

## Inflation and the Destruction of the Free Market Economy

SINCE 1933 the overall price level in the United States has increased with virtually uninterrupted regularity. In some years it has risen faster than in others, of course, but almost always it has risen. The level of prices now stands at more than five times the level of 1933 or—should 1933 be considered an inappropriate base year—about four times the level of 1929. In other words, the purchasing power of money is only about one-fourth what it was 50 years ago. During the past decade alone, the value of the dollar has fallen by about one-half. As we all know, it is currently continuing to fall rapidly as inflation proceeds at a rate near ten percent per year.

Some people, including some well-known and highly-regarded economists, do not consider inflation a very serious problem. It is, they think, merely an ongoing devaluation of the economy's unit of account that entails few if any significant real effects. This view is mistaken. In fact, inflation produces a variety of significant harmful effects. Most important for those who value liberty, inflation is, in at least four distinct ways, destroying the free market economy.

### Invisible Confiscation of Private Wealth

IMAGINE, if you can, a scheme in which agents of the Internal Revenue Service, surreptitiously and arbitrarily, steal billions of dollars worth of privately owned wealth from American citizens. What enormous social and political repercussions would certainly ensue. It strains the imagination very little to suppose that the government

responsible for such pillage would be abruptly and perhaps violently overthrown. Wanton confiscation of private wealth flies in the face of a Constitution that promises: "No person shall . . . be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation."

Yet inflation has in effect confiscated far more private wealth with scarcely a murmur against the responsible government. Inflation, as economists conceive of it, is equivalent to a tax on all monetary claims. Taking away one of every ten dollars of constant purchasing power—an explicit tax or confiscation—is equivalent to an inflation of ten percent. In either case the citizen loses one-tenth of his original purchasing power, his command over goods and services. Inflation taxes not just money balances; it taxes equally all claims denominated in units of money. The real value of bonds, mortgages, insurance policies, pensions, and similar financial claims depreciates equally with the real value of currency and bank account balances.

The magnitude of the current inflationary

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tax boggles the mind. In 1976, there was \$2,343 billion of life insurance in force in the United States. Public and private debt totaled \$3,355 billion. The money stock (currency plus checking and savings accounts) reached \$1,237 billion.<sup>1</sup> The total of these monetary claims was \$6,935 billion. During the two years, 1976-1978, the price level rose approximately 15 percent. Therefore, these claims depreciated by about \$1,040 billion in 1976 purchasing power. The incredible sum of over a trillion dollars was taken by the inflationary tax in just two years. This sum, which equals well over half the U. S. gross national product in 1976, is probably the largest tax levy in human history. It amounts to almost \$5,000 for every man, woman, and child in the United States! Astonishingly, this vast confiscation of private property occurred without explicit governmental deliberation or approval, without compensation, without due process of law. In view of these legal and moral defects, it seems somewhat inappropriate to call it a tax. Theft is more accurate and appropriate. To make matters worse, inflation does not simply exact its tribute once and for all. Rather, it continues erratically, day after day after day, with no end in sight.

But keep calm, certain economists exhort us. Although monetary creditors suffer from unanticipated inflation, monetary debtors benefit. We experience, as it were, windfall losses from our right pocket and equivalent windfall gains in our left one. It all balances: only the unit of account changes, as everyone pays more for goods and services purchased but receives more for goods and services sold. Unfortunately, however, the pockets experiencing windfall gains and those sustaining *equivalent* windfall losses seldom belong to the same pants. In fact, during an adjustment period that lasts for decades and may never be fully completed, net monetary creditors lose and net monetary debtors gain, and almost no one maintains a neutral position. (Eventually, as we shall see, almost everyone will probably lose.)

