Anti-Inflationary Policies in a Democratic Free Market Society

Barry Bosworth

There is no way to say that the battle against inflation in this country is going well, because it's not. In the last few months, mainly because of food prices, the rate of inflation has accelerated dramatically. However, we don't expect that to continue for the rest of the year. Taking a longer perspective on the inflation problem in the United States for the past few years, remember that in 1975, 9 million people were unemployed; the next year 7 million people were still unemployed. By the most conservative estimates we have now reached the "fantastically low" level of 6 million people unemployed in this country.

In the 1960s it would have been unthinkable to predict a three-year period when unemployment averaged around 7 million people each year without any slowdown in the rate of inflation. I remember working on the staff of the Council of Economic Advisers for the Johnson Administration when the unemployment rate was 3 1/2 percent. We thought we could stop inflation if we just let the unemployment rate rise to 4 1/2 percent. We were wrong. In looking at forecasts to see what kind of an unemployment rate it would take to stop inflation, most economists found that our estimates were consistently too low. A look at the behavior of consumer and industrial prices and wages now makes it perfectly obvious that we are making no progress: the rate of price inflation except for minor fluctuations in food prices, has been a steady 6 to 7 percent year in and year out. Until the beginning of this year prices showed no real signs of acceleration, but it was clear there were no signs of deceleration either. On the wage side, despite the high level of unemployment, increases were running at a very constant 7 percent a year for money wages; if fringe benefits and other compensation increases were included, increases amounted to about 8 percent a year.

Our rate of productivity growth has now declined from 3 percent in the 1950s and 1960s to under 2 percent a year; thus we have had unit labor cost increases of 6 to 7 percent a year, almost exactly in line with the rate of price inflation. Now I think that the inflation has reached an equilibrium. The best possible forecast for the next three or four years is an inflation rate of 6 to 7 percent a year. Certainly it is not likely to be any lower. To be realistic, we must acknowledge that none of our forecasts ever anticipates OPEC oil prices, crop failures, commodity shortages, or any of the things that always happen to us but are never anticipated. The risks that inflation will be considerable higher than 6

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to 7 percent three and four years from now are a lot greater than the probabilities that it will be lower.

We must also take into account the fact that we do not like 6 percent unemployment, and we want to make further progress on this front. While we may not want to argue that the rate of inflation will dramatically accelerate if unemployment is reduced, certainly the pressure is in that direction. That too would add to inflation. So if we don't do anything about the problem of inflation, we have to admit that in the next few years we will have at least 6 to 7 percent inflation, and it could be worse.

If we do not regard that as an acceptable outcome, then we must look at what the alternatives are and what policies we can possibly use. The problem that we have always had is that everyone, not just economists, has his own idea of what causes inflation. Perhaps the best procedure to illustrate these ideas is to discuss our limited choices and to look at their consequences.

People frequently propose balancing the budget. Another proposal, which amounts to about the same thing, is to slow the growth of the money supply. Since this is mainly a financial group, I would imagine that such policies are very popular with you. I think we can say frankly that yes, if we balance the budget over the next few years and if we slow down the growth of the money supply, inflation could be brought to a halt. At the same time we must be absolutely clear about the consequences of such actions. Those consequences would be something in the order of 10 to 12 million people unemployed. I know of no econometric study or arguments by economists that say that the cost of price stability to aggregate demand restraint is a lower level of unemployment than that. Most of the studies that I have seen indicate that lowering the rate of inflation by 1 percentage point will take one million people out of work for at least two years. Even if we follow such a policy and achieve price stability, we cannot continue to run an economy day in and day out with 10 and 12 million people unemployed. So we would have to go back to some lower level of unemployment, and as soon as we did that, the expansion period would cause more inflationary problems. When we got back down to the unemployment level that we have today, then the same inflationary problem that we now have would recur.

In other words, I think we have to conclude that within the current institutional structures that we have in this country unemployment, or the fear of increasing unemployment, is just not a viable threat or a viable means of trying to stop inflation. By any definition, the social cost of such policies has become intolerable. For better or for worse the fear of unemployment is not very effective anymore in restraining price increases. I think there are various reasons for this, but the basic cause is that our economy just really is not that competitive anymore. Most Americans do not want a competitive economy. We once had high degrees of competition, with a system that was very effective in allocating resources. But at the same time it was a very cruel economic system. The books of Upton Sinclair and others probably exaggerate the situation in labor markets at the turn of the century, yet they are representative of the type of problems that most of the institutional changes since have tried to address. We changed

the structure of our economy and attempted to make it more humane by dealing with its worst features and the cruelties of competition. But these changes have made the problem of inflation worse; we have given groups in society more and more discretion over their ability to set wages and prices. If we look at the way that labor markets operate today, there is almost no resemblance to the type of labor market that is described in Paul Samuelson's textbook on economics. It is not a competitive labor market, and the factors that determine wages seem to have very little to do with the fear of unemployment.

