COMMENTS ON: "TIP FOR INFLATION: WHY AND HOW"

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Dr. Weintraub has presented a proposal which emphasizes his concern about the seriousness of the current inflation and the continuing failure of the national authorities to correct the situation. I agree with his emphasis on inflation as an economic problem, and his analysis of resulting economic inefficiencies. However, I am uneasy about some of the analysis which supports his proposal and some of the effects which he foresees as a consequence of adopting his variation of a national incomes policy.

As I understand his position, Dr. Weintraub's recommendation for a tax-based incomes policy is based on two contentions. First, that alternative monetary and fiscal actions either will not work or are very inefficient -- in the sense that they would cause unacceptable losses in output and employment. Second, that if we are going to use something other than the traditional monetary and fiscal actions to fight the inflation, we should adopt a program which does not interfere with the market system.

Considering these premises in turn, there are four aspects of the proposal which are not handled satisfactorily. First, the manner in which the traditional analysis of inflation, as a monetary phenomenon,

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is dismissed is disconcerting. For example, a contention is made in the paper that inflation cannot be successfully combated by monetary actions because both current and prior chairmen of the Board of Governors of the Federal Reserve System have been "dedicated and implacable inflation foes" and yet the inflation has gotten worse. The clear implication here is that the Federal Reserve has actively pursued an anti-inflationary monetary program and failed. When I started in the Bank twelve years ago, one of the first things I learned from Homer Jones (former chairman) was that there is a distinction between monetary <u>policy</u> and monetary <u>actions</u>. I think that Dr. Weintraub fails to make this distinction, misinterpreting the rhetoric of monetary policy, which has been definitely anti-inflationary, and the deeds of monetary actions, which have not. In those rare instances, such as 1969-70, when the Federal Reserve has undertaken restrictive actions, the restriction was very short-lived. The Fed then backed away just as the anti-inflationary effect began to take hold. The economy was run through unnecessary recessions and periods of slow growth, and the monetary stimulus to inflation was then reapplied. The available evidence on leads and lags shows that the expected result from such a start/stop program is stagflation.

The monetary interpretation of inflation cannot be dismissed as irrelevant on the observation that the Federal Reserve has not reduced the inflation rate. The Federal Reserve has not taken any <u>action</u> to reduce the inflation rate. From a monetarist point of view, the key element is not considered by Dr. Weintraub -- a steady fifteen year acceleration in money growth. Perhaps, before we go on to an alternative proposal, such as TIP, the monetary actions suggested by the prevailing (but certainly not universal) theory of inflation as a monetary phenomenon should be tried.

However, the TIP proposal is also offered as necessary even if we agree that excessive money growth is the culprit in the inflation process. The contention is that monetary restraint is too expensive to employ, in terms of lost output and employment, and a program such as TIP can get to the problem, without this cost. Again, the available evidence seems to argue against this position.

A policy prescription derived from treating inflation as a monetary phenomenon does not necessarily mean that a steady non-inflationary rate of money growth should be achieved immediately. We are not starting with a clean slate. We have a decade of persistently inflationary experience and a large amount of economic behavior which is based on the presumption of continuing inflation. Borrowing Dr. Weintraub's analogy, it is a matter of a doctor advising you that treatment of your ailment is going to incur costs, one of which might be kidney failure. Is it reasonable then to seek other doctors until you find one that assures you that you can be cured at no cost to your kidneys? Are the policy recommendations of this last doctor correct? Not necessarily, but it certainly sounds better.

The other three areas of concern are with the proposal itself. The TIP proposal is based on Dr. Weintraub's well-known and long-standing analysis of the price setting mechanism in the economy -- the mark-up approach to price determination. It is safe to say that there are few people who would disagree with the contention that there is a functional relationship between unit-labor costs and prices. I certainly would not. I do have difficulty, however, making the transition from that empirical relationship to recommendations for an incomes policy. For example, it is true that over time the mark up of prices over unit-labor costs tends to be stable, with a slight trend. What does that tell us about policy? Does that tell us that if we control unit-labor costs directly, inflation will be controlled directly? Not at all. We are talking about a structural relationship within the economy which relates two endogenous variables to each other, with unit-labor costs on the right, "explaining" prices on the left. Unit-labor costs (in terms of rates of change) consist of the rate of change of money wages minus the rate of change of average product of labor. These too are endogenous variables. What causes wages to change? What causes productivity to change?

It is not enough to say that productivity grows at some "normal" rate over time and that wages will rise by whatever the market power of the labor union determines beyond the increase in productivity, simply because these variables have moved in line in the past. Considering relationships between endogenous variables, especially when they are prices, requires careful attention to the general system and the other factors affecting each. The relationship cannot be considered in isolation, without reference to how it fits into and is affected by the rest of the system. Establishment of an artificial relative price between goods and labor, without considering the other forces working on both prices, can only lead to a serious distortion in the system.

This has been the record in each and every case where direct controls have been applied and where fundamental factors, such as money growth, continue their inflationary path.

Thirdly, the TIP proposal is offered as a means to avoid the inefficiencies typically associated with a "mandatory" incomes policy. I have a great deal of difficulty in making that distinction. TIP seems to me to be a mandatory policy. The situation is much like that of the baseball player years ago who took umbrage at an umpire's call and expressed his emotions by flinging his bat in the air. Reportedly, the umpire very casually said, "Son, if that bat comes down, you're in a lot of trouble." By imposing penalities on market behavior in terms of wage, price, and output determination, the government is mandating behavior. By imposing tax penalties (and subsidies) on individual units who deviate from some average standard, the government is simply forcing the relative price mechanism of the markets to impose penalties on those who violate the government's decrees. It is difficult for me to distinguish between mandatory and voluntary on the basis of who administers the penalties.

Lastly, it has become standard that every proposal for an incomes policy be accompanied by an explicit reassurance that increases in the bureaucracy must and can be avoided. In looking at just some of the general details of the suggested implementation of a TIP policy, the potential for increasing the bureaucracy becomes infinite. Bureaucracies are like noxious gases -- they expand to fill the available space. A new regulation creates new space.