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Statement by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

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I am pleased to present before this distinguished Committee my personal views on the subject of tax-based incomes policies (TIP). Among the several versions of TIP that have been under discussion, my testimony will focus on the approach colloquially referred to as the "stick approach," on which Professor Sidney Weintraub of the University of Pennsylvania and I have collaborated since 1971. The stick version of TIP seeks to restrain inflation by imposing a tax on employers granting excessive wage increases. There is no interference with the forces of the market: employers who, for some reason, wish to raise wages substantially, can do so; TIP, therefore, in no way involves wage and price controls.

Various other forms of TIP have been proposed, especially the "carrot" approach, which rewards employers and employees for maintaining moderation in wage increases. A few comments on the differences between the two approaches will be made later in this testimony. I would like to stress, however, that what counts at this time is the general principle rather than the specifics. What needs to be examined now is whether any form of TIP can contribute to restraining inflation, rather than whether one or the other version may be preferable.

If other well-functioning weapons against inflation were readily available, there would be no need to discuss TIP. It is because the orthodox methods work slowly that leads me to believe that a device such as TIP, despite its obvious inconveniences, deserves consideration at this time.

Fiscal and monetary policy, the orthodox weapons against inflation, so far have not been successful in winding it down. This does not mean that they would be without effect in the long run. Nor do I believe that the cost of applying them, measured against realistic alternatives, would be as high as is sometimes believed. The alternative to successfully combating inflation is not a constant rate of inflation. We do not have the choice between doing something about inflation and leaving it alone. Left alone, it will accelerate. This tendency results from the fact that inflation increases the degree of uncertainty with which all participants in the market must cope. Thus business, labor, borrowers, lenders will all tend to inject mounting insurance premia into their wage, price, and interest rate behavior to guard against the contingency of higher inflation. Inflation itself tends to generate accelerating inflation unless effectively restrained. Accelerating inflation, however, means sure recession sooner or later. The cost of letting inflation run, therefore, is higher than even a costly form of restraining it.

TIP, moreover, should not be viewed as an outright alternative to monetary and fiscal restraint. In 1971, wage and price controls were viewed as such an alternative, and fiscal and monetary policy accordingly turned expansive. I do not believe that TIP could offset the consequences of excessively expansive monetary and fiscal policies. Some restraint by use of these traditional tools will continue to be needed.

Nevertheless, an appropriate combination of TIP and the standard tools of fiscal and monetary policy offers great promise for the longer run, once the present inflation has been wound down. TIP, continuously employed, would exert continuous restraint on wages and prices. This means that fiscal and monetary policies could be somewhat more expansionary once reasonable price stability has been restored. TIP would tend to reduce the "noninflationary rate of unemployment." Whatever the level of unemployment consistent with reasonable price stability (or a constant rate of inflation), the restraints imposed by TIP would tend to make it somewhat lower. Fuller utilization of resources and larger output would thus become possible. The payoff to a successful effort to wind down inflation would thus become very large over time.

Distinctive Features of Carrot and Stick Approach

Both approaches rest on the well documented fact that prices follow wages. Numerous researchers have arrived at that conclusion. At the same time, of course, prices influence wages, although the relationship is less close. There are other cost factors that often are claimed to be responsible for inflation - high profits, high interest rates, monopolistic practices, high prices of food, of oil, and the depreciation of the dollar. While at times each of these does exert an effect, the main factor governing prices nevertheless is wages. With about 75 per cent of national income representing compensation of labor, it could not be otherwise. All other elements, although at times possibly significant, are bound to be small by comparison. Therefore, restraint of wages means restraint of prices. Labor does not lose from wage restraint. Whatever it gives up in the form of higher wage increases, it can expect to get back in the form of lower price increases.

Such unchanging real wage gains as wages and prices decelerate is all that the stick approach offers. The carrot approach offers that, plus the benefits from a tax bonus. The stick approach operates by shifting the balance of bargaining power between management and labor. The carrot approach breaks into the wage-price cycle by providing a tax bonus for wage earners -- and possibly price setters -- conditional on wage and price restraint.

There are further differences inherent in the two approaches. One difference is implicit in the fact that adherence to a carrot scheme can be made voluntary but also would probably have to be made universally accessible. The stick approach would have to be mandatory but could be limited to a group of the largest firms. Another difference would result if the carrot approach were so formulated as to require meeting a wage guideline accurately on penalty of losing the carrot. The stick approach proposes the penalty to be scaled to the degree of overshooting of the guideline.

Finally there is the fact that thanks to its voluntary character and availability of a reward the carrot approach should be more readily acceptable while the stick approach avoids a revenue loss and may even yield additional revenues.

Form of Tax Under Stick Approach 1/

A penalty in the form of an increase in the corporate income tax rate, equal to some multiple of the excess of a wage increase over a guideline, is one of several options. It would have the advantage of relative difficulty of shifting the burden to consumers. It would have the disadvantage, on the other hand, of uneven impact as between capital intensive and labor intensive firms. Also, it would not be applicable to firms with losses, although such firms are perhaps less likely to grant excessive wage increases. The difficulty of applying an incomes tax penalty to unincorporated business, nonprofit institutions, and governments, would not weigh heavily if TIP is applied only to a limited group of large corporations.

Disallowance of an excess wage increase for corporate tax purposes would be a second option. It has the advantage of simplicity and of having been on the statute books on prior occasions. Its main disadvantage is greater shiftability.

A payroll tax offers a third option. Against the advantage of simplicity of administration stands the fact that it appears to penalize labor when the purpose of the tax is to exert pressure on management.

