952 and 1967. Rapid inflation became a chronic

disease for the first time in our history. In 1970, we experienced a recession that, unlike all previous recorded U.S. recessions, did not stop inflation in its tracks. Even more remarkably, the prolonged and severe recession of 1973–75 left us with a basic inflation rate of 6 percent, which remained essentially unchanged from late 1975 to the end of 1977.

Arthur M. Okun is a senior fellow in the Brookings Economic Studies program. This article is based on his contribution to the Special Study on Economic Change conducted by the Joint Economic Committee of the Congress.

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The transformation of our inflationary behavior is rooted in a system of price and wage decisionmaking that, throughout modern times, has departed further and further from the textbook model in which supply and demand call the tune promptly and reliably. As I will explain, our system of cost-oriented prices and equity-oriented wages actually slows an inflationary trend initially, but it also makes inflation much more stubborn once it has become entrenched. The resulting momentum of inflation feeds on itself, changing patterns of behavior that were once geared to an essentially noninflationary environment in ways that speed the wage-price spiral.

Realities of the Price-Wage System. In a small and shrinking sector of the U.S. economy, products are traded in organized auction markets in which prices vary from day to day to keep supply and demand in balance. Those prices respond promptly and sharply to recession. For example, prices of sensitive industrial raw materials fell by 15 percent between May 1974 and March 1975. That area, which matches the textbook model, offers a striking contrast to the rest of the economy.

Most of our economy is dominated by cost-oriented prices and equity-oriented wages. Most prices are set by sellers whose principal concern is to maintain customers and market share over the long run. The pricing policies designed to treat customers reasonably and maintain their loyalty in good times and bad times rely on some standard measure of costs. Prices are set to exceed costs by a percentage markup that displays only minor variations over the business cycle.

Similarly, the key to wage decisions in both union and nonunion areas is the common long-run interest of skilled workers and employers in maintaining their job relationships. Employers make investments in a trained, reliable, and loyal work force as well as in plant and equipment. They know that if they curbed wages stringently in a slump, they would pay heavily for that strategy with swollen quit rates during the next period of prosperity. Thus, during recession and slack periods, nonunion firms with workers on layoff and queues of eager job applicants find it worthwhile to raise the wages of their workers, in order to protect their longer term personnel relationships.

In those nonunion areas where workers have rapid turnover and thus employers and employees have little stake in lasting relationships, wages respond more noticeably to the level of unemployment. In most areas, however, personnel policies are sensibly geared to the long run with an emphasis on equitable treatment. The basic test of equity is that the pay of workers is raised in line with the wage increases of other workers in similar situations. Such a strategy introduces momentum in the rate of wage increase; it creates a pattern of wages following wages.

The customer and career relationships that desensitize wages and prices from excess supplies and demands in the short run have a genuine social function. They are not creations of evil business monopolies or unduly powerful labor unions, but rather efficient arrangements for a complex interdependent economy in which customers and suppliers, workers and employers benefit greatly from lasting relationships. The resulting influence on prices and wages cuts two ways. When total spending in dollars starts to expand rapidly, most of the increase takes the form of a bonus in output and employment, with little added inflation. In that sense, these institutions make inflation slow starting. But when the dollar value of GNP slows down, most of the decline consists in a loss of production with little relief from inflation. So inflation becomes slow stopping.

Adapting to Inflation. As people recognize the persistence of inflation, they change their behavior in ways that make inflation more rapid and more tenacious. Before the seventies, the U.S. economy had a basically noninflationary environment in which average inflation rates in peacetime rarely exceeded 2 percent for any sustained period. Price and wage decisions relied heavily on the dollar as a yardstick, as a scorekeeping device, and as a basis for planning and budgeting. People had a reasonable notion of the wage increase that was par for the course. And so labor and management were willing to sign contracts that fixed wage rates over a three-year interval. Firms set their prices on the basis of known actual costs that they had paid for their labor and supplies, rather than on hypothetical calculations of replacement costs. Salesmen accepted orders for the future delivery of products at guaranteed prices. Catalogs carried price lists that were subject to change only infrequently, often at stated intervals. Public utility and other regulatory commissions needed to review rates only occasionally.

