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Cost of policy to fight inflation far exceeds benefits

In the July Gallup poll, 59 per cent of those surveyed identified inflation as the No. 1 problem facing the country. This was consistent with the results of earlier polls.

It would be interesting if one could probe deep into the psyche of these people to learn what it is about inflation that they find so troubling.

Canadians, unlike Germans, are not haunted by inherited visions of hyperinflation and economic collapse. Instead, they must draw on their own experience in the past nine years of inflation averaging close to l0 per cent.

Repeated dire predictions of impending catastrophe notwithstanding, nothing much has happened during this period. The economy has continued to roll along arid living standards have improved. Real personal disposable income per capita increased by almost 3.5 per cent a year.

Pensioners, a group usually hard hit by inflation, benefitted from indexation and periodic increases in the old age pension and guaranteed income supplement. By and large, most groups shared in the increase in income despite inflation.

From a different angle, inflation does not seem to have further impoverished the poor or enriched the rich. The poorest fifth of the population received 3.6 per cent of the income in 1971 and 4.2 per cent in 1979; the richest fifth received 43.3 per cent of the income in 1971 and 42.3 per cent in 1979.

There is thus a dearth of hard evidence on the harmful effects of inflation *per se* to justify Canadians' anxieties. In contrast, there is a lot of evidence that it would be very costly to eliminate inflation through policy .

Moreover, the longer inflation persists the more difficult it is to eradicate. As people become more and more accustomed to inflation and as people's collective memories of past price stability dim, the enhanced momentum of the inflationary process will make it even harder to stop. This is in the future.

Even now, however, the costs of breaking the back of inflation through demand management policy are just too high to be contemplated by any government that wants to be returned at the polls.

For instance; in a Department of Finance study, *Canada's Recent Inflation Experience*, published in November, 1978, it was estimated that an increase of one percentage point in the unemployment rate would lower inflation by only about 0.25 per cent a year .

If a more optimistic estimate of the impact of unemployment on inflation were used, then the deceleration in inflation might be as much as 1 per cent a year. Even this, however, is a relatively modest slowdown in inflation, given the costs borne by the economy.

A two-point increase in unemployment would be associated with a 5 per cent reduction in gross national product. This represents $16.5 billion in lost output, by most accounts a high price to pay for such modest progress on the inflation front.

Significant progress would have a higher economic and political price tag, as Prime Minister Margaret Thatcher is in the process of so clearly and unhappily demonstrating in Britain.

Another cure for inflation that is worse than the disease is wage and price controls. It is not that controls are not effective: Make no mistake. They are.

The federal anti-inflation program was, in most respects, a success. Surging wages were restrained. Profits were kept within allowable margins. The controlled sectors of the economy respected the letter and spirit of the guidelines.

The central fact about the program to many, however, remains that aggregate prices exceeded the price targets in the last two years of the program. That this resulted from increases in uncontrolled food and import prices is often overlooked .

Perhaps it is for the best. It will make it more difficult politically to reinstitute controls and thus ensure that controls are used only as a last resort.

Controls are to be avoided because they substitute the rule of men for the rule of law and arbitrary bureaucratic decisions for the market. This introduces distortions and misallocates resources.

It intensifies and makes more explicit divisive controversies over the division of the social pie. Most importantly, it circumscribes the economic freedoms of individual Canadians that have intrinsic value in their own right.

Like it or not, it looks as if inflation is going to be with us for some time, so we might as well stop worrying and learn to live with it. A realistic approach is not tantamount to surrender and need not lead us inevitably down the garden path of accelerating inflation to hyperinflation.

A monetary policy that made sure that the growth of the money supply did not consistently outpace that of nominal income would provide sufficient insurance against that.

A realistic approach would recognize that inflation can only come down gradually from its, current 12.5 to 13 per cent range, and that it is going to remain in or near double-digit levels for the foreseeable future, barring propitious developments such as bumper crops or large drops in international oil prices.

The current fiscal policy, based as it is on gradually reducing the deficit, is consistent with a realistic approach. It should be tight enough to resist an acceleration of inflation and to exert a gradual downward pressure on it, but not so tight as to trigger a recession

Monetary policy, with its progressively lower money targets, is too tight. It would have to be respecified as part of a realistic approach to inflation.

A realistic approach would seek to minimize the damage to the economy caused by inflation through the distortions it introduces into economic decision-making.

For a start, this means that we must attempt to lift the veil that inflation puts over our financial reporting system so that we can ascertain the underlying real situation and thus make better-informed investment decisions. This would require the widespread adoption of some form of inflation accounting by business.

The principles of inflation adjustment and indexation might be profitably applied throughout the economy. The personal income tax and transfer systems are already indexed. This is probably one of the important reasons inflation did not contribute to a greater degree of inequality of income distribution. On the other hand, it is widely recognized that the corporate tax system is being seriously distorted by inflation.

Allowing only historical cost capital consumption allowances, taxing inflationary inventory prof- its, and not adjusting for real capital gains on debt outstanding is generating an unequal and unintended burden of taxation for, companies and industries that is leading to a misallocation of investment and resulting inefficiency. The corporate tax system should be made inflation-proof.

Uncertainty about inflation has devastated the long term bond market, making it increasingly difficult to raise money to finance investment projects. The Government could help resolve this problem by issuing indexed bonds and

encouraging the private sector to·., do likewise by establishing appropriate tax treatment' for such bonds.

The private pension system is being undermined by inflation. The availability of an indexed bond would facilitate the provision of' private indexed pensions to match those already enjoyed by civil servants. 7 ,-

These are only a few examples
of how inflation adjustments or indexing can be fruitfully applied. There are many others. Traditionally, the Government has. been reluctant to embrace this approach wholeheartedly. In part, this stems from a desire' to avoid creating the impression that inflation is likely to be a permanent feature of the economy, lest it become a self-fulfilling prophecy. The blind eye to the telescope may have worked for Admiral Horatio Nelson; but unfortu- nately, his success is unlikely to be repeated on the inflation battlefield

A major step in the direction of greater indexation would entail an extensive restructuring of Canadian institutions and could not be undertaken overnight, budget night being no exception. It would require a series of budgets all moving gropingly, but consistently, in the same direction over an extended period of time.

The issue of the design of the appropriate index – taking into account the distinct features of inflation resulting from imported goods, food, energy, and indirect taxes – would have to be addressed. The fiscal implications of any changes would also have to be taken into consideration to avoid an inappropriate over-all stance for fiscal policy.

Inflation is going to be with us for a long time yet. So we might as well stop spending our time on unproductive worrying and rise to the challenge of figuring out the best ways to minimize the harm it does to the economy.