



CAN WE LIVE WITH 5% INFLATION?

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This evening I want to talk to you about a disease . . . a disease, not of the organic sort that kills people, but rather a disorder of an economic nature which, if ignored and not cured, can ultimately destroy the economic fiber of this Nation. What I am referring to is inflation . . . inflation, not of the runaway, double-digit sort that accompanied the OPEC price increases in 1973 and 1974 . . . but rather a subtle and far more dangerous form of inflation. I refer to the chronic, persistent 5% - 6% annual rate of inflation which has become ingrained in our economy and which seems to be accepted by the American people as something we can tolerate and live with.

By accepting 5% annual inflation, we are behaving like an individual with a low-grade infection. Our current discomfort is not severe enough to cause us to go to the doctor and seek a cure. It doesn't cause acute pain, so we seem to hope that, if we ignore it long enough, our malady will go away of its own accord.

Unfortunately, just as a low-grade infection, if not treated, will ultimately debilitate an individual and make an ultimate cure much more difficult to come by, a 5% - 6% annual rate of inflation, if permitted to continue indefinitely, will eat away at the fabric of our economy and ultimately destroy our ability to achieve future growth and prosperity.

For nearly a decade now, inflation in our economy has averaged more than 5% annually. Specifically, from 1967 to 1976, inflation averaged 6.1%. Stated another way, a 1967 dollar is worth only 58 cents today in purchasing power. While we are thankful that the double-digit inflation of 1974 has subsided, current trends of inflation continue to hover in the 5% - 6% range with little prospect of early reduction downward. In the past four quarters, prices have risen 6.8%. Most recently, during the second quarter of this year, the most recent quarter for which data is available, the money supply has expanded 8.7% which portends further increases in the price level at rates significantly in excess of present rates of growth.

These statistics are alarming in themselves. Even more alarming is the "we can live with 5% inflation" attitude that seems to have become an accepted fact of life. Hardly anyone believes the rate of inflation in the U. S. will drop below 5% a year in the foreseeable future. But few find that belief particularly alarming. A rise in the price level of 5%

over a year's time just isn't sufficiently jolting. Besides, it is argued, if we all know what the rate of inflation is always going to be, we should be able to protect ourselves from its effects.

Let's examine this premise. Can we really adjust to persistent inflation without experiencing harmful consequences? I think not. A steady rate of inflation will reduce the take-home pay of taxpayers; it will lessen the incentive to produce; it will seriously limit capital formation so necessary for our future economic growth.

Consider the plight of the individual who retires in 1977 at age 65 on a \$10,000 a year pension. After ten years of retirement, if inflation has continued at an average of 5% a year, his \$10,000 pension will buy \$6,139 worth of goods and services.

With advances in the medical sciences, there's an excellent chance our 1977 retiree will still be living and healthy in 1997 at age 85. But by then he may question whether long life is really a blessing because his \$10,000 pension twenty years hence will be worth only \$3,769 in today's dollars. Over twenty years, his pension will have lost two-thirds of its purchasing power.

The reduction in the purchasing power of fixed incomes is only the most obvious adverse effect of constant inflation. There are other adverse effects of persistent 5% inflation.

If inflation continues at an annual rate of 5% for the next twenty years, in 1997 a suit for which you'd pay \$85 today would cost \$225. A car that now costs \$4,500 would sell for \$12,000. A house that would cost \$40,000 on today's market would cost \$106,000 twenty years hence.

Some would argue that wages will increase proportionately and, therefore, working individuals would not suffer. This isn't true, because under our system of progressive income taxes, take-home pay would be reduced.

If the federal income tax tables that are in use in 1977 are still in use in 1997, the take-home pay for an entry level job that today pays \$6,000 a year, even if adjusted upward for inflation, would not increase commensurate with the inflationary rise. Today, on an income of approximately \$6,000, a worker would pay a federal income tax of less

than 10%. By 1997, if we had experienced 5% average annual inflation, that worker would receive a gross income of \$16,500, on which his federal income tax rate would be about 15%. This is because his increased earnings would place him in a higher income tax bracket. His net income after taxes would be \$14,100. If inflation persists at 5% a year, his take-home pay of \$14,100 would have purchasing power equivalent to take-home pay of \$5,160 in 1977. Thus, while the total dollars received by our wage earner twenty years hence will be significantly greater, his actual purchasing power will be reduced by approximately 10%.

