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USING THE TAX SYSTEM TO RESTRAIN INFLATION

Statement by

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It is a pleasure to appear before the Joint Economic Committee to present my personal views in the area of incomes policies.

Disruptive inflation has plagued our economy for something like 12 years. During that period its virulence has varied, as high as 12.0 per cent in the fourth quarter of 1974 and as low as 1.5 per cent in the second quarter of 1967. But the experience has made clear that we are not "learning to live" with inflation. Increasingly inflation is seen for what it is -- a serious addiction that gradually undermines the vitality and even viability of the addict.

While currently inflation is being forecast for the indefinite future at a rate close to that of the present, there is no reason at all to believe that inflation will stabilize if left alone. Inflation has shown itself in recent years to be highly inflexible downwards. It has shown no similar inflexibility upwards. Any one of a number of factors could send inflation spiraling again. Pressure of demand on limited manufacturing capacity, a major wage breakthrough resulting from special circumstances that nevertheless could set a pattern, food prices, oil prices, all could trigger off higher inflation that then would work its way into wages and become resistant to any decline. Such a ratchet mechanism is a tangible threat.

Further acceleration of inflation almost certainly would, after some not very long interval, lead to renewed increases in

unemployment. Thus, there is no other choice but to try to bring down unemployment and inflation simultaneously.

It is largely because of concerns like these that a consensus has developed that the economy must be allowed to grow at only a moderate rate. Idle resources, human and material, can be absorbed only gradually. Moreover, the noninflationary limits to that absorption leave a distressingly high margin of unused resources even in the longer run.

Incomes policies have been suggested as a means of winding down inflation more rapidly. In the general view, however, incomes policies are associated with wage and price controls, or at least are seen as a step in that direction. This concern has helped to create an interest in a tax-oriented incomes policy (TIP) that cannot be charged with that defect because it is specifically designed to give full effect to market forces. While numerous versions of TIP exist, their common characteristic is a reliance on the tax system as a means of inducing more moderate behavior of wages and prices. With the Committee's permission, I would like to discuss a variant that was developed by Professor Sidney Weintraub of the University of Pennsylvania and myself.

Outline of Plan

The essence of the plan consists of a tax penalty on firms granting wage increases in excess of a guideline. The restraint is

on wages rather than on prices. But the tax is paid by the firm. In this way, evenhandedness is maintained. The plan can be extended to include a restraint on profits if that is regarded as necessary. To begin with, however, I would like to set forth why a plan focusing on wages combined with a tax paid by corporations seems adequate.

A considerable body of research indicates that prices in the long run are basically determined by wages. Nonwage factors such as those mentioned earlier -- demand pressures, nonwage costs -- may play an initiating role in price movements. But with wages and other compensation of labor amounting to 75 per cent of GNP, wages unavoidably are the principal factor in prices. A slowing in wage increases, therefore, will necessarily bring about a slowing in price increases.

If prices follow wages, wage restraint will not lead to any reduction in real wage increases. Given productivity gains of, say, three per cent, labor will get the same increase in real wages with a 5 per cent wage increase and 2 per cent inflation as with 9 per cent wage increase and 6 per cent inflation. The gains from productivity are all that the economy can give to labor, unless it is to be taken away from someone else. These gains will go to labor at any level of inflation, so long as the gap between

wages and prices, as it normally does, equals productivity gains. Wage restraint, therefore, imposes no sacrifice upon labor in real terms. On the contrary, by reducing the threat of inflation, wage restraint would permit the economy to move to lower levels of unemployment, and move there more rapidly, thereby benefiting both labor and all others who share in the national income.

Technical Aspects

A tax to be imposed on firms granting excessive wage increases could take one of several forms. It could be imposed as an increase in the corporate income tax, as a payroll tax, through disallowance for income tax purposes the deduction of any excess wage increases paid, and perhaps others. The plan could also be structured in the form of a tax reduction for firms avoiding excess wage increases.

Disallowance of excess wage increases as tax deductions has the advantage of having already been on the statute books after World War II and after the Korean War. An increase in the corporate income tax has the advantage that it could be scaled easily in proportion to the magnitude of the excess. This would help to make the penalty or threat of a penalty effective while largely eliminating controversies over marginal excesses. A rise in the corporate income tax, moreover, would be less easily shiftable than a payroll tax or denial of deductibility. On the other hand, it might more adversely affect the ability of the firm to invest.

Guideline. The setting of the wage guideline requires a governmental decision. A maximum wage increase equal to long-run productivity gains plus half the current rate of inflation might be appropriate. The guideline would in no way interfere with the functioning of the market, since firms and unions would be entirely free to make settlements above or below it. Thus, the concern that the guideline would become a first step on the way to a system of controls would be unwarranted. Likewise there seems to be no good reason for expecting the "maximum to become a minimum," since the guideline would not represent a maximum. The guideline would be lowered periodically as inflation was being reduced.

