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**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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System which includes twelve regional banks located around the nation as well as the Board of Governors in Washington. The Federal Reserve System was established by Congress in 1913 primarily to manage the nation's monetary affairs. Supporting functions include clearing checks, providing coin and currency to the banking system, acting as banker for the Federal government, supervising commercial banks, and enforcing consumer credit protection laws. In keeping with the Federal Reserve Act, the System is an agency of the Congress, independent administratively of the Executive Branch, and insulated from partisan political pressures. The Federal Reserve is self supporting and regularly makes payments to the United States Treasury from its operating surpluses.

Containing inflation is regarded by many observers as today's most pressing economic policy task. Current anti-inflation proposals range all the way from steadying the growth of the money supply at a constant rate to imposing wage and price controls.

This issue of the *Business Review* presents arguments for and against an anti-inflation proposal that has been discussed at length in policy circles but has received only limited exposure to the public at large. The case for a tax-based incomes policy (TIP) is presented by Laurence S. Seidman. Gary P. Gillum explains why he has reservations about the effectiveness and the cost of TIP.

Each author's views are his own. Neither should be interpreted as representing an official position of this bank or of the Federal Reserve System.—J.J.M.

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.

The Wage-Productivity-Price Link. An anti-inflation strategy that is to be successful

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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 6 percent. In contrast, in the early 1960s, 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 must eventually occur if price deceleration is to be more than temporary.¹ 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 on average stable. 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 wage 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.² 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

¹Even 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.

²See Donald J. Mullineaux, "Money Growth, Jobs, and Expectations: Does a Little Learning Ruin Everything?" *Business Review*, Federal Reserve Bank of Philadelphia, November/December 1976.

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 those 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 policy-makers 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.³ 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.⁴

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.⁵ 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.⁶

It has been suggested that this unrespon-

³George Perry, "Slowing the Wage-Price Spiral: The Macroeconomic View," *Brookings Papers on Economic Activity* 2 (1978).

⁴Arthur M. Okun, "Potential GNP: Its Measurement and Significance," *Proceedings of the American Statistical Association* (1962), pp. 98-104.

⁵Michael Wachter, "The Changing Cyclical Responsiveness of Wage Inflation," *Brookings Papers on Economic Activity* 1 (1976), pp. 145-146.

⁶Like others who advocate the monetary strategy, however, Wachter himself believes that his own equation overestimates the cost of using monetary deceleration alone because it underestimates the reduction in wage growth that would result from the monetary strategy. The reason he offers is that a well publicized monetary strategy would feed back into the wage growth process by lowering people's inflation expectations.

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 3 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 1975 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 Weintraub (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 guidepost and impose a tax surcharge on the corporate income tax of any large corporation which exceeded that guidepost. The wage guidepost would apply to all employee compensation, including executive compensation and fringe benefits. Suppose, for example, that the initial wage guidepost 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 6 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 52 percent.⁷ As the inflation rate came down, Congress would

reduce the guidepost 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

⁷Inaugurating TIP does not mean that corporate taxes would have to be driven higher. In fact, TIP would be compatible with a reduced base rate for corporate taxes, which might be favored, for example, to encourage capital formation.

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 9-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 9 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 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.⁸

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.

No 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 throughout 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

⁸As 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 policy-makers are 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.⁹ 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 im-

pact; it would occur only when the markup was widened to cover the TIP surcharge. Thereafter, wage deceleration would dominate price 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 1960 to 1966, 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 1970 to 1976, real wage growth and productivity growth were both approximately 1.6 percent, while money wage growth averaged 7.8 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

⁹See L. S. Seidman, "Would Tax Shifting Undermine the Tax-Based Incomes Policy?" *Journal of Economic Issues*, September 1978.

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-

ment and low profits and sales will monetary deceleration cause firms to grant significantly smaller wage increases.

TIP is an indispensable complement to monetary deceleration and fiscal restraint. Like voluntary guidelines and controls, TIP tries to influence wage and salary increases directly. But unlike these traditional incomes policies, TIP is fully compatible with our decentralized market economy. TIP would provide a tax incentive—limited to large corporations—to reduce wage and salary increases. Each corporation and union would then be free to weigh the incentive and respond as they wished, without government interference. The overwhelming majority of firms in the economy would be exempt from TIP and would bear no compliance cost. Like the investment tax credit or accelerated depreciation, TIP would complicate the tax code for the two thousand largest firms, but it would leave each firm free to make its own decisions.