Now some people would object to this scenario. They would say it's unrealistic to assume that the income tax structure will not be adjusted downward during the next twenty years to compensate for the effects of inflation. That may happen, but past experience is not very reassuring in this regard.

During the past 10 years of substantial inflation, very little has been done to adjust or index the tax structure for inflation. It's expecting a lot of government not to take advantage of every opportunity to increase its revenues. It is fair to assume that over the years some adjustment to the income tax structure will occur. But if past experience is any criterion, such adjustments are painfully slow in happening and there is little assurance, with a progressive income tax, that a taxpayer's take-home pay will keep up with inflation.

Likewise, given our corporate income tax structure, inflation has had an adverse impact on business capital formation. Plant replacement costs have risen sharply in recent years. However, depreciation deductions are based on original cost. Profits are thus overstated as real depreciation exceeds that amount which is deductible for tax purposes. This also results in an increasing portion of the Nation's income being channeled into the Government sector, and less into capital formation.

Inflation has the effect of raising taxes without the unpleasant aspects of legislative action. It is an automatic means of increasing the size of the Government sector and reducing the private sector. As government expands, the private economy has less and less incentive to produce, with less and less inclination to save and to invest in both human and nonhuman capital. It is reasonable to believe that an increasingly pervasive government would not only control an ever larger share of the Nation's wealth, but that it would also eventually significantly reduce the rate of growth of the Nation's total wealth.

Up to this point, I have attempted to emphasize what continued inflation at a constant level will mean to individuals, to business and to our Nation as a whole. Unfortunately, there is very little evidence that inflation can be contained at a constant level.

After experiencing an unacceptable rate of inflation for the last 10 years, how can we assume that the factors that contributed to a 5% average rate of inflation will not ultimately lead to even higher inflation? If we as a Nation can adjust to an attitude that "we can live with 5% inflation," what is there to prevent our tolerating 7%, 10%, 12 or even 15% inflation in the future? Certainly we can expect a continuation of the same pressures that have brought us to our present predicament. We can expect continued demands for deficit spending to satisfy the desires of special interest groups. We can expect continued calls upon the Federal Reserve to expand the money supply in order to keep interest rates low. We can expect continued pressure for our central bank to monetize the federal debt rather than the politically unpopular alternative of higher taxation. Each of these pressures is inflationary; each could lead to further inflation in the future.

The very fact that we have permitted 5% average inflation over a 10-year period reflects a lack of discipline in fiscal and monetary policies that could generate further excesses in the future. It is somewhat like the individual who develops a drinking habit that starts with two drinks a day, then escalates to three, then four, then six, then eight, and suddenly we have a full-fledged alcoholic. A "we can tolerate 5% inflation" attitude can become as addictive in an economic sense as drugs or alcohol can in a physical sense.

By yielding to the we-can-live-with-inflation syndrome, we are jeopardizing our economic health and even our national life. We are condemning everyone on a fixed income to an ever declining standard of living. We are permitting the transfer of wealth from private ownership to government ownership. We are subverting our traditions of individual initiative and free enterprise. Finally, we are risking a catastrophic acceleration to double-digit inflation that would be far more difficult to bring under control than our current 5 or 6% inflation.

A persistent low-grade inflation fever is symptomatic of a pernicious disease that can be deadly if it is ignored. We must seek a cure, and to find the cure we must look to the causes of our affliction. The fundamental cause of inflation is a national insistence that government give us more than we are willing to pay for on a current basis.

The ultimate cure, then, is obvious: we must ask less of government and more of ourselves.

We must overcome our national habit of turning to Washington for a solution to every problem we encounter. We Americans used to be fond of saying, "There ought to be a law." A modern version of that expression might be, "There ought to be a program." And a new federal program requires a new federal agency that will make additional federal expenditures.

Rather than relying so frequently on big government, we must renew our faith in self-reliance and free enterprise.

Perpetual inflation is both a cause and a symptom of a drift away from government as a guardian of liberty and toward government as the supreme authority. To embrace the we-can-live-with-inflation syndrome makes sense only if we are willing to see America move in that direction.

If you believe, as I do, in the capacity of free individuals to manage their own destinies, then you will agree that we must summon the will to rid ourselves of this affliction that threatens to destroy the vitality necessary for the survival of a free people.