

TIP Is Not the Answer to Inflation

*By Gary P. Gillum**

Over the last fifteen years, inflation has been making steady inroads on the U.S. economy. Now, despite an experiment with wage/price controls and occasional periods of monetary restraint, the nation is getting its second dose of double-digit inflation in less than a decade.

Not surprisingly, the present state of affairs has produced considerable public dissatisfaction, some of it directed at policymakers. One group of critics argues that our present arsenal of monetary and fiscal policies is adequate to the task but that policymakers have not used these policies correctly. Such critics believe that if policymakers will avoid stop-and-go policies that cause the

economy to alternate between boom and bust and instead apply monetary and fiscal restraint with greater patience, they will gradually squeeze out inflation.

Another group of critics argues that policymakers are not to blame because present policy options for fighting inflation won't work without imposing too costly a burden on society. They stress the need to clamp down on wages, arguing that wages determine prices and that upward pressures on wages are almost impervious to present anti-inflationary tools. They recommend a tax-based incomes policy (TIP) to dampen the upward pressure on wages.

The tasks facing policymakers are to decide whether TIP—an unproven policy—offers a reasonable prospect of success in reducing the inflation rate and to ascertain whether its costs are likely to be low enough to justify chancing a trial run of TIP.

*Gary P. Gillum, a senior economist at the Philadelphia Fed, was trained at the University of Chicago. He specializes in monetary policy.

WHY WILL THE FIGHT AGAINST INFLATION BE SO EXPENSIVE?

Economic theory and evidence suggest that the only permanent solution to our current inflation is a much slower growth rate for the money supply. Unfortunately, identifying the root cause of inflation is much easier than actually ridding the economy of it. The reason is that the initial effects of trying to slow inflation are likely to be concentrated in higher unemployment rates and lower standards of living rather than in slower rates of inflation.

In trying to explain the temporary but costly dislocations associated with slowing inflation, economists traditionally have singled out the slow adjustment of wages

and prices to the new circumstances of slower monetary growth (see **WHY WAGES AND PRICES ADJUST SLOWLY**). One explanation of why prices can be slow to adjust is that each firm, in setting its prices, needs to know whether the market conditions it faces are unique. Slower monetary growth reduces the growth of total demand for goods and services and thus affects the market conditions of all firms. But if firms do not perceive the general nature of the slowdown in demand, they tend to respond by cutting back on production and allowing their inventories to rise rather than by cutting the rate at which they increase their prices. As a result of the production slowdown, workers are laid off and the unemployment rate rises.

Once firms become aware that the lower

WHY WAGES AND PRICES ADJUST SLOWLY

The causes of slow adjustment in wages and prices are not very well known and are the subject of some controversy. Among the causes may be long-term business contracts, price-setting by law or government regulation, and the inability or unwillingness of individuals and firms to respond quickly to changed economic circumstances.

Many prices and wages are subject to specification in long-term business contracts. Such contracts limit the adjustment to new circumstances of the wages and prices specified in the contract. The most familiar are labor union contracts, determined through negotiations between unions and corporate management. Such contracts set wage rates for periods of one to three years, and with increasing frequency, include a cost of living adjustment (COLA). In a contract containing a COLA clause, wage rates may not fall below minimum levels specified in the contract but may be adjusted upward to reflect at least partially any increases in consumer prices during the term of the contract. Businesses also negotiate long-term contracts among themselves. Leasing and rental agreements cover such diverse situations as the rental of office space and the leasing of locomotives, airplanes, and cargo ships. Sales contracts occasionally set prices at which goods will be sold for periods of 10 to 20 years. The price at which coal companies agree to provide coal to an electric utility company is one example.

Government laws and regulations also can be important. Minimum wage levels keep at least some wage rates from adjusting downward in response to new circumstances. Agricultural price support programs establish minimum price levels for many agricultural commodities, thus limiting the downward adjustment of those prices. Airline fares, railroad freight rates, and truck transportation rates also have been subject to minimum price levels.