If everyone had equal ability to forecast correctly the future course of inflation, equal understanding of how to rearrange economic commitments to forestall its ravages, and equal capacity to carry out these rearrangements, then inflation would affect everyone in the same way. In reality, individuals differ enormously in these respects. Many have little understanding of what is happening to them; all they know is that "things cost more than they used to." Others, some of whom appreciate the situation and understand how they could attempt to insulate their economic affairs from inflation, have little or no capacity to carry out these rearrangements. This is so especially for private pensioners, who receive fixed money annuities and cannot renegotiate with their pension plans after retirement. Savings account depositors would like to receive higher interest to protect the real value of their deposits, and savings banks might be willing to offer higher interest rates in order to attract deposits, but legal restrictions hold down the allowable interest rates. Many ordinary citizens know little or nothing about alternative outlets for personal savings and therefore retain their savings account balances at banks. In recent years these depositors have earned in interest less than they have lost by inflation. Not only have they failed to earn any real interest, but they have lost real principal. (In November 1978 the Associated Press published a photograph of an elderly woman demonstrating against low interest rates outside a bank in San Francisco. In grim humor, her placard read: "savings deposits may be dangerous to your wealth.") Nor is such financial decay confined to widows and orphans. About half the major corporations are net monetary creditors, and evidence on their stock values during inflationary epochs shows that they have failed to evade the inflationary tax.<sup>2</sup> "The American public," as Arthur Okun

1. U. S. Bureau of the Census, *Statistical Abstract*, 98th ed. (1977), pp. 532, 533, 542.

2. Armen Alchian and Reuben Kessel, "Redistribution of Wealth through Inflation," *Science* 130 (Sept. 4, 1959): 538; Jerome B. Baesel and Steven Globberman, "Unanticipated Inflation and Wealth Redistribution Among Business Firms: Additional Evidence," *Journal of Economics and Business* 30 (Winter 1978): 87.

has observed, "cannot readily speculate hedge, or arbitrage on inflation."<sup>3</sup> Without doubt, perfectly anticipated inflation exists only in the frenzied dreams of certain macroeconomic theorists; "evidence has never been presented that *any* inflation was accurately anticipated—even on balance."<sup>4</sup> In the real world, gainers and losers are legion.

The social wounds inflicted by inflationary redistributions cut deeper than accountants can measure. Recalling the German inflation of the early 1920s, Thomas Mann declared that

*there is neither system nor justice in the expropriation and redistribution of property resulting from inflation. A cynical "each man for himself" becomes the rule of life. But only the most powerful, the most resourceful and unscrupulous, the hyenas of economic life, can come through unscathed. The great mass of those who put their trust in the traditional order, the innocent and unworldly, all those who do productive and useful work, but don't know how to manipulate money, the elderly who hoped to live on what they earned in the past—all these are doomed to suffer. An experience of this kind poisons the morale of a nation. . . . Inflation is a tragedy that makes a whole people cynical, hard-hearted, and indifferent.<sup>5</sup>*

Although the United States has not yet experienced a hyperinflation comparable to the German catastrophe of 1923, the same moral effects are now becoming visible. As Paul McCracken has said, "it is the capriciousness of these [recent inflationary] gains and losses that makes them so destructive of that broad

consensus so essential for our free institutions to flourish."<sup>6</sup>

Through the welter of redistribution, however, one persistent gainer marches stoutly onward: the federal government. It is, as everyone knows, a gargantuan net monetary debtor; the national debt now stands in the neighborhood of \$800 billion. As inflation proceeds, the real value of this debt steadily declines. When its bonds mature, the government repays, in command over goods and services, much less than it borrowed, much less than it implicitly promised to pay those who initially purchased the bonds and thereby transferred their command over goods and services to the government.

One naturally imagines that the spectacle of this gigantic public dishonesty would strike a deadly blow at the legitimacy of the federal government, inasmuch as the responsibility for the inflation itself rests squarely on the shoulders of the government. After all, excessive creation of money, for which *only* the government can be held accountable, is a necessary condition for inflation. Yet so successfully have politicians and governmental authorities shifted the blame for inflation onto the private sector—big corporations and labor unions, it is alleged, effectively conspire to raise prices and wages excessively—that the public stands largely mute while the holders of U. S. government "securities" are progressively defrauded.

