

Statement of

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AS AMENDED

Mr. Chairman and Members of the Committee:

Inflation can have many causes. Traditionally, inflation has been associated with high levels of economic activity--either very rapid growth or high levels of resource utilization. But inflation can develop or persist in periods of slack activity as well. Most recently, unprecedented high rates of inflation occurred simultaneously with our deepest postwar recession.

The downturn in economic activity in 1974 was accompanied by a 12.2 percent increase in the Consumer Price Index (CPI), the greatest yearly increase since 1947. The Wholesale Price Index (WPI) jumped 20.9 percent over the same period, with prices of industrial commodities rising 25.6 percent. The "double-digit" inflation of 1974 was linked to unusual dramatic increases in food and energy prices that are not expected to recur in the near future. However, inflation seems likely to persist in the 5 to 7 percent range over the next few years, a figure well above the historical average of 3 to 4 percent, despite considerable unused capacity in the economy and high rates of unemployment.

Inflation can have adverse impacts on certain groups in the economy. A traditional view holds that inflation has an adverse effect on creditors (due to the eroded value of their assets) and persons on fixed incomes; on the other hand it benefits debtors (as the real value of their obligations diminishes). But the distributional effects are more complicated than this. Sustained inflation leads to higher interest rates which may largely eliminate the debtor-creditor effects. Inflation that

originates in higher food and energy prices erodes nonfarm consumer purchasing power to the benefit of food and energy producers. The recent inflation has had, on balance, an adverse effect on the American consumer, adding to the burden of recession and unemployment. Because of these harmful effects, there is bound to be public pressure for achieving price stability in inflationary times.

Inflation and the Federal Budget

Inflation also affects the federal budget. The Congressional Budget Office recently issued a detailed analysis of the budgetary implications of inflation, entitled The Effect of Inflation on Federal Expenditures. With your permission, Mr. Chairman I would like to place that report in the record and summarize it very briefly.

The level of federal expenditures is directly affected by the rate of inflation because cost-of-living escalator clauses are built into many entitlement programs such as social security and because cost increases automatically cause some expenditures such as medicare benefits to rise. Over 60 percent of federal expenditures in fiscal year 1975 were for programs that are adjusted automatically for inflation, so that a 1 percent increase in the price level induces a 0.6 percent automatic increase in federal government expenditures.

Spending in non-indexed programs may be adjusted for inflation on a discretionary basis in an effort to keep real outlays constant. Our analysis shows that historically these adjustments

have occurred. However, there is a lag in the response of federal expenditures to inflation, so that in the short run, the effect is less than one-to-one.

On the revenue side, a 1 percent increase in prices generates a 1.2 percent increase in revenues due to the progressivity of the tax structure. This implies that the effect of inflation by itself is to reduce the federal deficit or increase the surplus, since automatic tax increases are not fully offset by expenditure increases. If one regards deficits as bad, that may be one of the good things about inflation--one of the few.

Sources of Inflation

It is important to distinguish between the initial causes of inflation on the one hand, and the processes by which inflation is transmitted and perpetuated on the other. From a policy perspective, initial inflationary influences need to be carefully monitored so that they can be avoided or offset. But it is because of the transmission processes that inflation persists long after the initial causes have disappeared. These processes need to be understood and mitigated if we are to overcome a persistent legacy of price increases resulting from unforeseen or unavoidable inflationary episodes.