Finally, firms and individuals may be slow to change the prices and wages at which they offer their goods and services. This may occur because they are slow to perceive that new economic forces have hit the economy. Or, if they understand that circumstances have changed, they may have difficulty judging how the new conditions will affect their own circumstances. And even if they do perceive that circumstances have changed but believe that the change is temporary, they may be reluctant to temporarily change their wages and prices because it can be costly to do so.

demand for their goods is a reflection of a general reduction in the demand for goods and services, they will be less reluctant to slow the rate at which their prices increase. They also will begin to rehire workers and move production back toward previous levels.

Ultimately, the levels of production and unemployment will return to their old levels and the inflation rate can remain permanently lower. Thus the final outcome is what is desired—reduced inflation. The unfortunate part of the story is that slower monetary growth also produces reductions in production and increases in unemployment which, although temporary, can be rather long-lived.

WILL TIP HELP REDUCE INFLATION?

Proponents of TIP often seem not to dispute the monetary source of inflation but rather choose to argue that the costly spillovers of monetary deceleration can be mitigated by tax-based incomes policies. They insist that prices are slow to adjust to slower monetary growth because wage increases are sticky—wages tend to keep rising almost regardless of what is happening in the economy—and they propose to use taxes to brake this upward momentum in wages. If wages slow their upward rise, they say, prices will follow automatically—at least so long as monetary growth is being slowed simultaneously.¹

While many different proposals for tax-based incomes policies have been offered, the basic proposal is deceptively simple—to impose a graduated tax penalty on firms whose wage settlements exceed a certain guideline. In any given year, the tax rate on corporate profits (perhaps limited to the top 2,000 corporations) would be determined by the size of the average wage increase paid by the corporation in that year. The larger the average increase over the previous year, the

higher the tax rate the corporation would face.

In explaining why they think TIP will work, proponents focus on the interaction of corporations with labor unions in the setting of wage rates. They argue that the imposition of TIP will give the typical corporation a strong incentive to insist on a lower wage settlement than it would otherwise. Greater corporate resistance to a high wage settlement would tend to increase the length of strikes by unions in support of their wage demands. Proponents argue that the union ultimately would moderate its demands as the strike dragged on and on, resulting in a lower wage settlement under TIP. The lower wage increases then would be passed on to consumers in the form of lower price increases—that is, less inflation—because corporations are said to set their prices at a percentage markup over their wage cost per unit of output. Proponents cite the historical evidence that the rate of inflation is, on average, equal to the rate of increase in wages minus the rate of growth of labor productivity as evidence that price increases will moderate because of a slowdown in wage increases.

Although this chain of reasoning may seem impressive at first glance, there are many weaknesses. The fundamental problem with TIP is that it does not attack directly the many causes of the slow adjustment of wages and prices. Instead, it would be just one more impediment to wage adjustment—although only upward adjustments are supposed to be affected. TIP's value in the fight against inflation depends critically on whether it would act as a countervailing force against the causes of wage stickiness or be just another impediment to wage adjustments. Further, TIP does not attack the causes of price stickiness, to the extent that these are distinct from the causes of wage stickiness. Even if TIP can slow the increase in wages, prices still could be resistant to a slowdown and thereby keep TIP from being effective as an anti-inflation measure.

¹For example, see L. S. Seidman, "Tax Based Incomes Policies," *Brookings Papers on Economic Activity* 2 (1978).

Even casting aside these broad questions about the sources of wage and price stickiness, there still remain many questions about the effectiveness of TIP. These concern both TIP's ability to put downward pressure on wages and whether any pressure on wages can be translated into downward pressure on prices.