Again, some assert that it all balances: what the bondholders lose, the taxpayers gain. But the two groups do not have equivalent membership, and hence real economic effects result from the actual redistribution of wealth. Moreover, the argument will not wash in a moral sense. Robin Hood was no less a thief because he gave some of the loot to the poor. And in the case of the government's systematic defrauding of its bondholders, it is by no means clear that the poor are the chief beneficiaries. In any event, the identity of the beneficiaries is irrelevant; the fundamental dishonesty, the profound corruption of public

3. Arthur M. Okun, "Efficient Disinflationary Policies," *American Economic Review* 68 (May 1978): 349.

4. Gardner Ackley, "The Costs of Inflation," *ibid.*, p.149, emphasis in original. See also Henry C. Wallich, "Stabilization Goals: Balancing Inflation and Unemployment," *ibid.*, p. 161.

5. Thomas Mann, "The Witches' Sabbath," in Michael Jefferson and others, *Inflation* (London: John Calder, 1977), p. 166.

6. Paul W. McCracken, "Towards Full Employment and Price Stability," *Nebraska Journal of Economics and Business* 17 (Autumn 1978): 7.

morality, remains. A former chairman of the President's Council of Economic Advisers, who ought to know, has recently confessed that "one of the worst evils of inflation is the accompanying deterioration of the level of public discourse."<sup>7</sup> In plain language, inflation encourages the leaders of government to lie about what they are doing and why they are doing it. Such behavior does not augur well for the future of our republican form of government.

There is, in short, a clear process whereby the federal government systematically shifts control over the economy's real resources from private hands to the government. It borrows to cover its budget deficits, thereby acquiring control over currently available real resources through voluntary contracts with its bond purchasers, who expect to be fully compensated by fixed interest payments and an eventual return of their principal sums. At the same time, however, the government, through the actions of its monetary authorities, "facilitates" the sale of its bonds by flooding the economy with more money than the public desires to hold under existing economic conditions. The public adjusts to this excess supply of money by exchanging some of the new money for bonds and some for currently produced goods and services until the prices of bonds and the rate of money income rise to levels at which the public is willing to hold the additional money. When the economy is already operating near full capacity, one result of this portfolio adjustment process is inflation. And with inflation, the government's promise to its bond purchasers is broken and resources *permanently* shifted from private hands to government control.

Some will object that this governmental capture of real resources through inflation cannot continue indefinitely. Surely people will catch on. History provides the conclusive refutation of this objection. The confidence game of inflationary finance has continued for decades in the United States; and during the 1970s, with the sharp acceleration of

inflation, more unsuspecting victims have been fleeced than ever before in peacetime. This is not merely because "there's a sucker born every minute," some of whom are foolish enough to believe the government can be trusted. It is also because the difficulties of forecasting correctly the rate of inflation are great—people are almost always surprised by an acceleration in the rate of inflation—and the financial markets are so hamstrung by governmental controls (*e.g.*, interest ceilings on savings accounts) that the adjustment process is highly imperfect, cumbersome, and painfully slow. Meanwhile, as private citizens struggle to protect their property from the invisible tax, the government's command over real resources grows steadily larger.

### Taxation of Phantom Gains

THE invisible inflationary tax on monetary claims would shift control over resources away from the private sector even if the government levied no explicit taxes. In reality, of course, the government levies many explicit taxes, including those on personal incomes, gifts, estates, corporate profits, and capital gains. Moreover, each of these taxes has a progressive rate structure linked to a taxable base denominated in units of money. If the tax rate schedules remain fixed, then even without inflation the progressivity of the rates insures that more and more real income, both absolutely and relatively, will be transferred to the government as economic growth takes place. If there is inflation without real economic growth, "stagflation" as the current unlovely expression has it, then the private sector will find itself with not only less real income relative to the government but less real income absolutely. No matter what the rate of real economic growth, the modern tax system operates to diminish the private economy. During inflationary epochs it also penalizes the maintenance of the real stock of productive capital, discourages real investment, and therefore retards real economic growth. Overall, the effect is systematically to shift resources to less productive (sometimes anti-productive) uses. When all this is well

7. Ackley, "Costs of Inflation," p. 153.

under way, self-appointed sages arise to tell us that the free market economy doesn't work any more.