During the seventies, these institutions changed as Americans adjusted to the persistence of inflation. The notion of par for the course for wage increases was

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revised upward. Escalator clauses spread through the major collective bargaining contracts and thus made wages respond promptly to inflation in the cost of living. Businessmen began to adjust their pricing to reflect the growing gap between replacement costs and actual historical costs. They shortened the intervals at which they raised prices, and many stopped taking fixed-price orders. These adaptations to chronic inflation speed up the spiral, transmitting higher wages and other costs into higher prices, and higher prices into higher wages even more rapidly.

The Principle of Malign Neglect

Because reliance on the dollar is so heavily embedded in our economic practices and thinking, these adaptations to inflation have really just begun. If the inflation rate is not reduced, they are bound to spread much further as people keep adjusting to inflation in self-defense. In a sense, some of these adjustments represent ways of learning to live with inflation, and hence they are welcomed by some economists. But while they can reduce the amount of pain per point of inflation, they are bound to increase the number of points of inflation. In my judgment, they are more a disease than a cure. If these institutional adaptations keep spreading, the inflation rate will keep ratcheting upward. Inflation tends to feed on itself rather than to correct itself. Thus the neglect of inflation is, in principle, malign rather than benign.

Adaptations to chronic inflation contributed to the bad news of 1978. Nonunion wages, which had been rising much less rapidly than union wages during the preceding few years, began to catch up. Because of the wide gap between historical and replacement costs, businessmen felt a need to raise their markups when the markets for their products strengthened—long before excess demand, in any objective sense, appeared. These developments should not have surprised anyone; they were entirely predictable.

To be sure, food and energy have contributed to the acceleration of inflation during the past year. But the prices of those products tend to spurt and slow down; indeed, the major inflationary danger they pose over the longer run stems from the way they can get into the wage-price spiral. Over the entire four years of economic recovery since March 1975, food and fuel have not raised the inflation rate significantly. Since March 1975, the consumer price index has risen at an average annual rate of 7.2 percent; the average for all items except food and energy has been nearly as large—7 percent. Thus we have been experiencing primarily a wage-price-spiral inflation—not an inflation caused by food, fuel, or other special factors.

The American people identify inflation as domestic public enemy no. 1 in opinion surveys. They did so by an overwhelming margin even during 1976 and 1977, when inflation proceeded at a fairly steady 6 percent rate and was well predicted. And they are concerned for good reasons. Only a small minority of Americans have obtained cost-of-living escalators that effectively protect their real incomes from inflation. They do not find opportunities in financial markets to protect their wealth against inflation and still preserve their liquidity. The stable interest rates on passbook deposits that once provided them with a predictable, reasonable return on liquid assets now do not even allow their principal to keep up with the price level—not even on a before-tax basis. Common stocks have been miserable failures as inflation hedges, because the era of stagflation brought higher volatility and lower growth of real corporate earnings. The single-family home has been the one good investment for most Americans, but many who have taken advantage of that opportunity have had to sacrifice liquidity and some have plunged over their heads with commitments for cash payments on mortgages. For the long run, no American can plan effectively in a world in which the dollar remains the yardstick, but shrinks in real value at an uncertain rate.

Moreover, the ratcheting up of inflation has produced a serious credibility gap between citizens and their elected officials. Americans have been told again and again that inflation would be curbed. The acceptable rate of inflation in policymaking rose from 1.5 percent in the early sixties to 3 percent in the early seventies. Anyone familiar with that history must wonder whether the present inflation rate of about 8 percent will be reduced, or whether it will be just one more turn of the ratchet.