TIP's Effect on Wages.² The case for TIP's putting downward pressure on wages rests upon the presumed ability of corporations to resist union wage demands and upon the willingness of unions to moderate those demands in the face of corporate acceptance of a long strike. But the frequency with which wage contracts are negotiated without recourse to a strike is a strong indication that labor and management have a mutual interest in getting the best possible settlement, but reaching it without a costly strike. Thus any corporation's willingness to resist union demands to the point of a strike must depend upon its assessment of the chances that the union will moderate its demands. In

turn, the union's willingness to moderate its demands as a result of a strike will depend on its assessment of the corporation's ability to continue the strike indefinitely. In some instances, labor and management are likely to conclude that TIP should have no effect on the wage contract being negotiated, even though the corporation would be paying additional taxes because of TIP.³ Such settlements would dilute TIP's effectiveness in slowing wage increases. And, of course, where wage settlements are not affected by TIP, price increases will not be affected by TIP either.

Another, and very obvious, problem with the proponents' scenario is that, whenever TIP is imposed, many corporations subject to the tax will be locked into existing wage contracts. Only as these contracts come up for renewal in later years will TIP be able to influence the resistance of these corporations to wage demands. Clearly, these existing contracts will further dilute whatever influence TIP might have on wage increases by spreading it over several years.

Finally, TIP proponents focus undue concern on labor markets where unions are present, given that less than one quarter of all workers are members of unions. In those labor markets where unions are not present, wages will be subject to downward pressure if corporations have market power—so that they individually are able to pay lower wages without losing all their workers.⁴ But in any

²The conclusions reached in this and the following section are based on an explicit model of how the economy works. In this model, the aggregate demand for goods and services can be slowed by reducing the growth of the money stock. In the long run, the aggregate supply of goods and services is that level of production which is consistent with full employment. In the short run, aggregate supply depends on the labor market behavior of firms and workers, including the sources of wage and price stickiness, and on past history. The interaction of aggregate demand and short-run aggregate supply determines how wages and prices change. See R. Dornbusch and S. Fischer, *Macroeconomics* (New York: McGraw-Hill, 1977) for a model of this type.

Following the arguments of TIP proponents, TIP is assumed not to affect aggregate demand and prices are assumed not to be sticky. Wage stickiness is assumed to be the result of slow adjustment of workers' wage demands to the new circumstances of slower monetary growth. And workers are assumed to be willing, in the short run, to work more hours if offered higher wage rates.

Even if these assumptions are not fully satisfactory, they do seem to capture the essence of TIP proponents' arguments.

³This result depends, in part, upon the union being a fully informed monopolist in supplying labor to the corporations involved in the negotiations. Not only must there be no non-union competition but there must be no union infighting with respect to seniority benefits, the distribution of contract gains across union members, and so forth. Further, the union must not be using the length of a strike as a way of learning the maximum wage settlement that firms will accept.

⁴By definition, corporations with labor market power face upward sloping supply curves of labor. TIP will induce such corporations to lower their wage rates, so that they will face lower tax rates under TIP than otherwise. By paying lower wage rates, these corpora-

labor market where the typical hiring corporation quickly would lose all its workers by paying lower wages, there will be no downward pressure on wages.⁵

Clearly, TIP's effectiveness in putting downward pressure on wages has been greatly exaggerated. Of course, in those instances where TIP does not put downward pressure on wages, there can be no downward pressure on prices. But there are two cases where TIP should put downward pressure on wages: where unions' wage demands can be moderated by a long strike; and where there are no unions but corporations have market power over the wages they pay. In these two cases TIP might have some favorable effect on price increases if downward pressure on wages can be translated into downward pressure on prices.

Lower Prices from Lower Wages? TIP proponents rely heavily on the historical relationship between the inflation rate and the rate of increase in wages to suggest why downward pressure on wages will lead to downward pressure on prices. A linkage between wage increases and price increases is not surprising since wage rates are simply the price of labor services and therefore are linked to the money supply in the same way that the prices of goods are. And, over the longer run at least, there is no real question of whether rising wages cause prices to rise,

tions will not be able to get as many workers or produce as many goods for sale. But the combination of lower tax rates and higher prices for the goods they do sell will more than offset the effect of the drop in production volume on profits. See D. A. Nichols, "Comparing TIP to Wage Subsidies," *American Economic Review* 69 (1979), pp. 207-211.

