Curbing inflation is clearly the most urgent immediate economic problem facing not only the United States but also the Western World as a whole. Inflation is rampant at rates that are unprecedented in recent history for peacetime periods. It is therefore encouraging that this subcommittee is probing into ways of facilitating the ending of inflation.

There is no technical problem in curbing inflation: let the monetary and fiscal authorities follow a policy that reduces the rate of growth of the quantity of money and inflation will slow down as surely as night follows day—though unfortunately after a much longer and less predictable interval.

But stating the correct cure is easier than applying it. The reason is that, under current conditions, the cure would have adverse side effects that make it politically difficult to impose the cure and even more difficult to continue the treatment as long as is necessary. These adverse side effects arise because a reduction in the rate of inflation affects different prices with different time delays. Some prices are affected at once, but others much later. Many prices are set for a considerable time in advance. Once inflation has proceeded as long as it has in the United States, these advance prices—wage rates, price lists, construction prices, interest rates, and so on—will include an allowance for the expected inflation. In consequence, if the cure starts to work, and inflation starts to recede, these prices will be left much too high compared to others. Consider only the simple case of a person who has recently taken a mortgage on his house at an interest rate of 10 per cent. This rate embodies an expectation of about 6 per cent inflation. Let inflation fall to 2 per cent, and the mortgagee will be in a very difficult position.

The consequences of the temporary distortions in relative prices is an adverse effect on output and employment. That is why curtailing inflation would, under present circumstances, produce a temporary, though perhaps fairly protracted, economic slowdown or recession and a rise in unemployment. This rise would be temporary. Once expectations are readjusted, it would disappear. But in the process, it would generate great pressure to end the cure and instead resort to “the hair of the dog that bit you,” i.e., to more inflation.

Some of the greatest minds in economics over the past two centuries have pondered “Remedies for the Fluctuations of General Prices,” to use the title of an article published in 1887 by Alfred Marshall, the great English economist. The proposal that they supported, termed a “tabular standard,” has recently been receiving renewed attention under the label of “indexation” or “escalation” of long-term contracts. This is not a new harebrained device. It has been supported by such great economists, in addition to Marshall, as as W. S. Jevons, Walter Bagehot, and, in this country, Irving Fisher. It has been applied on a narrower or wider scale in Finland, the Netherlands, Canada, Israel, Brazil and other countries.
The essence of the proposal is simply that long-term contracts should be expressed not in fixed dollar terms but in terms of dollars to be adjusted after the event for any change in the general price level (as shown by a “table” of prices, whence the term “tabular standard”). The currently most widespread form of such contracts in the U.S. consists of “escalator clauses” in wage contracts, which now cover many millions of workers.

The same principle can be and should be applied to other contracts. Consider, for example, a loan for, say, five years. Instead of taking the form of a promise to pay, say, $10,000 after five years and annual interest of 10 per cent, or $1,000 a year, it would take either of two alternative forms: (1) to pay $10,000 after five years plus interest each year at the rate of 5 per cent plus the rate of inflation. For example, if the rate of inflation were 5 per cent the first year, interest paid that year would be at a rate of 10 per cent or $1,000; if it were 6 per cent, interest paid would be at a rate of 11 per cent or $1,100; if it were 3 per cent, interest paid would be at a rate of 8 per cent or $800. (2) To pay $10,000 times the ratio of the price index five years later to the initial price index and to pay each year $500 times the corresponding ratio for that year. For example, if prices rose by 10 per cent each year of the five-year period, the price index, relative to the initial year, would be 110 at the end of the first year; 121, of the second; 133, of the third; 146, of the fourth; and 161, of the fifth. The interest paid each year would be $550, $605, $665, $730, and $805 respectively; and the final principal paid back would be $16,100.

These two methods are equivalent, the first in effect involving amortizing the (real) loan each year the second, adjusting the interest each year, but paying back the principal only at the end of the five years.

It is highly desirable that such arrangements should become widespread, should apply to mortgages and loans, to time deposits at banks, to insurance policies, and so on.

The widespread adoption of such arrangements will not by itself either increase or decrease inflation; nor would they prevent needed adjustments in relative prices. But they would reduce the distortions introduced into relative prices by unanticipated changes in the rate of inflation. They would thereby reduce the harm that such unanticipated changes impose, and reduce the severity and duration of any temporary economic slowdown produced by effective measures to curb inflation.

Indexation is now spreading rapidly on a strictly voluntary basis. The urgent need is for the U.S. government to legislate indexation for its own activities, and to remove obstacles to private indexation.

On the government level, social security payments, many wages, and many other items are now escalated. The main additional areas requiring attention are taxation and borrowing. Our present personal income tax should be rendered inflation-proof by escalating the personal exemption, low income allowance, and limits of the tax-rate brackets, and by permitting taxpayers to adjust the basis of capital gains and of depreciable property for inflation from the date of purchase to the date of sale or use. The corporate income tax should be similarly adjusted. Government borrowing should be on a basis adjusted for inflation, not, as now, in terms of dollars without adjustment.
These changes in taxes and in borrowing are provided for in S.3396, a bill introduced by Senator James Buckley on April 29, 1974.

These changes should be enacted not only to facilitate ending inflation but also to promote fairness and justice in the relations between government and citizens. The income tax now imposed on individuals in different circumstances bears on them very differently than Congress intended. Inflation—for which no legislator has explicitly voted—has changed the burden of taxes drastically. Similarly, the U.S. government borrowing has been a bucket-shop operation of unprecedented scope. Almost every purchaser of U.S. Savings bonds has seen his supposed “interest” more than eaten away by inflation and, to add insult to injury, has had to pay tax on the fictitious “interest.”

In addition to inflation-proofing taxes and borrowing, it would also be desirable to eliminate obstacles to private indexation. Legislative limits now imposed on rates of interest that may be paid by thrift institutions and other borrowers, or that may be charged to lenders, constitute one such obstacle. Uncertainties about the tax treatment of inflation adjustments to recipients and to persons paying them, particularly in connection with loans, deposits and other financial transactions, are another obstacle.

I have not myself done enough work on this subject to set down a specific agenda. But I have done enough to know that the subject requires careful exploration and has so far hardly been touched. The detailed exploration of what the obstacles are and how they can be removed would be a highly worthwhile and important task for your subcommittee.

Unanticipated inflation disturbs economic arrangements, reduces production, and redistributes income and wealth arbitrarily. But far more important, it tears asunder the delicate fabric of shared values that holds a free society together. The preservation of that free society requires that we restore a reasonably stable price level. Indexation will not by itself do that, just as anesthesia will not by itself cure appendicitis. But indexation will greatly facilitate the restoration of a stable price level, just as anesthesia will greatly facilitate the removal of a diseased appendix.

[Note: I append herewith for the record some Newsweek columns I have written on the subject.]