Finally, inflation has increased social divisiveness. It is not easy for families to know where they stand in the price-wage race. They feel threatened by it and regard it as unfair. Many undoubtedly feel that they are behind in the race, even when that may not be objectively the case. And so they believe they have been given the short

Okun to Receive Seidman Award

Arthur M. Okun has been named winner of the sixth annual Frank E. Seidman Distinguished Award in Political Economy, whose purpose is to recognize and encourage economists who are attempting to extend their methodology into interdependent areas of other social sciences. The recipient must also "have made an outstanding contribution to public policy, to innovation or change, to the interdisciplinary nature of his work, and to the theory of his and related fields." Previous recipients have included Arthur Burns, Gunnar Myrdal, John Kenneth Galbraith, Kenneth Boulding, and Thomas Schelling. The $10,000 prize will be conferred in September at Southwestern at Memphis College, which administers the award program.

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end of the stick and are convinced that someone else must have the long end. The principal new product of the American economy in the decade of the seventies has been sticks with two short ends.

A Diversified Attack on Inflation

Inflation must be reduced substantially over the years ahead. That task can be accomplished only gradually; and it can be accomplished efficiently only through the concerted use of a variety of anti-inflationary policies, including fiscal-monetary restraint, federal cost-reducing initiatives, and price and wage restraint.

Fiscal-Monetary Restraint. In battling against inflation, we must accept some downside risks on output and employment in the short run to clear the way for sustained growth in the long run. In retrospect, we did not balance these risks prudently enough in setting fiscal-monetary policy during 1977–78. We must do better in the future to establish a safety margin against overly strong markets.

On the other hand, we must recognize the ill effects of overdoses of fiscal and monetary restraint. Those effects are clear in the sad experience of 1974–75, when we crusaded against inflation by relying solely on tight budgets and tight money. During fiscal year 1974, the federal budget was nearly balanced in the face of a recession; during calendar year 1974, the growth of money (currency and demand deposits) was held to 4.5 percent. The beneficial impact on inflation was disappointingly small, while the unfavorable impact on employment, production, and capital formation was enormous.

Using that approach, the nation squanders about $200 billion of real production and roughly 5 million worker-years of jobs for every point that it reduces the inflation rate. The evidence of recent years suggests that, through its fiscal and monetary policies, the federal government can control—within a reasonable margin—the total growth of the GNP measured in dollars. But it cannot control the division of that growth between increases in output and increases in the price level. When the government pushed the economy into deep recession and prolonged slack, each dollar trimmed from GNP meant a loss of roughly 90 cents of output and a saving of about 10 cents on the price level. Any anti-inflationary proposal that relies solely on balancing the budget and tightening money is, in reality, a proposal for an encore of that experience. It should carry a truth-in-packaging label revealing that its probable contents are 90 percent production losses and job losses and only about 10 percent inflation saving.

Undoubtedly, inflation could be eliminated by fiscal-monetary restraint alone, but the consequences of such a strategy for production, employment, capital formation, and our social fabric would be horrendous. Average citizens cannot reasonably be expected to recognize those consequences fully, and it is understandable that some of them grasp at the straw of budget balancing in the hope of a rescue from inflation. But our political leaders ought to know better, or to learn better.

Federal Cost-Reducing Initiatives. Federal policies have pervasive impacts on costs and prices in many sectors of the economy. The federal government adds to the price level when it imposes cost-raising taxes, like excises on products or payroll taxes on employers. Its regulations affecting safety, health, and the environment are a source of higher costs and prices—necessary in part, but unnecessary to some degree. Its economic regulation of industries with public utility characteristics

influences their prices and costs. In pursuing certain equity objectives, the government sets floors on some prices (as in the dairy and sugar programs) and on pay (as in the minimum wage). It affects the output of various private industries through such provisions as acreage controls and restrictions on timber cutting and oil leasing. It also influences prices and costs through tariffs and other restrictions on imports.

Because most individual government actions and policy changes in these areas have relatively small effects, they often go unnoticed; yet they add up to a great deal. In my judgment, the most serious inflationary stimulus in recent years came from a series of such self-inflicted wounds incurred during 1977: a major increase in payroll taxes on employers, a large rise in the minimum wage, reinstituted acreage controls on farmers, added regulatory burdens on business, and new barriers to imports.

Proposals that would reduce costs have been fre-

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quently rejected. Hospital cost containment was not enacted by the last Congress; presidential proposals to cut certain federal excise taxes were ignored. Indeed, some congressional leaders now advocate a new value-added tax that would surely add to our inflationary woes.

