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The Cost of Regulation: Inflation and Recession

By Richard W. Rahn

The Federal Reserve's traditional weapon for fighting inflation is tight control of the money supply. At the same time, the Fed is obliged to print money in order to cope with the costs imposed upon society by government regulation.

Regulation is inflationary. Those prices that are most sensitive to government policies rise fastest: The price of medical services is rising twice as fast as the overall consumer price index. Prices in those segments of the economy least amenable to government intrusion are far more stable: Basic commodity prices have shown a flat or even declining level of prices over the past two years.

The total cost of regulation is hard to measure, but I have concluded that between 34% and 67% of last year's 5.4% consumer price index increase was probably due to the monetization of growth in government regulation. Another 11% to 14% was due to the monetization of increases in federal, state and local taxation. Thus, as much as 80% of the reported CPI may be explained by the Federal Reserve's practice of creating money to cover government-mandated cost increases.

There has been some discussion at the Fed of the extent to which these government mandated cost increases should be monetized. The majority over the past two years clearly has favored only partial, rather than full, monetization. Unfortunately, while changes in the CPI lag changes in monetary policy by as much as two years, the real economy responds quickly to monetary changes. As a result, although real economic growth has been in a two-year decline, measured inflation has just begun to fall.

Inflation as measured by the CPI increased at an annual rate of only 1.5% over the past three months. The Fed achieved this reduction in inflation through a high interest rate policy designed to slow economic growth, resulting in rapidly increasing unemployment and economic misery. At the same time prices of real assets, particularly land and buildings, were being driven down, greatly aggravating the savings and loan, banking and insurance crises. The fall in asset prices was further exacerbated by the 1986 Tax Act, which increased the capital-gains tax rate and reduced passive loss deductibility for certain types of real estate investment.

This has put businesses in a bind. The government is imposing upon them ever toughening wages and hour laws, environmental standards, safety and health measures, land use rules and so on, even as federal, state and local taxes go up. These costs increases do not just disappear because the Federal Reserve decides to have a non-inflationary monetary policy. Because of these mandated costs, the prices of new goods are rising. Consumers must pay higher prices for new goods, and are therefore forced to pay less for existing goods and assets. So those prices must fall, causing hardship to the holders of these assets, particularly real estate, and a cycle of self-defeating tax increases to bail out the socialized financial insurance funds that were supposedly protected by the value in these assets.

The misery caused by the current policy is clear, but what would have happened if the Fed had accommodated or monetized these government tax and regulatory cost increases? The rate of inflation would have been slightly higher. Again, if my estimate is correct that half or more of the increase in the CPI is accounted for by these mandated cost increases, then inflation might be running at 5% or even 6% today, as it did for the past two years. This would drive up the nominal rate of interest and could even lead to greater inflationary expectations unless the Fed was very explicit about what it was up to. If the Fed again could explain and convince people it was not starting a new inflationary engine but merely trying to compensate for bad tax and regulatory policy, then the side effects could be somewhat less damaging than that of the current monetary policy.

As long as government mandated cost increases are greater than productivity growth, real incomes will fall. However, given current government programs to provide financial insurance funds at taxpayer expense, the current and future tax burdens on these funds could be somewhat reduced with a slightly more inflationary policy. Also, the special hardships of foreclosures or firm shutdowns under a slightly more inflationary policy would probably be less.

Many economists believe that a 1% to 2% annual rise in the CPI is an appropriate goal in the real world. The CPI does not gauge quality improvements in products, which are often considerable. Since wages are "sticky"—that is, since they are tough to cut, even when other prices are falling—a little inflation enables wages to adjust downward while fostering the important psychological illusion of wage stability. Such modest illusions provide a social lubricant to make painful economic adjustments a little less painful.

Few economists, however, are happy with inflation rates much above 2%. Only a near-zero rate provides the predictability needed to maximize productive investment and avoid destructive taxation on inflated, as opposed to real, income. This is particularly important in capital-gains taxation.

But reported inflation averaged a little over 5% for the 1989-90 period and thus is clearly above the desired goal of 2% or less. Hence, many have argued that the Federal Reserve has not been sufficiently "tight" and needs to slow monetary growth even further, or at least decline to reduce interest rates for the time being.

This demand for more and more tightness is at variance, though, with the real cause of much of today's inflation. If the Fed could maintain 5% or 6% inflation, under the current regulatory blitzkrieg, the pain to most citizens might be reduced. Congress is forcing the Fed to choose between gradually impoverishing a large number of citizens or rapidly pauperizing fewer of them. Clearly, the long-term solution is to educate Congress, the administration and the American people that their tax and regulatory costs cannot grow faster than productivity does without reducing standards of living.

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