Most of us fully appreciate the relation of inflation to our personal income tax liabilities. It has been calculated that a typical family of four paid just over nine percent of its \$15,000 income in federal income taxes in 1977. If this family's income should continue to increase by seven percent annually, and if inflation should proceed at the same rate, in ten years the family would have the same real gross income, but it would have to pay almost 18 percent of its income in federal income taxes; its real tax liability would approximately double.<sup>8</sup> A similar calculation for a typical California family, taking into account all income and social security taxes and projecting 6.5 percent annual inflation with no gains in real income, deduced that in about eight years the family would be subject to a tax rate of 50 percent on any additional income.<sup>9</sup>

Even more drastic are the effects of inflation on the real returns to investment. Martin Feldstein has recently testified before the Joint Economic Committee of Congress that

*during the past decade, effective tax rates have increased dramatically on capital gains, on interest income and on direct returns to investment in plant and equipment. Investors in stocks and bonds now pay tax rates of nearly 100 percent—and in many cases more than 100 percent—on their real returns.*

*... Our tax system was designed for an economy with little or no inflation. But if current rates of inflation persist, the existing tax laws will continue to impose effective tax rates of more than 100 percent on investment incomes. To make matters even worse, the current tax laws imply that future tax rates will depend haphazardly on future rates of*

*inflation and therefore cannot be predicted at the time that investment decisions are being made.*

*... [I]n 1973 individuals paid capital gains tax on \$4.6 billion of nominal capital gains on corporate stock. When the costs of these shares are adjusted for the increase in the consumer price level since they were purchased, this gain becomes a loss of nearly \$1 billion.*

*... Inflation not only raises the effective tax rate, but also makes the taxation of capital gains arbitrary and capricious. Individuals who face the same statutory rates have their real capital gains taxed at very different rates because of differences in holding periods.<sup>10</sup>*

Naturally, all this has had a chilling effect on businessmen's willingness to invest. Those who are puzzled by the ten-year slump of the stock markets or by the recent failure of real investment in plant and equipment to expand and push up labor productivity at historic rates need look no further for an answer.<sup>11</sup>

Unfortunately, however, there is more. Inflation has further penalized investment through its effect on depreciation allowances computed for tax purposes. The tax laws provide that part of a firm's gross income may be set aside for the maintenance of its plant and equipment as they wear out or become obsolete; that is, part of the gross income may be treated as what it is, a cost of doing business rather than a net return. However, the tax laws require that the depreciation allowances be based on the original dollar cost of the capital being replaced. As inflation proceeds, such allowances become more and more insufficient to cover the increased dollar costs of replacements. Feldstein concludes:

10. Martin Feldstein, "Inflation and Capital Formation," *Wall Street Journal* (July 27, 1978). See also Richard W. Kopcke, "The Decline in Corporate Profitability," *New England Economic Review* (May-June 1978): 36-60.

11. Charles R. Nelson, "Inflation and Rates of Return on Common Stocks," *Journal of Finance* 31 (May 1976): 471; Peter K. Clark, "Capital Formation and the Recent Productivity Slowdown," *ibid.* 33 (June 1978):956-975.

8. John Pierson, "Is It Time to Index Taxes?" *Wall Street Journal* (Aug. 9, 1978).

9. "Squeezing the Average Family," *Fortune* 97 (Feb. 13, 1978):66.