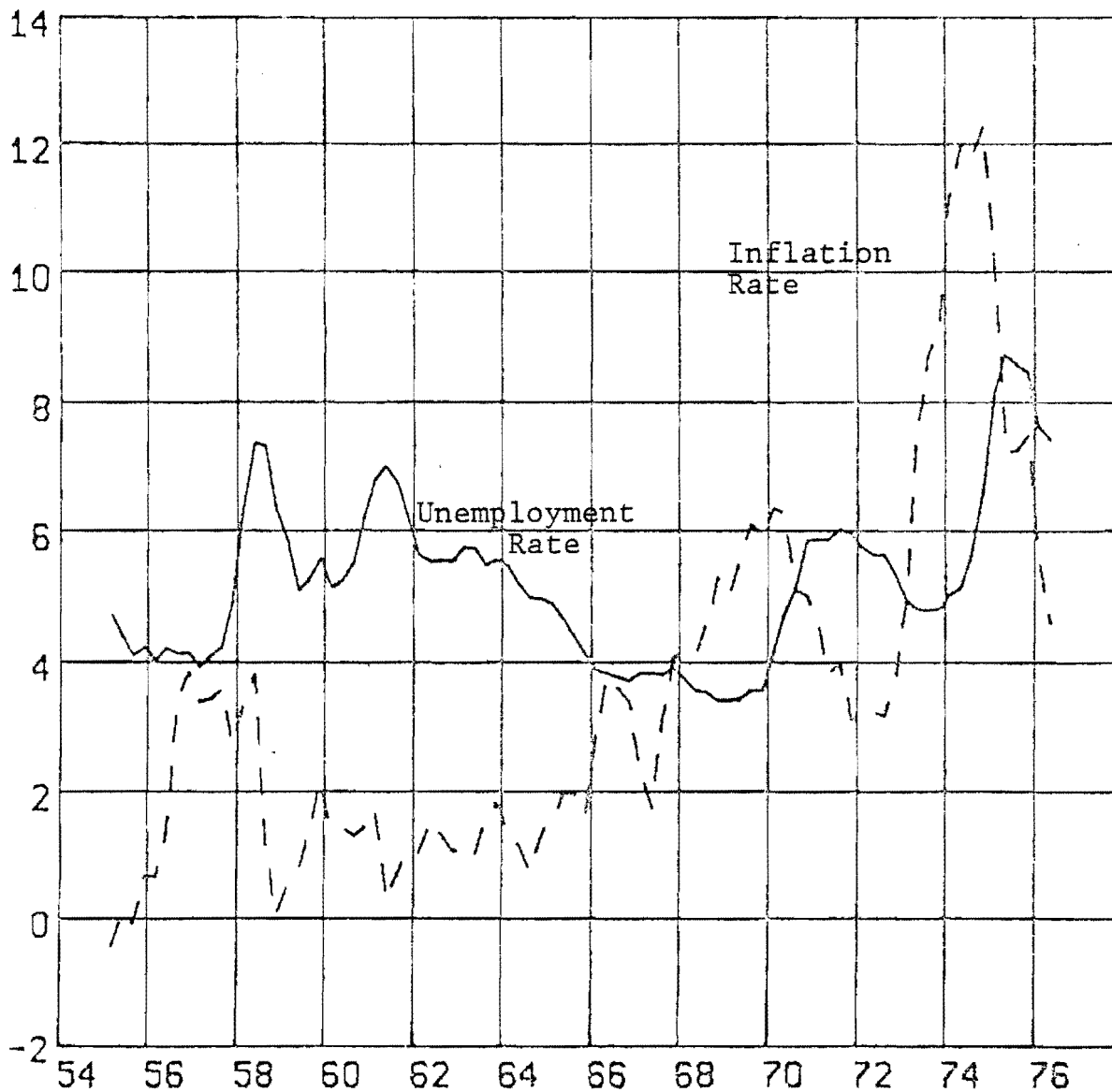
Various factors can initiate inflation. The classic case is a speedup of money demands when the economy is operating at or near capacity. Expansionary fiscal policy under such conditions adds to demand without increasing capacity and, hence, contributes to inflation. If monetary growth accommodates growing demands an inflationary spiral can continue indefinitely.

In the U.S. over the last two decades, as seen in the accompanying chart, periods of low unemployment have generally been followed by an upsurge in inflation. From 1966 to 1969, for instance, unemployment remained below 4 percent for four years while inflation escalated from 1.9 percent in 1965 to 6.1 percent in 1969. Monetary growth and the increased budget deficit contributed to the inflationary spiral. Monetary growth averaged 5.7 percent from 1966 to 1969 compared with 3.3 percent from 1961 to 1965. The federal budget deficit moved from \$1.6 billion in 1965 to \$25.2 billion in 1969. Tax increases, cutbacks in government spending, and monetary restraint would have reduced inflationary pressures on capacity.

Moreover, rapid rates of growth can lead to structural bottlenecks and shortages even when GNP is below potential, and such shortages can cause price rises that will be transmitted economy-wide. Remedial policies in this case include slower growth (although if unemployment remains high this may be a costly and unpopular strategy) or structural measures to reduce shortages--for instance, reduction of import restrictions, sales from stockpiles, subsidies to firms or industries in exchange for not raising prices, and measures to reduce demand for scarce commodities. Bottlenecks in a few critical industries were among the causes of inflation in 1973, which took place even though unemployment was not nearly as low as in 1968-69 or earlier expansions. Some forecasters are predicting a return of the bottleneck problem a year or two hence. However, we do not think that

UNEMPLOYMENT AND INFLATION
1955-1976, Quarterly

Percent



SOURCE: Bureau of Labor Statistics.

