Fighting Inflation with a Tax-Based Incomes Policy

TIP Is Not the Answer to Inflation
EDITOR'S NOTE: THE TIP ISSUE

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Fighting Inflation with a Tax-Based Incomes Policy

By Laurence S. Seidman*

In the past, most economists and policy-makers have regarded monetary policy as the key lever for winding down inflation. But recent experience suggests that monetary policy by itself may not be viable as an antidote to inflation because it requires too large a cut in employment and output for each unit of decline in the inflation rate. Virtually all economists agree that monetary restraint is necessary to control inflation. But would it be too costly if used by itself? Some economists think it would be, and so they have proposed a novel complement to monetary restraint—a tax-based incomes policy (TIP)—that they believe would reduce the cost of the anti-inflation fight.

**BRINGING DOWN INFLATION: IS MONETARY RESTRAINT ENOUGH?**

Virtually all economists agree that a permanent reduction in the growth rate of the money supply, by itself, eventually would produce a permanent reduction in the inflation rate. They agree also that monetary deceleration is essential to any successful anti-inflation strategy. They disagree, however, about how much such a policy would cost in lost output and unemployment as well as about whether the cost would be reduced by supplementing monetary deceleration with a policy such as TIP.

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in reducing price increases must heed a fundamental relationship. To avoid upward pressure on prices from the wage side, the average money wage per worker must grow no faster than the real output per worker (wage refers to fringe benefits as well as employee salaries). In recent years, however, the gap between money wage and labor productivity growth has widened.

From 1976 to 1978, compensation per hour increased 8 percent annually. But the growth rate of output per manhour—labor productivity—was only 2 percent. And so unit labor cost increased 6 percent (8 percent minus 2 percent). It is therefore not surprising that price growth was also approximately 8 percent. In contrast, in the early 1980s, wage growth was only 4 percent; productivity growth, 3 percent, so unit labor cost growth was 1 percent (4 percent minus 3 percent). Not surprisingly, price growth was also approximately 1 percent.

Changes in price growth also feed back into wage demands, so that causality runs from price to wage as well as from wage to price. Nevertheless, it remains true that the rate of price increase cannot decelerate permanently unless wage growth also ultimately decelerates. Whether wage deceleration leads or lags price deceleration, such deceleration will eventually occur if price deceleration is to be more than temporary. The reason is that firms must eventually set prices to cover unit costs, and labor makes up a large share of those costs (roughly two-thirds of the value added in the average firm).

With trend productivity growth near 2 percent (varying between 1 percent and 3 percent over the past two decades), price level increases can only be brought down to zero permanently if wage growth is ultimately brought down to 2 percent, so that unit labor costs are manageable. If a corporation faces an 8 percent increase in its unit labor cost—the average experience in 1978—it will have to raise its prices approximately 8 percent just to cover its higher cost. What is required, then, is to find a method of restraining wage increases.

The Monetary Strategy. How would a slowdown in monetary growth influence wage increases? According to the monetary strategy, if the Federal Reserve clearly announced a scheduled deceleration of money growth and stuck to it, workers and employers soon would respond by reducing wages and price increases in step with the monetary slowdown. If price deceleration were prompt and substantial, the smaller quantity of money still would support a full employment quantity of real output. If there were a short lag in price deceleration, only modest, temporary declines in real output and rises in unemployment would occur. Soon the economy would return to full production and employment, inflation having been brought under permanent control.

But why should wage increases decelerate if the Fed adopts such a money growth policy? The most optimistic answer comes from the theory of rational expectations. Because workers and employers are rational, it is thought, they will recognize that if they do not immediately decelerate wage increases to match the monetary slowdown, the smaller growth of money will support less real output (at the high wage and price level); sales will decline, and layoffs will occur. To avoid this, in advance, they will settle for lower wage increases.

A less extreme but still quite optimistic reply is that as soon as workers and employers observe an initial decline in sales and rise in layoffs, they will respond significantly by

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[1] Even with a change in tax policy to encourage capital formation and productivity, it is unrealistic to expect more than a 1 percent or 2 percent increase in trend productivity growth, so that unit cost deceleration depends primarily on wage deceleration.

cutting wage increases, thereby minimizing layoffs and declines in output. It is conceded that a modest, temporary recession must be experienced to induce the wage adjustment. But it is argued that the transition will not be as costly as it would be under any alternative anti-inflation policy.

In fact, however, it appears that using the monetary strategy could be extremely costly in terms of unemployment and lost GNP. The reason is that the rate at which wages grow is not as flexible as the monetary strategists suppose.