⁵Firms which are competitive in the labor market can hire workers only by paying the market wage rate. Moreover, they will not reduce the number of workers they hire in response to TIP because TIP is a tax on capital, a fixed factor of production in the short run. The profit-maximizing number of workers to hire thus does not change under TIP, so the demand for labor in competitive labor markets is unchanged. See Nichols, "Comparing TIP to Wage Subsidies."

as businessmen might say, or whether rising prices cause wages to rise, as labor leaders might say. Rather, rising prices and excessive increases in wages have a common cause—too high a growth rate of the money supply. But TIP proponents claim to find in the historical linkage between rates of increase in prices and wages more than this common causal relationship to monetary growth. They argue that this evidence also suggests that, over the short run, wage increases must moderate in order to get a reduction in inflation.

Even if proponents' interpretations of this past evidence were correct, it would be wrong to conclude that TIP, by putting downward pressure on wages, would bring about a reduction in inflation. Taxes cause people to alter their economic behavior. For example, Europeans historically have bought smaller, more fuel-efficient cars than Americans. This partly reflects the higher European excise taxes which have made gasoline more expensive there. Since a new tax can lead to future changes in the economic behavior of firms and individuals, past economic relationships may be quite useless as predictors of future behavior.⁶ In fact, the cases where TIP seems to put downward pressure on wages can serve as a very good example of how easily this can occur.

Let's start with the case where labor unions are prevalent and willing to moderate their wage demands in the face of a prolonged strike. On the face of it, the relationship between the rates of change of wages and prices might appear to be unchanged by TIP.⁷ But some corporations will be locked

⁶See R. E. Lucas, Jr., "Econometric Policy Evaluation: A Critique," *The Phillips Curve and Labor Markets*; Carnegie-Rochester Conferences on Public Policy, Vol. 1, 1976, ed. by K. Brunner and A. H. Meltzer.

⁷A rationale for union behavior of the type posited has been given in O. Ashenfelter and G. E. Johnson, "Bargaining Theory, Trade Unions, and Industrial Strike Activity," *American Economic Review* 59 (1969), pp. 35-49. Corporations which act jointly in the labor

into wage contracts at the time TIP is imposed and they might respond to their increased tax burden by raising prices, since there is no way they can reduce their wages.⁸ Any such price increases induced by TIP potentially could more than offset any price declines induced by TIP. Thus it is possible that the net effect of TIP would be to temporarily aggravate inflation even though some wage moderation might have occurred.

The possibility that TIP will have a perverse effect on inflation, at least initially, also is suggested by proponents' depiction of greater strike activity as part of the mechanism for moderating union wage demands. More strike activity means lower production of goods and services. Unless monetary growth were lowered in response to this, there would be more money chasing fewer goods. This would mean greater inflation, at least so long as strike activity was abnormally high. Again, the effect of TIP could be to slow down wage increases, but only at the expense of higher inflation.

The historical relationship between wage increases and price increases also would be significantly altered by TIP if corporations possess market power in the hiring of workers. For simplicity, suppose that there are no labor unions opposing these corporations.

negotiations but competitively in their hiring behavior after settlement will respond to TIP by resisting union demands. As a result, a lower wage settlement will be achieved and corporations subsequently will charge lower prices for their goods, reflecting their lower wage costs. This result assumes, however, that all wage contracts are renegotiated when TIP is imposed and it ignores the effects of strikes upon the level of national output.

⁸This does not seem to represent profit-maximizing behavior on the part of firms. On the other hand, TIP proponents argue that corporations set prices as a percentage markup over costs (these costs often are simplified to include just wages). Corporations that are locked into wage contracts when TIP is imposed cannot evade the tax burden imposed by TIP. Since such taxes are part of the costs of doing business, proponents presumably believe that such corporations will raise prices.