NOTE: Inflation is measured by the percent change from two quarters earlier in the Consumer Price Index, expressed at an annual rate.

significant shortages of materials capacity are likely to develop in the next two years, given overall output growth in the 4.5 to 6.5 percent range.

Another source of general inflation is increases in prices of important commodities as a result of "external" factors like world market pressures or monopoly power of foreign suppliers such as OPEC. This is particularly likely to occur for raw materials or food, where U.S. business cycle conditions have little effect on world-market prices. Inflation from this source is also particularly likely to carry the danger of bringing on a recession since this type of inflation reduces the real purchasing power of domestic households. For instance, OPEC price increases in 1973-74 raised the U.S. fuel oil bill by about \$33 billion per year. Since very little of this increased spending on oil and oil products found its way into the pocketbooks of American consumers, demands for other goods and services had to be cut back.

Why Inflation Persists

However it starts, inflation does not usually disappear when its initial causes are removed. Various transmission processes are inherent in the structure and institutions of our economy that cause inflation to persist. The 5 to 7 percent inflation rate we project over the next year or two is primarily the product of these transmission processes.

One such factor is the downward rigidity of both wages and prices. Minimum wage laws, union resistance to wage cuts, and a general acceptance in wage bargains that wages not be lowered in money or even real terms, means that wage gains made in inflationary

times will not be reversed in slack times. Administered prices established in non-competitive industries, together with the fact that downward rigidity of costs produce a similar downward inflexibility of some prices. This means that price increases in individual industries that result from sectoral bottlenecks, shifts in demand, or external price increases tend to result in a rise in the overall price level. This one-way behavior of wages and prices also makes it especially difficult to control inflation by limiting public or private demands, for goods and services, because the demand limitations have major impact, at least at first, on output and employment rather than wages and prices.

Another type of transmission mechanism has developed from an increased "inflationary consciousness" of income recipients. Both expectations about future inflation as well as a desire to catch up past losses due to inflation and recession have an impact on wage settlements and profit setting. Increased use of cost-of-living escalators is one manifestation of the prevailing inflationary psychology. Despite a lack of underlying inflationary pressures, wage increases are projected to be 7 to 8 percent in 1976 rather than the 3 to 5 percent typical of recoveries in the 1950s and 1960s. It will probably take several years for inflationary expectations and catch-up factors to recede, even though unemployment remains very high by historical standards.

Policy Alternatives for Controlling Inflation

At the present time, inflation persists largely because of the continued transmission of post inflationary shocks, not because of new ones. What policies might be adopted that would reduce the

transmission of inflation? As the Committee requested, I shall focus on incomes policy as an anti-inflation measure. However, first I would like to mention other things that have been proposed that might reduce the tendency of our economy to transmit inflation.

On the product-market side, various proposals have been put forth. Some of these would serve to make prices more responsive to contractionary fiscal and monetary policies. These include stricter enforcement of anti-trust laws and overhaul of regulatory procedures. Other measures suggested would put downward pressure on prices by increasing supply. Among these are reduction of import restrictions, sales from stockpiles, and various types of commodity-reserve arrangements.

On the labor-market side, reduction of the minimum wage, repeal or modification of the Davis-Bacon Act, and restrictions on collective bargaining have sometimes been proposed as mechanisms to promote downward wage flexibility in periods of high unemployment. Undesired income effects of these changes might be offset by tax changes favoring lower income groups. Further, measures to increase the employability of groups in the labor force with high rates of structural unemployment, regional labor-market and industrial-development policies, and the like, could potentially lower the unemployment rate and raise real output without adding substantially to inflation. Changes in the unemployment insurance system might have similar effects.

Incomes Policy as an Anti-inflation Measure

The term "incomes policy" refers to a diverse collection of policy actions including various types of wage and price guidelines,

The basic idea behind an incomes policy is to limit nominal wage and profit increases to expected productivity growth and purge them of the influences of expected increases in prices or a desire to make up for past losses in real income. An incomes policy can affect the inflation process in two ways: First, directly, by restraining wage and price increases; and second, indirectly, by reducing inflationary expectations.