With TIP directly countering wage growth inertia, monetary deceleration could reduce inflation permanently without subjecting the economy to severe stagnation. Although TIP would impose an efficiency cost on the economy, it seems likely that this cost would be outweighed by the benefit of the lower cost of decelerating inflation. The burden of the cost of TIP would be spread throughout the population, while the burden of decelerating inflation without TIP would fall disproportionately on the unemployed. The two strategies therefore differ with respect not only to economic efficiency but also to social equity and stability.

TIP is a limited intervention that preserves decentralized decisionmaking, the economic freedom of each corporation and union, and the role of market forces in guiding resource allocation. It deserves careful consideration.

¹⁰See L. S. Seidman, "TIP: Feasibility and Equity," *Journal of Post-Keynesian Economics*, Summer 1979.

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The Men Who Made the Fed



Federal Reserve Bank of Philadelphia

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.

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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 TIP⁷. 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.

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

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

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

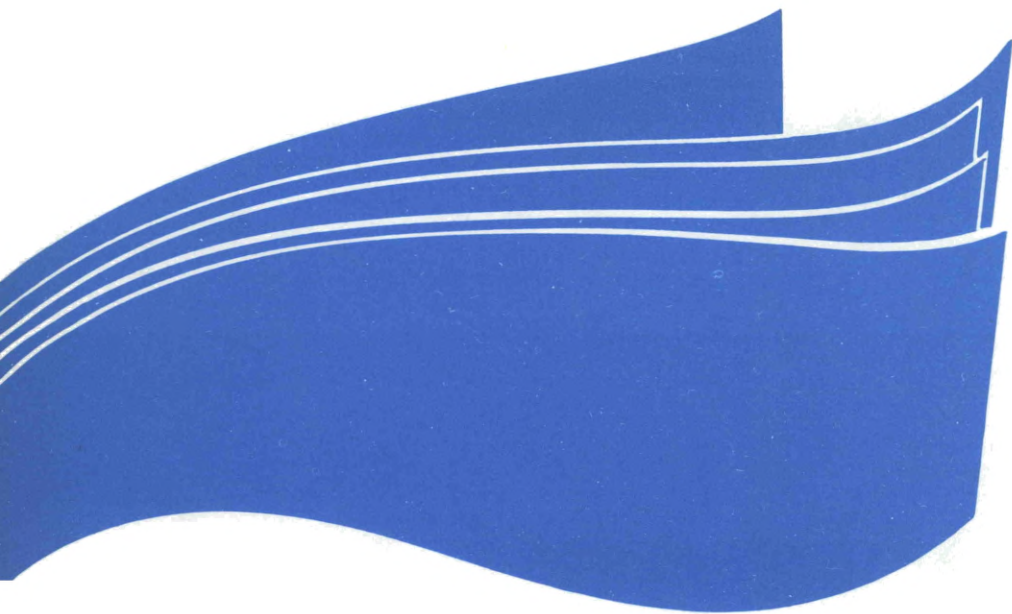
¹¹In fact, the higher the tax rates, the more closely TIP will resemble wage controls.

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.

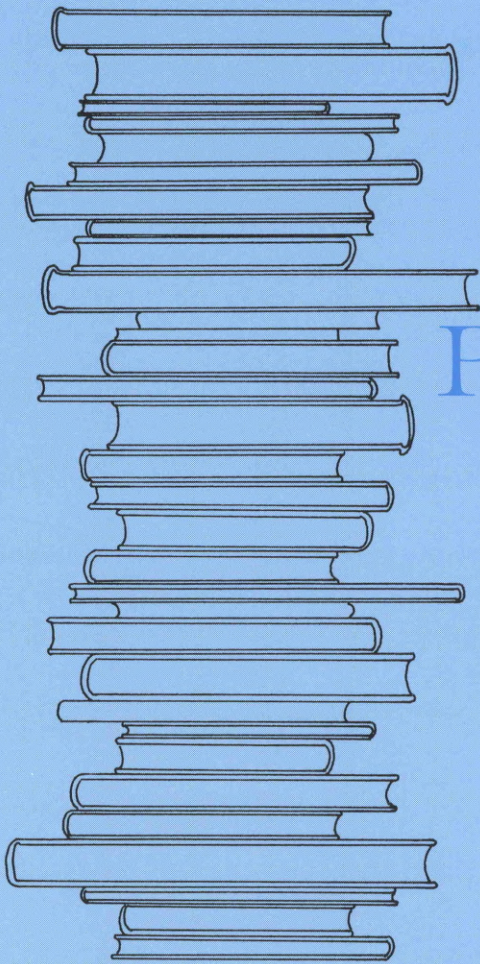


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