For example, recently we spent a considerable period of time looking at union wage negotiations and the patterns of long individual union settlements. We have a series on union wage increases and union contract negotiations that extends back into the 1950s. As far as I can detect, the magnitude of union wage negotiations and settlements shows no sensitivity to the unemployment rate. In the 1970 and the 1975 recessions union wage settlements actually were halved, but the magnitudes of the settlements increased during that period. Even adjusting for underlying factors, such as inflation and others that affected those wage increases, unemployment clearly had very little impact on large union wage negotiations. They followed and still follow a life and a pattern of their own. Basically, each union wants what the other union got last time around, so there is a pattern of ongoing settlements. If you look at the whole sequence of the teamsters', the auto workers', and the railroad workers' negotiations, you find the pattern of their wage increases will not vary from one to another by more than about 3 percentage points over the entire three-year contract. They all got almost exactly the same contract. It varies only slightly in terms of how much the wage increase is and how much the fringe increases are.

Many of these labor contracts are so structured today that they build in inflation. In looking at the automobile contract, for example, even before the negotiations open, the companies will owe the union a 27 percent wage increase over three years. This is due to financing the existing benefits of pensions, health care, and vacation days with no expansion, paying a cost-of-living adjustment and the annual productivity improvement factor that the contracts call for in their second and third years. So *many* of these union contracts just build in inflation. Trying to deal with this sort of situation by creating higher levels of unemployment is simply not an effective solution.

At the other extreme, another possible solution that is very attractive to some people is wage and price controls. Although we have no legislative authority to put on controls, we could probably get it in about 24 hours if we really wanted it. However, the administration is determined not to go to controls for another reason, and that is its real belief that controls are not effective. Controls are only a short-term device, and after a period of time people will find ways to avoid or get around them. We have learned that from past attempts. If there is one thing we should know by now, it is that inflation in this country is not a short-term problem. It is deeply imbedded in the nature of our institutions and it cannot be solved by a short-term period of controls.

Therefore, we continue to struggle to find some way to change the institutions to get lower rates of inflation. I think in the short run we are left with

trying to do something in a voluntary program and trying to identify the real alignments of our institutions. How do we change the nature of labor-management negotiations to give people adequate incentives to hold down their wage and price increases without trying to use an incentive that has proved pretty ineffective, namely, increasing the fear of unemployment? I think the administration has finally begun a policy that will be effective in dealing with the problem, at least for the short run. That policy has four basic parts.

First, we must recognize that the government has become a major source of inflationary pressures, not by trying to create too many jobs or by running budget deficits, but by all the other things the government does. All the legislative actions which are responsive to special interest groups, the farm bill that came up a few months ago, and the sugar bill that is currently before Congress are examples. At times the list appears endless. It includes both the regulatory areas and some actions taken because we are afraid of the pressures of international competition. If you look at the last few years, those actions have had a very large and a very significant impact on the magnitude of inflation. For example, we estimate that in 1978 alone three government actions – the minimum wage increase, the Social Security tax increase, and the unemployment insurance tax increase – contributed 3/4 of a percentage point to the 1978 inflation rate. In the field of economic regulation, the most conservative estimates of the activities of EPA, OSHA, and other regulatory agencies suggest that they also account for about 3/4 of a percentage point in the inflation rate. Just that narrow range of government action represents about 1 1/2 percentage points of the overall inflation rate at the present time. So we are trying to figure out mechanisms to limit these actions. We can't promise that the government will never commit an inflationary act again, but we can pledge to commit fewer inflationary acts. We are trying to make major changes in the regulations.

In the past, government agencies regulated without analyzing the benefits or the costs. To clean up the environment, a standard was just set for pollution; the benefits over the costs of this standard were never measured. The administration now requires every regulatory agency to put forth an analysis showing the costs, the benefits, and any alternatives that the agency might have considered when proposing a regulation. To make sure that the agencies really take into account benefit-cost analysis in its final regulation, an interagency review group has been established which is supposed to examine the analysis to see if there is some less costly way to achieve the goal.

Earlier, I would have been quite hopeful that it was unnecessary to cut back on our regulatory goals, and I still think most of them can be achieved. The biggest waste comes from the inefficient way the regulations are carried out. Recently we had our first test of whether the administration would be able to deal effectively with that sort of situation. It was a regulation affecting the textile industry having to do with cotton dust emissions which cause a disease called byssinosis. Well, I have seen some bloody battles in my life, but an attempt to change a minor regulation in several minor respects became about the biggest internal political battle this administration has had in the last two years. We are now at the point where the President's attempt to say anything to the

Secretary of Labor about how a regulation ought to be promulgated leads to court suits because, although you may not realize it, a President's communications with a Secretary of Labor are "ex parte." They must be put on the public record; the public must have an opportunity to comment on them and to refute his statements of how the regulations ought to be enacted. Under the law apparently the President is not entitled to examine how OSHA regulations should be put into effect. That is left solely to the Department of Labor.