The imposition of TIP will lead these corporations to reduce the wage rate they pay workers. Some workers will leave so that these corporations will not be able to produce as many goods for sale. But, with fewer goods available in the marketplace, corporations will be able to charge a higher price for the goods they do sell. Once more TIP can moderate wage increases only by simultaneously aggravating price increases.

All in all, there are strong reasons to doubt the potential effectiveness of TIP in reducing inflation. In many cases, TIP will not put downward pressure on wages, and where it does not, it will not be effective in reducing inflation. But even where TIP can put downward pressure on wages it is not likely to be effective in moderating price increases. Only when unions respond to longer strikes by reducing their wage demands do lower wage increases make lower price increases possible. And even that possibility is undermined by the effects of greater strike activity and current wage contracts. By contrast, there are several ways by which TIP easily could have the perverse effect of aggravating inflation.

The case against TIP is not limited to its likely ineffectiveness in reducing inflation. TIP is not a costless policy that can be tried on the off-chance that it will work. Rather, TIP will produce costly side effects all across the economy.

SIDE EFFECTS OF TIP

These costs would be especially heavy in terms of the economy's ability to allocate resources to their most productive uses. But, in addition, TIP would make it harder for policymakers to control the economy, it would impose administrative costs, and it would raise questions of equity.

Lower Efficiency and Productivity. TIP will cause the economy to operate less efficiently by diverting resources from their most productive uses. Typically, wage rates will be changing rapidly in industries that are experiencing high growth in productivity

or product demand. Efficiency in the use of resources requires that such industries be free to bid workers away from other industries where the demand for goods is not so high or where productivity is not improving so rapidly. But TIP could inhibit the shift of labor from declining industries to expanding industries and thus reduce the efficient reallocation of resources to more profitable uses within the economy.

The decrease in efficiency will depend upon the size of the TIP tax and on the length of time TIP is used in an attempt to reduce the inflation rate. To the extent TIP is effective in slowing the growth of some wages, wage rates which were comparable in two labor markets before TIP might not be comparable afterward. Opening up differences in wage rates will tend to cause labor to shift from one market to another. These shifts should be associated with a reduction in productivity and in the efficiency of the economy.

TIP also would have longer run effects on productivity through its effect upon corporate profits. These profits are largely returns on the capital invested by shareholders in the corporation. Other things being equal, a firm that has higher profits per unit of capital will be more ready to make additional investments than a firm that has lower profits. To the extent that TIP would lower a corporation's after-tax profit per unit of capital, it should be expected to have harmful effects upon corporate investment. Even if the general corporate tax rate is lowered sufficiently to offset the tax burden of TIP for the average corporation, TIP will discriminate against capital-intensive industries (those that use large amounts of capital per worker).⁹ Lower investment would lead to slower growth of the capital stock for such corporations and therefore to lower productivity for them.

⁹The relatively heavy tax burden of TIP upon capital-intensive industries has been shown by Nichols, "Comparing TIP to Wage Subsidies."

When these effects are added up over all corporations, the result must be lower productivity for the nation as a whole, if for no other reason than that capital is being diverted to less desirable opportunities. The adverse effect of TIP upon the nation's productivity would seem to be of particular concern at this time, when there is so much discussion of the need to reverse the recent trend toward slower productivity growth.

Lessened Control of the Economy. Policymakers set monetary and fiscal policy in light of what they expect the economy to do. Because the inflation and unemployment effects of TIP are so unpredictable, the imposition of TIP will increase uncertainty about how the economy will behave. As a result, policymakers will find it even more difficult to select a proper stance for other components of economic stabilization policy.

Management of the Federal budget is a good case in point. Federal tax revenue must be forecast if fiscal policy—measured, say, in terms of the Federal deficit—is to be controllable. Under TIP, the revenue collected from each corporation would depend upon not only the level of its profits but also the amount by which its wage increases exceeded the TIP guidelines. Forecasting TIP revenue is likely to be much more difficult than, say, forecasting revenues from the present corporate income tax.¹⁰ And so it will be more difficult to predict the Federal deficit, making fiscal policy less controllable and less useful for fighting inflation.