*This reduction in the real value of depreciation that is caused by the historic cost method of depreciation is equivalent to a substantial increase in the rate of tax on corporate and other investment income.*

*In 1977, the historic cost method of tax depreciation caused corporate depreciation to be understated by more than \$30 billion. This understatement increased corporate tax liabilities by \$15 billion, a 25 percent increase in corporate taxes. This extra inflation tax reduced net profits by 28 percent of the total 1977 net profits of \$53 billion. This is the single most important adverse effect of inflation on capital formation.<sup>12</sup>*

The most devoted enemy of America's free market economy could scarcely devise a more devastating instrument for its destruction than the combination of our tax laws and inflation. Together they have so vastly reduced the real returns on investment in plant and equipment that there remains little incentive to invest. Along with the historically subnormal rates of investment during the past decade, we have, not surprisingly, also experienced historically subnormal rates of real productivity growth. At the same time, however, the public sector has grown apace, its expansion fed by the invisible taxation of money via inflationary financing of its budget deficits and by explicit taxation of phantom gains in the private sector.

### **Heightened Economic Uncertainty**

ECONOMISTS can, and usually do, easily overlook the distributional effects of inflation. In the standard textbook macroeconomic models the variables are so few and so highly aggregated that such effects cannot be represented. In these models there are no pensioners to be impoverished. Indeed, except for "the" real wage, there are not even any relative prices. With a single output and a single price of output, these models in effect reduce the analysis of inflation to a matter of

*numeraire, of mere notation. If all prices change by the same proportion (the single price assumption is defended on the grounds that it is analytically equivalent to the assumption that all implicit relative prices remain constant), then no real effects are supposed to ensue; the dollar serves only as a unit of account and its real "value" has no particular significance. Economists actually consider this abstraction from relative prices a virtue. After all, the greatest sin for a professional economist is to confuse nominal (absolute) and real (relative) prices; and what better way to forestall confusion than explicitly to assume the structure of relative prices fixed while analyzing the overall absolute price level.*

Of course, every economist knows that relative prices do change during the course of inflation, that there are gainers and losers, and that the consequent shifts in the personal and group distributions of wealth may set in motion social conflicts. But so what? The economists correctly note that relative price changes and consequent distributional effects would occur even if the overall price level were constant. Therefore, they insist, to attribute the distributional effects that occur *during* an inflationary epoch to the inflation itself is simply to confuse once again absolute and relative prices. There is some virtue in this position, but not much. It completely overlooks the transfer of command over real resources to the public sector, as explained above. Moreover, the economist goes too far when he insists that the rate of inflation and the relative price structure are independent.

Because such independence does not exist, inflation cannot be understood fully as a "zero-sum game" played between net monetary creditors and net monetary debtors, where one group's gains exactly offset the other's losses. This approach takes too narrow a view. Not only does it abstract from the role of the tax system and from the effects of inflation on the structure of relative prices, but it also ignores the effects of inflation on the perceived legitimacy of the free market economy and hence on the institutional stability of the socioeconomic system. It is

12. Feldstein, "Inflation and Capital Formation."

unlikely that people (especially politicians) will forever stand quietly aside and respect the rules of the alleged zero-sum game of inflation.

Empirical evidence indicates that as inflation becomes more rapid it also becomes more variable.<sup>13</sup> Not only is more rapid inflation itself an evil; it is an even greater evil because it is more difficult to forecast just *how* rapid it will be next month or next year. This uncertainty creates problems in the credit markets, because it makes consensus more difficult to reach between borrowers and lenders with respect to the expected rate of inflation. But the difficulties extend much more widely. As Milton Friedman has observed, "The more volatile the rate of general inflation, the harder it becomes to extract the signal about relative prices from the absolute prices."<sup>14</sup>

Two recent statistical studies have established that inflation and the structure of relative prices are not independent; rather, their variances are positively related. Examining annual data for the United States, 1947-1974, Daniel Vining and Thomas Elwertowski have shown that "as the general price level becomes more unstable or less predictable relative to its trend value . . . the dispersion in relative prices increases." They comment on their findings:

*If general price change instability is highly correlated with and accompanied by price inflation, and if dispersion in individual price changes widens in such periods, . . . then a general atmosphere of higher risk and insecurity is the result. . . . Indeed, one would hardly expect general price level instability to be the public policy problem that it manifestly is if it didn't have some systematic and predictable effect on the prices that are important to the individual, i.e.,*

*the prices of goods that he sells relative to those of the goods that he buys.*<sup>15</sup>

In a similar but somewhat more sophisticated study, Richard W. Parks, using annual data for the United States, 1929-1975, has shown that "unanticipated changes in the rate of inflation have a significant effect on the amount of relative price change in the economy and result in nonneutral real effects."<sup>16</sup>

Heightened economic uncertainty is never good for a free market economy. Inflation creates greater uncertainty because it enlarges the random element in *all* markets. As inflation becomes more rapid, this effect is magnified more than proportionately. Coping with greater uncertainty requires higher real costs and therefore reduces the efficiency of the free market economy. As Ackley has noted, "because long-term contracts of *all* kinds involve more risk in inflationary periods and places, people refuse to enter upon them, sacrificing the many real production efficiencies and economies which are made possible by such contracts, as well as wasting resources in more frequent negotiation."<sup>17</sup>

Most serious of all, enlarged randomness in the market process threatens the institutional legitimacy of the free market system. When the links between effort and reward grow more tenuous, when the "poker-game aspects of capitalism come to the fore,"<sup>18</sup> when the winners in the race for wealth are increasingly viewed as the recipients of windfall gains, lucky rather than able or hardworking, then people perceive less fairness in the market distributions of income and wealth. In the long run, nothing can

13. Dennis E. Logue and Thomas D. Willett, "A Note on the Relation Between the Rate and Variability of Inflation," *Economica* 43 (May 1976):151-158.

14. Milton Friedman, "Nobel Lecture: Inflation and Unemployment," *Journal of Political Economy* 85 (June 1977):467.

15. Daniel R. Vining, Jr., and Thomas C. Elwertowski, "The Relationship between Relative Prices and the General Price Level," *American Economic Review* 66 (Sept. 1976):701,705,706.

16. Richard W. Parks, "Inflation and Relative Price Variability," *Journal of Political Economy* 86 (Feb. 1978):81.

17. Ackley, "Costs of Inflation," p. 153, emphasis added. See also Okun, "Efficient Disinflationary Policies," p. 349; and Wallich, "Stabilization Goals," p. 161.

18. Kenneth E. Boulding, *Beyond Economics: Essays on Society, Religion, and Ethics* (Ann Arbor: University of Michigan Press, 1968), p. 206.

undermine the free market economy more surely than a widespread deterioration of belief in its basic equity. As Kenneth Boulding has said, "the dynamics of legitimacy . . . really determine the future of the world."<sup>19</sup> With a stable price level, "the old-fashioned virtues of hard work, thrift, honesty, and so on come into their own."<sup>20</sup> Needless to say, these are precisely the sorts of virtues that have helped to make America's free market economy so productive and progressive historically. If they disappear, the future will be grim. It may be grim anyhow, because the diminishing legitimacy of the free market economy, which inflation is doing so much to accelerate, is creating not only a readier acceptance of governmental controls but a positive demand for them.

### Price Controls

**D**URING both world wars and the Korean conflict and again under Nixon, the federal government has undertaken to supplant extensively the market determination of prices and to hold many prices below market-clearing levels while simultaneously stimulating aggregate demand to a high degree. The recurrence of these episodes suggests strongly that people do not learn from history. Although almost everyone recognizes that price controls "did not work" the last time, many support their reimposition. And indeed, in the brief afterglow of their reintroduction, they enjoy high popularity. This dissipates as the inevitable distortions, inequities, and absurdities induced by the controls become more evident. Eventually, almost everyone begs for termination of the program. Like epidemic diseases, price controls tend to rise and fall in accordance with their own internal logic.<sup>21</sup> Unfortunately, a full-fledged episode of price

controls usually deposits a permanent residue of less comprehensive but more permanent controls, such as the energy price controls that persisted after Nixon's infamous Phases had passed away.