I think we do have to find some mechanism to budget Federal regulations and try to scale them down. The most important thing is to find ways to regulate more efficiently.

I am also trying to get businessmen to recognize that part of the inflation problem is their fault. They have to exercise more restraint on their cost increases, and undertake more of an obligation to hold down their price increases. To do that, we have asked each and every business firm to try to hold down its price increases below the last two-year average. On the whole, business firms have been quite responsive. In part, they are no doubt worried about the public implications of criticisms for not cooperating with the government and many of them are genuinely concerned about inflation.

Unfortunately, however, when we tried to point out a similar solution to labor, we made absolutely no progress. Probably our greatest difficulty at present is trying to come up with the means of restraining wage increases, particularly those for the large labor unions.

During past recessions, union wage increases tended to run ahead of and be slightly larger than nonunion wage increases. But they were never before at the magnitude of the last recession or of the magnitude they continue to be at present. Now, the very large unions like steel, autos, airlines, teamsters, railroad unions, and others are getting annual wage increases about 3 percent higher than what everybody else in the rest of the economy is getting. If we are going to slow the rate of inflation, we have to bring the wage increases of those very largest unions back in line with the rest of the economy. In the meantime, unless we achieve success in this area, as unemployment declines and labor markets strengthen, the nonunion sector and the smaller unions will naturally push to get wage increases that match those of the large unions. The differential tends to be closed, not by a slowing of the large wage increases, but by an acceleration of the magnitude of wage increases among the smaller unions.

In other words, the greatest difficulty in slowing the rate of inflation, particularly with respect to wages, is the ability of large unions (which are unresponsive to unemployment and continue year in and year out no matter how economic conditions change) to get wage increases far in excess of the rest of the economy. When good times return, and unemployment fears decline, other people push to get wage increases of equal magnitude. We are beginning right now to get considerable acceleration for the smaller unions and 10 percent annual wage increases are becoming more common. Clearly, without some way to limit the gains of the large unions, I think we will inevitably face a situation where the rate of wage inflation will accelerate over the next year or two and the inflation rate will gradually begin to worsen. One way to measure whether we

are successful in that regard will be the outcome of the teamster and automobile negotiations next year. Because if the teamsters get 10 percent wage increases each year, then all of the big unions will demand matching wage increases. If we embark on another three-year cycle of 10 percent wage increases among the larger unions, the problem of trying to slow down the rate of inflation on the rest of the economy will be largely hopeless. The magnitude of the wage differentials and the accompanying inequities will have become so large that it will be almost impossible to restrain them.

Finally, we recognize that in this inflation there are some special problem areas – the health care sector and the housing industry are two examples – where the rates of price increases have been dramatic. Most Americans are terribly upset about the rate of health care cost increases and would like to do something about it. I would like to point out that we proposed a program to hold down the magnitude of hospital cost increases to the Congress 18 months ago, but neither the Congress nor the administration has made any progress whatsoever in getting that bill decided. It just takes an interminable amount of time for the government to make any change, even when most people seem to agree that there is a basic problem and something ought to be done about those health care costs.

The political processes of trying to get people to agree move so slowly that there is little hope of making the sort of dramatic changes in individual sectors that would have a sharp impact on the rate of inflation. Many people have said that this voluntary program we are trying won't work, and because it won't work, they are not going to do anything. Everybody sits back and waits for somebody else to take action. As a result the program has not had many positive results.

Assessing it sector by sector, the administration's concern about the inflationary implications of its actions shows its willingness to undertake a lot more restraint with respect to the government's regulatory decisions. The President did threaten to veto the farm bill and he has taken stronger action on similar issues than in the past. I also think we have had some encouraging cooperation from business, particularly the basic industries. For example, we have pledges from the steel industry to try to hold down their price increases to a reasonable level. We have a pledge from the automobile industry to cut the size of its price increases this year below those of the last two years. The aluminum industry has made a commitment to hold its price increases considerably below those of the last two years. There are also several other basic industries where individual firms aren't in a position to make a formal public commitment to price restraint, but their increases will be less than the average of the last two years. It appears that their prices are not going to rise as rapidly this year as they did in the past.

So in these basic industries I think we have had considerable support, but right now our problems lie mainly in the labor area, in trying to devise a meaningful formula that will be acceptable to labor. We need some means by which labor is willing to reduce the magnitude of wage increases in large union contracts and that puzzle will be the focus of our policies over the next few months. We will see whether it will be successful in those early contract negotia-

tions of next year. That will be a turning point at least for *this* type of a voluntary anti-inflation program. If it is going to succeed, some signs of success will have to be visible by the first part of next year. Otherwise I think that if those negotiations start over again at their present high levels, then it is unlikely that this type of voluntary restraint approach to inflation can be a successful mechanism.