**Wage Growth Inertia Raises the Cost of Controlling Inflation.** Wage growth inertia—the tendency of wage increases to continue at a roughly constant rate—is a central macroeconomic feature of modern capitalist economies. If wage increases recently have averaged 10 percent, for example, they probably will resist attempts to drive them much below 10 percent unless a severe, prolonged recession (or a policy like TIP) counters their trend. Wage growth inertia is particularly tenacious in the downward direction—the direction relevant to the monetary strategy. Part of this resistance results from long-term labor contracts, which keep wages from making quick adjustments to changing economic conditions.

In an important share of the economy, long-term (three-year) labor contracts keep wage growth from rapidly adjusting downward. When these contracts are being negotiated, neither workers nor employers know what the future will bring. And so they base their agreements on what they perceive as current economic trends. Even if policymakers succeed in slowing money growth down, it may take several years to negotiate appropriately lower contracts. And even if shorter term contracts become more common, workers who are fairly sure of retaining their jobs through a slowdown will not find it in their interest to reduce their wage demands. Thus inertia throws a serious obstacle in the way of anti-inflation efforts from the monetary side.

Two recent econometric analyses offer a measure of how strongly wage growth resists downward pressure in the current policy environment (other studies may give a less pessimistic result). Based on statistical research over the past two decades, including several recessions, George Perry of the Brookings Institution recently concluded that a 1-percent increase in the unemployment rate (for example, from 6 percent to 7 percent) for a full year would reduce wage growth by only 0.3 percent. Since (according to Okun’s Law) a 1-percent increase in the unemployment rate corresponds to a 3-percent loss in real GNP, reducing wage and price increases 3 percent might require a loss of approximately 30 percent of annual real GNP.

Also, according to the wage equation statistically estimated by Michael Wachter of the University of Pennsylvania several years ago, an increase in the unemployment rate from 5.5 percent to 8 percent, if maintained for three years, would reduce wage growth by only 2.4 percent; for six years, by 4 percent. Wachter’s estimate is quite close to Perry’s; both imply that a 1-percent increase in the unemployment rate, if maintained for three years, would reduce wage growth approximately 1 percent.

It has been suggested that this unrespon-
siveness of wage growth could be offset if the monetary strategy were implemented with effective publicity. Wages adjusted slowly in the past, it’s argued, because inflation expectations adjusted slowly. If the Fed announced in advance that it intended to slow money growth down to a certain range, wage response would be much more rapid.

But this suggestion may well reflect wishful expectations. The substantial empirical evidence supplied in behalf of wage growth inertia for the U.S. and other mixed capitalist economies over the past half-century stands in sharp contrast to the scarcity of evidence for significant downward money wage responsiveness. If workers and employers continue to behave as they have for these 50 years in virtually all advanced market economies, the monetary strategy will cause stagnation—at least several years of high unemployment, low growth, little if any improvement in the standard of living, and widespread discontent with our capitalist system.

Without TIP, the lost output occasioned by monetary deceleration cannot be averted by gradualism, only stretched out. Sudden deceleration would raise unemployment sharply and cause an immediate, large loss of GNP. Gradual deceleration would cause only a moderate rise in the unemployment rate; but it would have to be sustained for a much longer period to achieve the same reduction in wage growth. Either policy would cause a significant loss in GNP and hardship for the unemployed (see WAGE ADJUSTMENTS DURING RECESSION).

Economists who believe the costs of the monetary strategy are too great therefore seek a method of directly decelerating wage inflation, not as a substitute for monetary restraint, but as a complement to it.

TIP CAN LOWER THE COST

Earlier attempts at restraining wage and salary growth directly have taken two forms—voluntary guidelines and controls. Guidelines have proved too weak, controls too

WAGE ADJUSTMENTS DURING RECESSION

The statistical results of Perry and Wachter are supported by evidence from the 1975 recession.* Real (inflation-adjusted) GNP declined 1.3 percent from 1974 to 1975, instead of increasing 5 percent (its normal growth rate)—hence a loss of over 4 percent of GNP. The unemployment rate averaged 8.5 percent in 1975 and 7.7 percent in 1976. Yet compensation per hour in the private business sector declined from a peak of 9.9 percent in 1973 only to a trough of 8.1 percent in 1977.