1/ These and many other technical aspects are examined by Richard E. Slitor in a report, "Tax-Based Incomes Policy: Technical and Administrative Aspects," prepared for the Board of Governors of the Federal Reserve System.

The Guideline

The setting of a guideline for nonexcessive wage increases is not as critical a decision within the TIP framework as is sometimes argued. The consequences of a relatively high guideline can be compensated by more severe penalties for overshooting. The likelihood that a relatively low guideline will be frequently overshot can be compensated by a more moderate penalty. The concern that a guideline will become the minimum rather than the maximum should be largely allayed by the favorable effects of a guideline on wage setting in smaller firms, unincorporated businesses, and other employers that probably would not be covered. The guideline should embody the well-known principle that nationwide rather than industry or firm-wide productivity gains are the proper standard for wage increases. The guideline would be the sum of this long-term nationwide productivity trend and an amount, such as perhaps one-half of the going rate of inflation, that would allow for the fact that inflation must be wound down gradually rather than overnight. At the present time, this sum might be 5.5 per cent, reflecting 2 per cent for productivity and 3.5 per cent for inflation. The guideline would have to be reset periodically, perhaps annually, at lower levels ideally, until wage increases equal productivity gains.

If prices follow wages, as can be expected, labor would not suffer from accepting a moderate guideline even if, at the original rate of inflation, this guideline seemed to leave no room for real wage increases. As inflation decelerates, real wage gains will be restored to their normal level, i.e., on average equal to average productivity gains.

Costing the Wage Increase

To establish the tax consequences of overshooting the wage guideline, exact costing of a bargaining agreement including all types of fringes, is necessary. This requires measuring the total increase in compensation, including pensions, medical benefits, cost-of-living adjustments, improvements in working conditions, and others. It also becomes necessary to determine the increase per employee, or per hour worked, or per hour worked in each differently paid employee category. In all probability, the best approach would be an index of increases covering all employee categories, weighted by hours worked.

For both types of calculation -- total increase in compensation, and the per cent increase for a given firm -- there are well established precedents. The Internal Revenue Service continually has to deal with the question of what constitutes compensation and what does not. From the experience of the Council on Wage and Price Stability and before it that of the Pay Board, which administered wage controls during Phase Two, the problems involved in costing out a percentage increase are familiar. They are not simple, but they would yield to careful writing of regulations. The task would be made easier if the number of firms to be covered is limited. It would be eased also by the fact that small differences between taxpayers and the IRS would have only small consequences in terms of the penalty to be assessed under a graduated penalty scheme.

If a surcharge on the corporate income tax is employed as the tax "stick," the unit for which the wage increase must be computed clearly must be the parent corporation, rather than particular subsidiaries or plants. This means that a number of bargaining units may be involved, with different wage settlements. The fact that in such a situation management would be impelled by TIP to resist all wage increase demands, both high and low, is not a disadvantage, however. Wage restraint, to the extent possible, should be applied with equal strength at all margins.

Coverage

Conceptually, TIP can be applied to all employers, including unincorporated business, nonprofit institutions, and governments. Penalties other than the corporate income tax would, of course, have to be employed for some of these. In practice, limiting applicability to the largest thousand or two thousand firms seems preferable from an administrative point of view. The largest one thousand firms alone cover about 26 per cent of all nongovernmental payroll employees. These firms also are the pattern setters for wages so long as the economy is not overheating. The existence of a guideline should help uncovered employers restrain the demands confronting them.

Narrow coverage would reduce a number of troublesome administrative problems. Among these are problems of new firms, and of merging or splitting firms.

One possible defect is inherent in narrower coverage. The closeness of the relation of prices and wages may diminish if coverage is incomplete. A loosening of this linkage could, of course, occur in special circumstances. A manner of dealing with it is outlined in the next section.

Restraining an Increase in Profits

In terms of nationwide averages, prices move with wages. Under some circumstances, the link may loosen. Some of these instances are not capable of being remedied. For instance, a decline in productivity, a rise in oil prices, and the consequences of a drop in the dollar, are "real" phenomena which affect the availability of goods. They are bound to affect real wages. This is not the case, however, of a loosening of the linkage of wages and prices that is reflected in a change in profit margins. In the unlikely event that deceleration of wages should fail to be followed by deceleration of prices without any of the above noted factors being present, profit margins would widen. The share of profits in GNP, in that event, would rise as a consequence of wage restraint.

This contingency could be guarded against by changing the corporate profits tax rate in such a way as to restore the after-tax share of profits to its previous level. In order to eliminate the influence of purely cyclical factors, some benchmark for the profit share based on historical relationships might be established. A tax designed to hold profits down to this share could be regarded as an "excess profits tax" on the profits of the entire corporate sector. It would fall on corporations with high and low earnings. It would probably have a very moderate impact, thereby avoiding the familiar drawbacks of an excess profits tax geared to the profits of particular enterprises. Given the close historical link between wages and prices, this "corporate sector excess profits tax" probably would rarely, if ever, be triggered. But its existence would serve as a protection against an adverse shift in the distribution of income.

Revenues

Neither the penalty tax on excess wage increases nor the "corporate sector excess profits tax" are intended to raise revenue although they may do so. Any revenue that does accrue could be employed to reduce income taxes. The amounts raised by the penalty tax depend, of course, on the level at which the guideline would be set and on the penalty rate on overshooting these guidelines. The objectives in setting rates should be not the raising of revenue, but the optimal functioning of TIP.