Administrative Costs. Also, there will be considerable administrative costs associated with the implementation of TIP. These costs will be incurred by the IRS as well as by the corporations being taxed. Proponents of TIP often argue that these costs will be relatively low by comparison with the costs of wage

¹⁰Forecasts of TIP revenue will require estimates of the variation in wage gains and profits from corporation to corporation in addition to forecasts of the average level of profit per corporation.

and price controls, and that probably is true. But still they will not be unimportant.¹¹

TIP will give employers an incentive to disguise wages as other business costs. Instead of giving a wage increase, for example, a firm might provide an employee with a company car and let the employee use the car for family purposes as well as for business. The IRS, which would have to enforce TIP, would have a very hard time judging whether or not such cars were reserved exclusively for company use. Even if the IRS could determine that the cars sometimes were being used for nonbusiness purposes, it would have difficulty assessing the true market value of such services in order to estimate the wages being paid.

Firms also would have an incentive to distort the number of hours worked by employees. By overstating the hours worked, a firm could report a lower wage rate, which would lessen its tax liability under TIP. Thus the IRS would need the capability to check the firm's report of hours worked. Or firms could make an agreement with employees to reduce their regular work day to, say, seven hours, but each day ask employees to work one hour of overtime at double pay. In this way, larger wage rate increases could be given without running afoul of the TIP tax.

Administrative costs would not be limited to the IRS. Corporations would need complex computer programs to generate data on wages and wage increases required for tax purposes. And they would have a considerable incentive to hire specialists in reducing tax liabilities under TIP.¹²

The Inequity of TIP. Finally, the tax burden associated with TIP would vary greatly across the economy. Some corporations would have to absorb the tax burden in reduced after-tax profits. Others might be

able to shift an appreciable portion of their tax burden to workers and consumers by paying lower wages and charging higher prices.

Workers also would be affected unevenly. Those who found their wages adversely affected while other workers were unaffected by TIP would ask why that should be so. Clear answers are not obvious, particularly when workers adversely affected by TIP already might be receiving lower wages as a result of the market power possessed by the hiring corporation.

This inequity of TIP in the distribution of the tax burden arises in large part because TIP does not attack the fundamental causes of the slow adjustment of wages and prices. It simply tries to put downward pressure on all wages. When the rationale for the distribution of a tax burden is so clearly weak, those who are adversely affected are likely to be resentful of an additional tax burden and to be vocal in their resentment. By raising such questions of equity, TIP might well aggravate the political tensions associated with squeezing inflation out of our economy.

SHOULD TIP BE TRIED?

TIP is unlikely to be able to dampen inflation. Its ability to put downward pressure on wages has been greatly overstated. Without that pressure, TIP cannot work. Yet even in those circumstances where TIP can be effective in putting downward pressure on wages, there is the strong possibility that TIP will aggravate rather than reduce inflation.

TIP is not a costless policy that can be tried in the off-chance that it might work. TIP would have significant side effects. It would make coordination of the war against inflation more difficult. It would add to the administrative costs already borne by government (and therefore by taxpayers), and it would impose new compliance costs on the firms being taxed. TIP also would make the economy less efficient overall, the loss in