It is true that the implicit price deflator for the private business sector declined from a peak of 10.1 percent in 1975 to a trough of 5.1 percent in 1976. Although this might appear to contradict the view that price increases cannot permanently decelerate without comparable wage deceleration, the 1975-76 data must be interpreted cautiously for two reasons. First, the quadrupling of the world price of oil by OPEC in 1974 raised price increases relative to wage increases in 1974 and 1975. Even without a recession, the stabilizing of the world price of oil in 1976 would have reduced the inflation rate. Second, the recovery that began in mid-1975 and continued in 1976 raised the growth rate of output per hour (labor productivity) to 3.5 percent in 1976, approximately 1.5 percent above its normal growth rate of 2 percent. The sharp increase in productivity growth temporarily reduced the growth rate of unit labor cost by 1.5 percent and may have reduced price inflation by a comparable amount. Thus it seems likely that an important fraction of the one-year 5-percent decline in the inflation rate was only a temporary improvement.

*All data on the 1975 recession are from the Economic Report of the President 1979, Tables B-2 and B-38.
rigid. In 1971, Henry Wallich (then Professor of Economics at Yale, now Member of the Board of Governors of the Federal Reserve System) and Sidney Weilntraub (Professor of Economics, University of Pennsylvania) proposed a new method. Their aim was to use the tax system to induce socially desirable wage behavior—hence the name “tax-based incomes policy.” Several modifications of TIP have since been suggested. But the original remains in many ways the most attractive TIP design.

The Wallich-Weintraub Approach. Employees and their unions who seek higher wages and salaries in an inflationary environment are simply reacting to protect their own self-interest. Similarly, when business firms pass on wage increases through higher prices, they are protecting their own profit position, given the constraints they face. The aim of TIP is to restructure financial incentives so that noninflationary wage settlements will promote the self-interest of both labor and business.

TIP would establish a national compensation guideline and impose a tax surcharge on the corporate income tax of any large corporation which exceeded that guideline. The tax surcharge would apply to all employee compensation, including executive compensation and fringe benefits. Suppose, for example, that the initial wage guideline were set at 7 percent. If a large corporation granted a 7-percent increase, its tax rate would remain at the base rate (currently 46 percent for most corporations). For each 1 percent above 7 percent, its tax surcharge might be 8 percent (this TIP multiplier would be set by Congress). Thus a corporation that granted an 8-percent increase would find its tax rate increased to 32 percent. As the inflation rate came down, Congress would reduce the guideline in stages until it reached the labor-productivity growth rate of 2 percent—the rate of wage growth required for price stability. TIP is intended to apply only to the largest corporations—perhaps 2,000—which produce half our economic product. Nearly 2 million smaller corporations, 11 million sole proprietorships, and 1 million partnerships would be exempt from TIP and experience no compliance burden. Thus compliance cost would be limited to the largest corporations—each of which has tax and accounting departments well equipped to respond to a new tax surcharge (see TAXING FOR TIP overleaf). But the beneficial effects of TIP would spread across the economy, because the pattern of wage and price behavior set by large corporations and unions, reinforced by monetary and fiscal restraint, would induce deceleration in the uncovered sector.

Incentive for Tough Bargaining. The prospect of a TIP tax penalty would work to raise the resistance of management to wage increases above the guideline. Thus determination to hold the line would be strengthened. Even if the union posture remained unaltered, the average settlement should be less, because labor’s push and management’s resistance should balance at a lower wage increase. Moreover, each union would observe that other unions were facing the same stiffer resistance from management. A smaller wage increase therefore would not mean a relative wage decrease for a given union.

Why would TIP be more effective than monetary deceleration alone in countering wage growth inertia? The crucial difference is in the certainty of the penalty at the time the wage decision is made. Monetary deceleration alone—if it were carried out—ultimately would penalize both management and workers if they refused to reduce the wage increase at their firm.

The key question is: Is it possible to get workers and managers, at the time the wage is set, to perceive that a certain penalty of significant magnitude will follow unless
they reduce the size of their wage increase? Achieving this perception requires two conditions under the monetary strategy. First, they must understand that a high wage settlement which is reflected in higher prices will reduce sales, profits, and thus employment at their own firm if the Fed carries through with monetary deceleration. Second, they must believe that, in all likelihood, the Fed will persist in its monetary slowdown even when the going gets tough and the painful recessionary effects of the slowdown begin to be felt.

But it seems that neither condition will be met until workers and managers first experience the actual pain of recession and see the Fed holding fast despite the political pressures that this pain will generate. Most workers and managers probably would understand and accept the bearing of their high wage settlement on their own misfortunes only after they actually went through the discomforts of layoffs and declining sales and profits. It’s even possible that this lesson wouldn’t be learned without several rounds of recession under the monetary strategy.