Joseph Schumpeter placed great emphasis on the role of price controls in facilitating the "march into socialism." They could, he warned, *result in a surrender of private enterprise to public authority.*

*. . . Perennial inflationary pressure can play an important part in the eventual conquest of the private-enterprise system by the bureaucracy—the resultant frictions and deadlocks being attributed to private enterprise and used as arguments for further restrictions and regulations.*

He noted in passing that "they will certainly not call it Socialism or Communism."<sup>22</sup>

For the politician, especially for the President, price controls serve a vital purpose: with great fanfare, they decisively shift the blame for inflation onto the private sector. Perhaps this is the sense in which one can say that "they work." No matter how many times excessive expansion of the money stock is shown to be the necessary condition for inflation,<sup>23</sup> the public stands perpetually prepared to swallow cost-push, administered-price, and other superficial theories of inflation. Politicians know this. They know, too, that well-known economists can be enlisted to support at public forums each of these competing theories. The ensuing Tower-of-Babel exhibitions (e.g., President Ford's inflation "summit meeting") in effect communicate to the public the message that "no one really understands our present inflation." Amid the confusion, the politicians wriggle off the hook. After all, how can the ordinary citizens really be sure that excessive creation

19. *Ibid.*, p. 52.

20. *Ibid.*, p. 208. See also Wallich, "Stabilization Goals," p. 163.

21. George P. Schultz and Kenneth W. Dam, "The Life Cycle of Wage and Price Controls," in *Economic Policy Beyond the Headlines* (New York: W. W. Norton, 1977), pp. 65-85.

22. Joseph A. Schumpeter, "The March into Socialism," in *Capitalism, Socialism, and Democracy*, 3rd ed. (New York: Harper and Row, 1950), p. 424.

23. Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton: Princeton University Press, 1963); and Peter I. Berman, *Inflation and the Money Supply in the United States, 1956-1977* (Lexington: Heath, Lexington Books, 1978).

of money to facilitate the financing of huge budget deficits is the true cause of inflation? Why, even the economists can't agree.

At the end of 1978 we had again come full circle. With inflation accelerating toward double-digit rates and the previous episode of price controls almost five years behind us, the President announced a brave new program to cage the beast of inflation and, over many years, to tame it. His program of "voluntary" wage and price constraints displayed all the absurdities of its predecessors. As the program lacked Congressional authorization, firms were merely invited to comply voluntarily with the guidelines; but if they declined the invitation, the government would use its procurement powers to punish them. It would also provoke the consuming public to ferret out offending firms and withdraw patronage from them. Profits as well as prices would be subject to allowable ceilings. Senseless distinctions were made between different fringe-benefit costs to employers. Ridiculous exemptions were granted to agricultural, fishery, and mineral products because their "prices are determined purely by supply and demand factors"<sup>24</sup>—as if other prices were determined by gnomes and gremlins. But what could one expect from a Council on Wage and Price Stability whose chairman, Alfred Kahn, was reported to have said that an "excessive" increase in the salaries of Chicago aldermen would "seriously undermine our efforts to bring inflation under control."<sup>25</sup> Economic balderdash of this caliber would have been slightly humorous if it had emanated from a less threatening source.