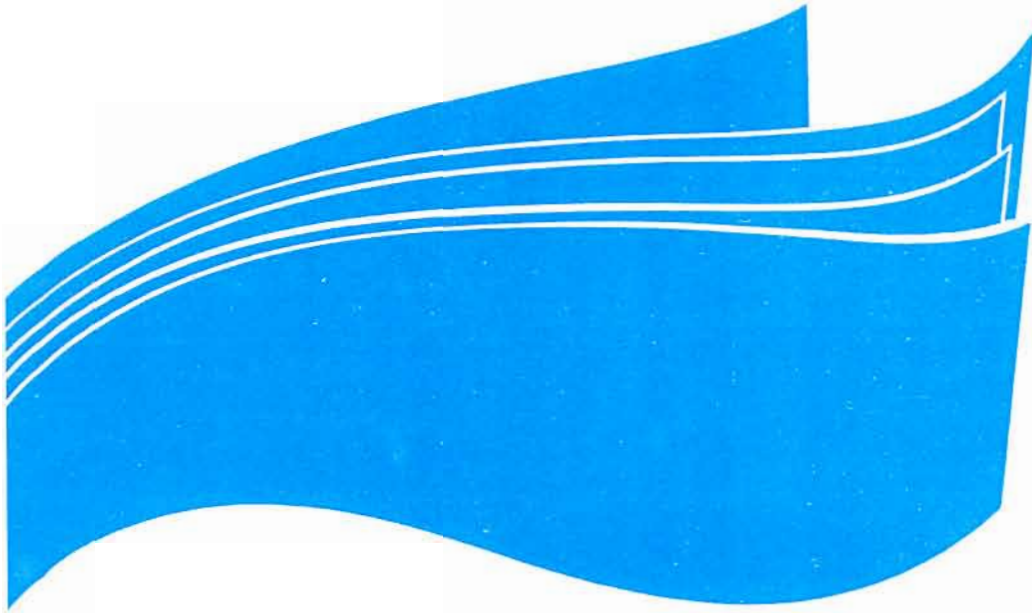
¹¹In fact, the higher the tax rates, the more closely TIP will resemble wage controls.

¹²Firms presently have such specialists for areas of the corporate income tax; they simply would hire more.

efficiency becoming greater the longer it remained in effect. One result of this efficiency loss would be lower productivity—a particularly unfavorable result in light of the oft-expressed desire for increased productivity. Finally, the burden of fighting inflation through TIP would be distributed unevenly among members of our society, thus raising important questions of equity.

Proponents of TIP have the same goal as many other Americans—to rid the economy of inflation in the least costly way possible.

But TIP would impose costs that would far exceed any benefits. Why should our society be put through, with TIP, the kind of costly and disillusioning experience that wage/price controls provided in the 1970s? It would be far wiser to rely on a gradual reduction in monetary growth—and on related policies whose effects are relatively well known—where success can be fairly well assured if only we persist in our application of restraint.

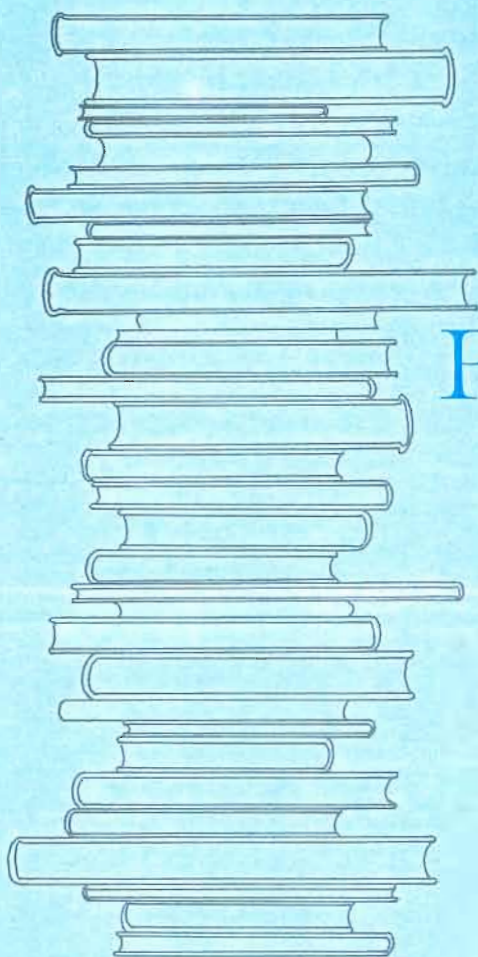


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