In contrast, TIP makes the penalty to the firm certain at the time of the wage decision. The change in a firm’s tax rate follows promptly, and unconditionally, on its wage settlement. This certainty is evident also—whether acknowledged or not—to the union. Thus, when management argues that a 10-percent settlement under TIP is as costly as an 8-percent settlement without TIP, it can point with certainty to the tax surcharge that will follow from a 10-percent wage increase.

**TAXING FOR TIP**

TIP would complicate the tax code for the country’s largest firms. But so do the investment tax credit and accelerated depreciation, which require IRS to develop service lives for many classes of assets, often requiring arbitrary judgments. Businessmen clearly do not regard such tax incentives as controls. Despite their complexity, these incentives leave each firm free to make its own decisions. It cannot be overemphasized that TIP is a tax incentive, to which firms can respond as they wish.

The practical difficulties of implementing TIP are exactly analogous to those encountered with accelerated depreciation. The IRS must carefully draw up rules that firms must follow in computing their tax liability. Under TIP, the IRS will have to define how the wage increase, including contributions to fringe benefits, is to be computed for tax purposes.

The most serious technical problems that have been raised against some versions of TIP can be largely avoided if TIP is properly designed. For example: the question has been raised: Whose estimate of the cost of a labor contract will be accepted? This question, however, disappears if TIP is based on the labor expenses actually paid by the firm in a given year, rather than attempting to estimate what the negotiated contract implies. Tax liabilities are based on actual income earned, not on a forecast of prospective income. What must be grasped is that TIP is a tax incentive and should be implemented according to standard principles of taxation, not according to the methods of controls.

Moreover, if a firm actually pays 8-percent more per man-hour this year than last, it should not matter how much of this is the base wage, a cost-of-living adjustment, or a contribution to health or life insurance or pensions. The important fact is that actual total labor expense per man-hour has increased 8 percent; this is what counts for the firm’s costs, pricing, and inflation, and is therefore the basis on which TIP should be computed.

The most valid practical objections have been raised against versions of TIP that would provide penalties or rewards based on prices or profit margins. A TIP that provides incentives for labor compensation—the original version discussed here—avoids most of these problems.
Under the monetary deceleration strategy, only the possibility of a future penalty can be cited.

It is irrelevant to argue that if monetary deceleration were widely believed and its consequences for each firm were widely understood, then the monetary strategy would have a low cost. TIP is offered as a supplement solely because it is implausible to expect these two conditions to be met without first subjecting the population to a painful dose of instruction. Thus TIP would rely on financial incentives to help slow the increase of wages and prices. But rather than use a TIP approach, some policymakers appear to think of wage and price controls when inflation heats up.

TIP vs. Controls. Regulating a maximum level for wage and price increases is a technique that most Americans associate with times of war or national emergency. The reason is that controls inhibit the freedom of management and workers to arrive at their own wage and price decisions, and they impede the allocation of resources in response to market forces. Thus their consequences can be fairly severe.

But TIP differs from controls. The TIP penalty for exceeding the wage guidepost is stiff but not prohibitive. Where market forces call for a relative wage increase, TIP allows the firm to exceed the guidepost.

Suppose, for example, that 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. TIP would not replace the market forces working on each firm and would not prevent the relative wage increase required by A to attract additional labor. Both A and B would be free to set their wage increases without government approval.

Contrast this with the situation of A and B under controls. Each firm would be prohibited from exceeding the wage guidepost unless it could prove to a regulatory board that it should be treated as an exception. A’s case would be submitted to the board. Its collective bargaining agreement would, in effect, require government approval. The outcome would not depend on management’s own assessment of the situation in its industry but on the assessment of a board reviewing a large volume of cases—a board which would be far less informed about the merit of A’s case than A’s management. The appeal process under controls would be time consuming, inefficient, frustrating, and costly. TIP would avoid this regulatory interference in collective bargaining and managerial choice. It would preserve the freedom of business and labor at each firm to make their own decisions.

But while each firm would be free to respond as it wished, without seeking approval from regulators, TIP would not be costless. The new tax provision would impose a compliance cost on the largest 2,000 corporations. And in all likelihood, it would reduce the speed with which labor is reallocated from declining firms to expanding firms, thus introducing a new source of economic inefficiency.

The estimate of this efficiency cost of TIP has been provided by either supporters or opponents. Advocates of TIP suspect that the efficiency cost of TIP is outweighed by its benefit—the lower overall cost of decelerating inflation. They note that the efficiency cost of TIP would be spread through the population while the cost of monetary deceleration without TIP would be borne disproportionately by the unemployed. And they urge that the implications for social equity as well as economic efficiency should be given careful attention.