Major issues in designing an incomes policy include:

- Determination of the legal basis for the policy; should it be a result of congressional action, or a policy statement of the executive branch?
- Determination of who should decide on the wage and price standards. Should the standards represent a consensus of affected parties or should they be announced or imposed by the government?
- Determination of wage and price standards. How much increase should be allowed? Should there be a uniform national standard or should differentials be allowed on an industry-by-industry basis? How should inequities be handled?
- What enforcement mechanisms, if any, will there be?
- How will labor disputes (strikes, etc.) be handled?
- When, if ever, should guidelines or controls be removed?

Bearing these issues in mind, I would like to review briefly three periods in our postwar experience in which some form of incomes policy was in effect: the Korean War period, the guideposts of the Kennedy-Johnson administration, and the 1971-73 controls.

During the Korean War, Congress passed emergency legislation that empowered the President to impose wage and price controls. The techniques and institutions used during this period drew heavily from the controls experience during World War II. A tripartite Wage and Stabilization Board (WSB) was established--with labor, management, and public representatives--together with an Office of Price Stabilization (OPS) that was not tripartite.

The OPS announced price freezes and other general price regulations, but with the pressure of war demands in certain key industries like steel, it soon became clear that across-the-board regulations were not consistent with efficient allocation of resources on an industry-by-industry basis. On the wage side, the WSB was faced with unscrambling a grossly inequitable wage structure that had emerged from the turbulent year of 1950. Further, there was the need to attain high levels of defense production in the face of extremely shaky labor-management relations. This meant a disputes mechanism would be a necessary component of the wage policy. But it was widely recognized that individually established wage standards were also unworkable.

The history of the controls program in the 1950-1952 period was marked by dissension, frequent changes in the organization and composition of OPS and WSB, and disputes about wage and price regulations. Price and wage standards were set forth in various regulations issued by OPS and WSB. However, individual cases were handled and settled in the courts. An elaborate regional apparatus for case handling was also set in place. Dramatic presidential intervention occurred in the celebrated

steel industry dispute in 1951 and later in the coal mining strike in 1952. Unlike the days of the National War Labor Board during World War II, the WSB had only a limited responsibility for settling disputes. However, unlike the Pay Board under President Nixon, the WSB did bring suit against violators of its wage standards.

The controls program was effectively abandoned in 1953 after the election and in anticipation of the end of the Korean War. How effective the controls had been in restraining inflation is still controversial. Both wage and price performance during the Korean War was better than during World War II, but the pressure of demand was also considerably less. Once controls were removed there was remarkably little upsurge in prices.

A second period of a much less formal incomes policy began with the announcement of wage-price guideposts in 1962 by the Council of Economic Advisers. These guideposts were not the result of tripartite negotiations, nor were they the result of congressional action, but instead were simply part of the government's overall economic stabilization program. Unemployment was relatively high by historical standards when the guideposts were announced and, unlike the Korean War period or the later controls experience under the Nixon administration, there was no impending fear of a serious inflationary outburst or legacy of an inflationary psychology. Instead, the plan was to use expansionary fiscal and monetary policies to restore full employment, with the guideposts serving as a benchmark for non-inflationary wage settlements.

Thus, while price and wage controls under Truman and Nixon were viewed as emergency stopgap measures (and hence explicitly temporary) the guideposts were part of an economic program to achieve full employment without inflation.

The wage standards in the guideposts allowed increases in compensation (wages plus fringe benefits) to match the trend rate of productivity growth for the economy as a whole. In 1964, a numerical target of 3.2 percent was established. This meant that if, for any particular industry, productivity growth equaled the trend, unit labor costs would stay constant (a 3.2 percent wage increase is exactly offset by the 3.2 percent increase in output per hour) and prices should not rise. In industries with rapid productivity growth, prices should fall; in low-growth industries prices should rise. Certain exceptions were to be allowed for very low wages and for areas of extreme labor shortage or surplus.

The Kennedy-Johnson administrations relied on voluntary compliance as an enforcement mechanism, although there was presidential intervention in both wage settlements and price disputes. The simplicity of the guideposts, the lack of a legal basis or social consensus, and the absence of an enforcement or disputes mechanism have led some observers to question whether the Kennedy-Johnson guideposts actually constituted an incomes policy.