Many merely scoffed at the President's program, secure in the conviction that the "voluntary" controls would prove impotent. But such extreme confidence was unwarranted. In fact, many large enterprises would comply, at least for a while. As the *Wall Street Journal's* editors quickly noted, "The

great corporations have fallen pusillanimously in line."<sup>26</sup> George Meany, on the other hand, blasted the program as "unfair and inequitable" and warned that it would lead to "public scapegoating." So far, so good. Meany, however, reasoning as if a vast extension of a limited evil would somehow make it virtuous, called for a more comprehensive and mandatory control program.<sup>27</sup>

Here, indeed, lies the gravest danger of the guidelines program. As Herbert Stein has observed,

*such weak interference is frequently the prelude to stronger interference. It feeds the belief which still exists in some quarters that such intervention is the way to control inflation, and creates a demand and temptation for the President to do more of it when weaker measures are seen not to have worked.*<sup>28</sup>

Somewhere in the Valhalla of great economists, Schumpeter must be smiling sadly.

## Conclusions

FOR decades inflation has been contributing significantly to the ill-being of America's free market economy, and during the most recent decade its virulence has increased. The effects are multiple and interactive. Financing of the government's huge budget deficits by the invisible tax on monetary claims—the modern counterpart of taxation without representation—shifts real wealth from the private sector to the control of government, defrauding public bondholders in the process. The combination of our tax laws and inflation creates disincentives for investment. The consequent slowdown of productivity increase is then widely attributed to inadequacies in the free market economy. Inflation heightens the uncertainty

24. "Some Wage and Price Standards are Altered, But Thrust of Inflation Plan is Unchanged," *Wall Street Journal* (Dec. 14, 1978).

25. "Chicago Aldermen Bow to Carter, Cut Pay Raise," *Wall Street Journal* (Dec. 14, 1978).

26. "The Imperial Presidency" [editorial], *Wall Street Journal* (Dec. 11, 1978).

27. "Mandatory Wage, Price Controls Urged by AFL-CIO; Voluntary Plan Assailed," *Wall Street Journal* (Nov. 1, 1978).

28. Herbert Stein, "Is Government Our Partner?" *Wall Street Journal* (Jan. 30, 1978).

surrounding *all* economic transactions: higher inflation tends to be more variable; and more variable inflation goes hand in hand with more variable relative prices. Enlarged randomness in the price mechanism attenuates the links between effort and reward; windfalls proliferate. The increased role of luck and the decreased role of thrift and hard work diminish the legitimacy of market-determined rewards; hence, there arises an increased acceptance of and a positive demand for controls of the market mechanism. Wage and price guidelines respond to these demands. The weak and vacillating guidelines themselves do relatively little harm, but they can easily evolve into comprehensive and mandatory controls of wages, prices, and profits. If they do, the free market economy will be gone. It has been lost before, and at least partially recovered. No one knows how many times we can play this dangerous game before all our economic freedoms are lost irretrievably and hence our other freedoms placed in greater jeopardy.

Ironically, the most accurate and complete brief statement I have found of the relations between inflation and the destruction of the free market economy appears in an early work by the economist who would subsequently do more than anyone else to provide a theoretical justification for the universal adoption of inflationary fiscal-monetary policies in the western nations. In his *Economic Consequences of the Peace*, written in 1919, however, John Maynard Keynes saw clearly what the effects of inflation already had been in postwar Europe, and he feared for the future. He wrote:

*Lenin is said to have declared that the best way to destroy the Capitalist System was to debauch the currency. By a continuing process of inflation, govern-*

*ments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and, while the process impoverishes many, it actually enriches some. The sight of this arbitrary rearrangement of riches strikes not only at security, but at confidence in the equity of the existing distribution of wealth. Those to whom the system brings windfalls, beyond their deserts and even beyond their expectations or desires, become "profiteers," who are the object of the hatred of the bourgeoisie, whom the inflation has impoverished, not less than of the proletariat. As the inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery.*

*Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.*<sup>29</sup>

After sixty years, the validity of this analysis remains unimpaired.

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29. John Maynard Keynes, *The Economic Consequences of the Peace* (New York: Harcourt, Brace, and Howe, 1920), pp. 235-236. See also Ackley, "Costs of Inflation," p. 151 and the remarks by Mann cited above.