Coverage. A good case can be made for subjecting only a limited number of large corporations to the guideline and tax. In an inflation such as the present, which is kept going because one high wage settlement leads to another but where there is no excess demand for labor, moderation in the settlements of large firms and some consequent slowing of the price trend would probably lead to moderation for most employers. Limiting the plan to large firms would greatly ease administrative complexities. However, an alternative and opposite procedure could also be envisaged -- to cover not only all incorporated, but also unincorporated business.

Administrative problems. The fact that laws disallowing excess wage increases under the post-World War II and Korean War wage and price control legislations have been on the books suggests that the technical problems of measuring excess wage increases have been considered by the legislature and not found to be intractable. There are, of course, a wide range of technical problems to be resolved of which the following are indicative:

In an economy characterized by multicorporate enterprises, how is the tax-paying unit to be defined -- a plant, a corporate entity, or an entire conglomerate? How are the excesses to be measured? By total payroll and total employment, by individual categories of workers, with allowance for overtime, for fringe benefits including deferred compensation, cost-of-living adjustments, and health insurance and all the rest? How are new firms, firms with losses, with multi-year labor contracts, with numerous subsidiaries to be dealt with? Should the TIP penalty be applied for one year only, for a fixed multi-year period, or for a lengthy or indefinite period?

A large number of decisions will have to be made in writing the tax regulations. This is the same analysis, however, that firms and unions engage in during wage bargaining sessions, and which at the present time the Council on Wage and Price Stability must also undertake. Furthermore, the initial evaluation of a wage package, which

would form the basis for a pay-as-you-go approach to the tax, can be revised upon eventual audit by the Internal Revenue Service. Since the tax penalty would be proportionate to the degree of infringement of the guideline, minor differences between the taxpayer and the tax authorities would not involve large amounts of tax and could be compromised as many differences arising in tax audits are.

A Tax to Restrain the Share of Profits

It was noted earlier that the wage guideline proposal does not contain a corresponding restraint on prices because prices can be expected to follow wages. However, if the evidence supporting this view is not generally accepted, a supplementary device could be introduced that would serve to restrain, not prices, but profits. A failure of prices to move with wages would tend to show itself in a corresponding change in profits. Labor would have a legitimate right to expect that no special benefits for profits should emerge from an acceptance by labor of a wage guideline. To ensure that this expectation is not disappointed, the corporate income tax could be raised so as to prevent the rise in total after-tax profits from exceeding some historical relationship to GNP. This would be a tax proportionate to the "excess profits" of the corporate sector as a whole, but not related to the profits of any particular corporation.

As a practical matter, such a tax increase probably would never be triggered at all. But if it were, the increase in the corporate tax could hardly amount to more than a few percentage points. Such a tax would be an "incomes policy" in the proper sense of the term, since it would specifically be designed to deal with income shares. The setting of a profit share, presumably in the light of historical experience and the need for business capital expenditures, would be one of the difficult decisions to be made under this approach.

Tax Revenues

To the extent that the tax measures here proposed are cast in the form of tax increases for exceeding a guideline, rather than tax reductions withheld, some incremental revenues would be collected. Their magnitude would depend on the nature of the guidelines set and on the magnitude of penalties in relation to violations. These additional revenues could be utilized to reduce the income tax burden. Given the uncertainty of these additional revenues, however, a precise link could probably not be established.

Expected Duration of the Plan

Since inflation is expected to come to an end under the plan, the arrangements insofar as they do not involve carryovers from the operative period of the plan, should be terminated when success has been achieved. It might be better to reinstate the scheme if inflation should revive thereafter.



a time when it is not needed. Even after termination of the plan a better understanding of the role of wage increases in price determination should prevail and should make it easier to avoid renewed bursts of inflation.

Alternatively, the arrangements could be kept alive even during a period of stable prices as a means of permanently facilitating lower rates of unemployment. It is the pressure of strong demand for labor which, at low levels of unemployment, tends to give rise to excessive wage increases. The threat of such increases, implying demand pull inflation, in turn prevents the adoption of fiscal and monetary policies that would lead to such lower levels of unemployment. If the wage-increasing effect is restrained by a tax-oriented incomes policy, the achievement of permanently lower levels of unemployment should be within reach.

It should be clear, however, that TIP cannot serve as a counterpoise to, or justification for, overly stimulative fiscal and monetary policies. The rate of growth of the money supply would have to be reduced in line with diminishing inflation and eventually would have to be stabilized at a level consonant with the rate of real growth and the trend in velocity. Fiscal policy would have to limit the government's demands on the credit markets to whatever could be financed with that rate of money growth at stable prices and interest rates consistent with full employment.

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