Economists have attempted to assess the effectiveness of the guideposts in the 1962-66 period by simulating how the economy would have behaved without them. The consensus of these studies

is that price and wage behavior was more restrained than it had been in the preceding decade and that the guideposts moderated inflation by about 1.0 to 1.5 percentage points per year. However, some people attribute the moderate price performance in those years to increased stability in the composition of aggregate demand. And it is clear that, whatever their effectiveness in the 1962-66 period, the informal guideposts with no enforcement mechanism were useless once aggregate demand pressures pushed the economy near its capacity limits. As demand pressures grew in 1965 and 1966, wage and price increases began to accelerate and the guideposts essentially collapsed.

A much more comprehensive scheme of wage and price controls was established as part of the Nixon administration's New Economic Policy. Unlike the experience in the 1962-66 period, the Nixon controls were adopted after an inflationary psychology had developed and in the face of mounting public pressure to impose controls. An important purpose of the controls system was to reduce inflationary expectations by limiting price increases at the retail level.

In 1970 Congress provided the President with authority to impose wage and price controls. In 1971, President Nixon initiated the first phase of a four-phase program that began by freezing all prices, wages, and rents for 90 days. This was followed by a set of wage standards and price regulations administered by a tripartite Pay Board and an all-public Price Commission. The Pay Board established a uniform 5.5 percent standard for annual

wage increases based on the assumption of a 3 percent productivity increase and a 2.5 percent annual cost-of-living adjustment. Price increases were allowed if they could be justified by increases in costs.

The standards and regulations were intended to be self-enforcing although the Pay Board and Price Commission did review some cases on an individual basis. To rectify all inequities and apply standards uniformly would have entailed a larger administrative apparatus than most people thought was appropriate at the time. Instead, the focus was on reducing the inflationary psychology by maintaining the general credibility of the controls program.

There is general agreement that the price control policy of the Nixon administration substantially reduced the rate of inflation from its inception to the end of 1972. One estimate is that during Phases I and II (August 1971 to January 1973) nonfarm price inflation was about 2.0 to 2.5 percentage points lower than it would have been in the absence of controls. However, some observers contend that price controls merely suppressed inflation in this period and attribute the sharp upsurge in prices in 1973 and 1974 at least in part to the removal of controls.

In 1973 external factors produced sharp increases in food, fuel and other commodity prices. The U.S. economy was growing rapidly, and this coincided with a world-wide boom in which shortages developed for many commodities, resulting in panic buying and withholding of supply. Long lines at gasoline stations were only one symptom of the problem. Major dislocations in agricultural

markets also resulted. Controls could not contain these increases, and only exacerbated shortages before they were abandoned in 1974.

In the present situation, incomes policy as an anti-inflation tool would be more likely to take the form of wage and price guideposts or targets, modified from time to time as the inflation rate changes, rather than an elaborate system of direct controls. Compliance might be voluntary or enforced by tax policy or other means and could conceivably remain a permanent feature of stabilization policy. However, should new demand pressures or shortages occur, controls would be much more difficult to enforce and would probably prove unworkable unless measures were taken to relieve demand pressures or alleviate shortages.

Budgetary Implications

Let me turn finally to the budgetary implications of alternative incomes policies. Administrative costs of an incomes policy need not be large. The Kennedy-Johnson guideposts, for example, had negligible administrative costs.

Some measures have been proposed however, that could entail budget costs in addition to those of simply administering the system. One such idea is to link a guidepost for wage increases to a promise that if prices rise by more than some target amount, income taxes will be cut to make up the fall in real purchasing power. A real wage insurance plan of this kind has recently been adopted in Great Britain. Another proposal is to enforce a set of wage and price regulations by taxing violators. Tax cuts can also be used to offset external price increases in isolated sectors of the economy rather than allowing these to be passed on in the form of higher domestic wages and prices.

Even a program of this kind need not have a large net budget cost if, for instance, it imposes higher taxes on firms that raise prices, but then reduces the overall corporate tax rate to make business tax liabilities unchanged. Alternatively, tax cuts could be offset by expenditure reductions.

Other forms of tax policy that could lower prices would be reductions in sales taxes, excise taxes, and payroll taxes. These reductions would also have substantial budget implications unless revenues lost were offset by other tax increases.

In sum, past episodes of guidelines and controls have seen some temporary successes, but have encountered increasing problems the longer they continued. But there are many forms of incomes policies which this country has not tried at all and whose impact and budget implications are highly uncertain. Since inflationary pressures seem almost certain to continue an increasingly serious effort must be made to seek out and evaluate remedies which do not have the damaging effects on output and employment of contractions in aggregate demand.