Enormous anti-inflationary benefits could be reaped in this area. We could cut federal payroll taxes on employers; we could use grant formulas to encourage states and cities to lower their price-raising and cost-raising taxes. We could reform regulation to reduce its cost burdens. This is the most efficient strategy for curbing the price level. It does not put people out of work, and it need not constrain private price and wage decisions.

As a first step into this area, I have suggested a procedural reform: the development of a system of inflation scorekeeping. The Congressional Budget Office (or General Accounting Office) should be asked to issue a quarterly report that identifies all actions and proposals by the President and by the Congress that would either raise or lower the price level and estimates their dollar impact. Nobody has yet told me why this idea is defective, but nobody has acted to implement it.

Price-Wage Restraint. During recent years, the price-wage spiral has been the fundamental source of rapid inflation in the United States. An efficient cure for inflation must get directly at that source. At the present time, the administration's program of price-wage standards deserves our full support.

Any plea for voluntary cooperation in our society implies a threat of focusing the spotlight of public opinion on flagrant violators. Beyond that, the present program carries a threat of sanctions associated with the privileged relations that many business firms have with the federal government. These provisions strengthen the credibility of the program, though they invoke an unlegislated bureaucratic power that is not ideal. All in all, I can accept them. It would also be useful for the President to have clearly legislated authority to delay major price or wage decisions that could threaten the entire program. But the very discussion of such legislation would intensify the widespread fears of business that we are on the road to controls. In fact, I do not expect the President to seek control authority, and I would emphatically oppose mandatory controls over prices and wages.

As originally proposed by the President, the program was reasonably equitable as between business firms and workers. But its fairness depended heavily on the provision for real wage insurance. Without that provision, the standards impose on workers a heavier burden of restraint and much more potential risk than they do on businessmen.

America's workers are being asked to ante up for the deal. Thus far most are doing so. Despite a few collective bargaining settlements that exceeded the wage standard, the behavior of pay since last October has accorded remarkably well with the standard. On the other hand, the behavior of industrial prices suggests significant violations of the price standard. But the identification of violators is apparently a complex and difficult task. All in all, I expect this program to contribute to the deceleration of inflation as wage restraint passes into price restraint, and as businesses are made more conscious of the urgent need for their cooperation.

Our historical experience and that of many other countries suggests that informal, "semivoluntary" policies of wage and price restraint can help significantly over some periods of time. But such programs have crumbled as economic conditions have changed and resistance has mounted. Eventually they are phased out, then reshaped and reinstituted. Keeping an incomes policy in the anti-inflationary arena is not easy. P. T. Barnum once noted that keeping a lamb in a cage with a lion requires a large reserve supply of lambs. Similarly, society may need a reserve supply of incomes policies. We will need some program of price-wage restraint for years to come.

Along with other economists, I have been advocating the development of a tax-based incomes policy that would reward compliance or penalize noncompliance with the guidelines. The social interest in wage and price restraint can be better pursued by providing market-like incentives through the tax system than by relying on voluntary appeals or rigid mandatory rules. The tax approach would allow people to make choices in light of the rewards or penalties provided, making it worthwhile for most firms and workers to practice the restraint that benefits the entire society. Undoubtedly such a program would add to the burdens on the tax system, but so do the rules governing capital gains, the residential energy credit, and the targeted jobs credit.

In combination with fiscal-monetary restraint, a federal cost-reducing program and a tax-based incomes policy are essential parts of an efficient strategy to combat inflation. Some of these proposals are untried and unproved; some pose administrative problems and meet political opposition from major interest groups. But I am convinced that these proposals are realistic, not "imaginative" as some have labeled them.

Two popular doctrines are imaginative indeed. One is that inflation will either simmer down naturally or become tolerable to the American people. The other proclaims that fiscal and monetary restraint can cure inflation without deep and prolonged recession. These strategies have been tried and proved false. It is time to face the realities of the new disease of chronic inflation and to use the prescriptions that are appropriate for curing it.

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