If those who favor TIP are correct, their program would cut the costs imposed by the

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As Henry Wallich has written: "The essence of TIP is that it differs fundamentally from the usual kind of wage and price controls. Business and labor are free to bargain for any wage increase they choose. Only the weight of market forces is changed, with the tax doing the weighting."
monetary strategy, avoid the serious inefficiency caused by controls, and achieve its aim—lower inflation—without imposing major costs of its own. But not all policymakers were convinced that the TIP scenario would play out as its proponents say it would.

**SOME CONCERNS ABOUT TIP**

In common with other novel policy proposals, TIP has evoked responses marked by caution, concern, and—in some cases—severe criticism. Some economists have suggested that TIP surcharges would be ineffective because firms would shift them forward to consumers. Others have objected that TIP would impose an unfair burden on labor.

Shifting Forward... It has been contended that large firms would shift the TIP surcharge to consumers by raising prices and therefore grant the same wage increase without suffering a burden. If this were true, TIP would temporarily increase inflation instead of permanently decreasing it.

Large corporations probably would attempt to shift the TIP surcharge. But even in industries dominated by one corporation or a few large firms, shifting should not undermine TIP. The TIP penalty multiplier could be made large enough to guarantee an after-tax profit squeeze for any firm that ignored TIP in setting its wage increase, regardless of its market power. And even if firms could shift part of any TIP surcharge, this upward push on price would be small relative to the downward pull of the smaller wage increase, because unit labor cost represents perhaps two-thirds of unit cost (on average), while unit profit—on which the TIP surcharge is levied—is only about 10 percent of unit cost.

Further, any upward push on price from partial shifting would have a one-time impact; it would occur only when the markup was widened to cover the TIP surcharge. Thereafter, wage deceleration would dominate behavior. Also, import competition should help check shifting in several important industries. Finally, limiting TIP to the largest corporations could further contain the shifting problem. Smaller firms not subject to TIP might be able to erode the market share of large firms that tried to pass on a TIP surcharge.

...or Burdening Labor. Because TIP focuses its incentive on wage and salary increases, it has been supposed that labor would bear the heaviest part of the burden under a TIP regime. But TIP would not be unfair to labor.

Deceleration of money wage growth under TIP would not reduce real (inflation-adjusted) wage growth, which is determined by the growth of labor productivity. Wage deceleration of x percent would be followed by price deceleration of x percent. From 1950 to 1956, for example, real (inflation-adjusted) wage growth and productivity growth both were approximately 3 percent annually, while money wage growth averaged 4.3 percent. From 1957 to 1976, real wage growth and productivity growth were both approximately 1.8 percent, while money wage growth averaged 7.0 percent. This suggests that neither raising nor lowering money wage growth would affect real wage growth—the genuine determinant of labor’s well-being.

Two proposals that could be included in a TIP package would insure fairness to labor. The first would provide an automatic across-the-board tax rebate to all low-income and middle-income households in any year when the average inflation-adjusted wage increase was significantly less than the average labor productivity increase in the economy. This proposal would not require each firm to measure its own wage increase; it would therefore impose no compliance cost on firms.

The second would impose a uniform tax

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surcharge on the large corporations covered by TIP if the ratio of aggregate profit to aggregate labor compensation for the whole covered sector rose unusually when TIP was introduced. No individual firm would be penalized for its own increase in profit; only aggregate profit for all covered firms would be relevant. Each firm would therefore retain the incentive to improve efficiency. The income tax surcharge would be imposed only in the year of the increase; it would not be permanent. Thus no attempt would be made permanently to constrain the distribution of income between labor and capital.

These two insurance policies would make the TIP package fair to labor without imposing additional compliance costs on the largest corporations or any compliance cost on the vast majority of firms exempt from TIP. 10

Thus there is little reason to fear that either labor or consumers would suffer unfairly from TIP.

CONCLUSION

The Federal Reserve must slow down the growth of the money supply if the U.S. is to see a permanent reduction in inflation rates. Without TIP, however, monetary deceleration would subdue inflation only by subjecting the economy to a prolonged, severe recession. Wage growth inertia—a central macroeconomic feature of modern capitalist economies—is the Achilles heel of any policy approach that relies solely on monetary deceleration. Unless wage growth is restrained, price increases cannot decline permanently and significantly, because firms must set prices to cover unit costs. Only through years of sustained high unemploy-

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