Wages and Inflation

Wages play a crucial role in the transmission of inflationary impulses through the economy. This observation does not depend upon any particular theory of the causation of inflation. Rather, it rests upon the structure of productive processes: labor compensation accounts for about two thirds of total costs of production in the private business sector and more than half of total government expenditures for goods and services. Hence, any attack on inflation that does not rely exclusively on aggregate demand restraint must work more or less directly on wages.

Why not rely solely upon policies to restrain aggregate demand? To be sure, the case for demand restraint is overwhelming. After three and one half years of relatively rapid economic growth in the United States, most of the slack in the economy has been absorbed. Effectively full employment of experienced workers has been achieved, and shortages of certain skills have emerged. The growth of output during the past two years has continued to outstrip the growth of productive facilities, so that the rate of utilization of capacity in the manufacturing sector is now well above its long-run average. The pressure of demands for goods and services against limited potential for increased supplies is being reflected in a step-up in the underlying rate of inflation. Clearly, careful demand management is needed to avert unhealthy excesses and accelerating inflation.

But our inflation problem runs deeper than the recently emerging pressures of aggregate demand. Rapid inflation persisted throughout the severe recession of 1973-75 and the early stages of the subsequent recovery, when substantial excess capacity existed virtually throughout the economy. Such deeply imbedded inflation responds only slowly to restraint on demand. Most estimates indicate that it would take several years of slack in the economy—with high unemployment and sizable losses of potential output—to restore general price stability through demand management alone. Recognition of this predicament has given rise to searches for ways to hasten the return to price stability in the context of a prosperous and growing economy. The search has turned up various proposals for incomes policies such as wage and price guideposts or standards, use of regulatory and procurement policies to encourage moderation in wage and price setting, and tax-oriented incomes policies. The President's anti-inflation program incorporates elements of all these proposals, which recognize that wage moderation need not penalize labor, provided a competitive climate is maintained to hold profits in check.

In searching for ways to influence private-sector behavior in the interests of price stability, other steps the Federal Government can take to influence labor costs ought not to be overlooked. The following three articles touch on selected aspects of the wage-price problem and the Government's involvement in it. The first article provides a perspective on the minimum wage. Perhaps the most serious unintended side effect of the minimum wage is to restrict employment opportunities for relatively unskilled workers, especially youths. In addition, increases in the minimum wage raise costs of production and hence prices. It has been estimated that the initial effect of the 15 percent boost in the minimum wage at the beginning of 1978 was an increase of about ⅓ percent in the general level of prices. A similar result is expected from the 9.4 percent boost in the minimum wage that is scheduled to take effect on January 1, 1979. Admittedly, that is not a large impact in the context of the nation's overall inflation problem. But the effect does not stop there. By helping to cement inflationary expectations, continual increases in the minimum wage work at cross purposes with policies to contain inflation. It seems clear that a prompt review of minimum wage policy is called for.

The Federal Government did take a step to foster an atmosphere of wage moderation in holding the October 1, 1978 increase in the General Service schedule for Federal white-collar workers to 5.5 percent (and in imposing a similar cap on pay increases for blue-collar workers). That was significantly below the 8.4 percent increase that the President's pay agent had found would be needed to maintain comparability with private-sector wages. Are Federal workers thus being asked to bear an unfair share of the burden of wage restraint? The second article in the collection reviews this issue. Using an analytical approach fundamentally different from that employed in establishing pay comparability, it marshals evidence that, at least through 1975, Federal workers on average were generously compensated, compared with workers having similar personal characteristics in the private sector. These findings certainly do not mean that all Federal workers are overpaid, but they do suggest that the Government's example of wage restraint will not penalize unfairly the average Federal employee.

There is one important qualification to the foregoing generalization. High-level professional and managerial positions in the Federal Government are not compensated comparably to those in the private sector. This situation could have an adverse effect on the quality of the high-level Federal work force. Good government requires a pay policy that enables the government to attract and to retain exceptionally qualified individuals for professional and managerial positions.

The third article deals with the automatic linking of wages and retirement income to the price level. Indexation of wages has become increasingly widespread with the persistence of rapid inflation in the United States, and many retired persons enjoy indexed government pensions or social security benefits. Such indexation at least partially protects the incomes of some from the ravages of inflation and mitigates some of the inequities inflicted by inflation. At the same time, however, indexation may tend to perpetuate or even aggravate inflation and to exacerbate inequities *vis-à-vis* those who are not protected by indexation. Moreover, indexation, by making inflation relatively painless for some, narrows the constituency for price stability.

If inflation continues unabated, pressures will grow for more widespread linking of wages, pensions, financial instruments, and taxes to prices. The pressure for indexation stems from an understandable quest for security in an uncertain world. But it would be far better to conquer inflation than to multiply devices to make inflation more palatable to some. The example of wage moderation shown by the Federal Government will be fruitless unless it can mark a step toward eventual price stability. Review of policy toward the minimum wage could be another auspicious step. Ultimately, of course, responsible fiscal and monetary policies are essential for inflation to be brought under control. Given that fundamental, the path to price stability can be smoothed by the exercise of wage moderation in the public and private sectors.