Published by

AMERICAN INSTITUTE
*for* ECONOMIC RESEARCH

Great Barrington, Massachusetts 01230

# RESEARCH REPORTS

Vol. LXV No. 21 November 9, 1998

## What's So Bad About Lower Prices?

*A growing number of economists are warning that the prospect of deflation is greater now than at any time since the 1930s. However, lower prices are not necessarily a bad thing, and the likelihood of the economy falling into a deflationary spiral of declining output, sales and employment is remote.*

Is it time to start worrying about deflation? For the past seven years, price inflation has generally trended downward in the Unites States, and during the past year the Consumer Price Index increased just 1.5 percent. In the past year the prices of some goods (mainly commodities) have fallen sharply. These downward price trends have led some analysts to proclaim that the era of price inflation is over, and that the United States is heading toward a new era of deflation in which falling prices will become as common as rising prices were in the 1970s and 1980s.

The evidence for this view is apparent is the accompanying chart, which shows the annual rate of change in various price indexes. The first panel of Chart 1 shows the Producer Price Index for finished goods, which are durable and nondurable goods that are ready for use by consumers. This index has been decreasing for over a year. The prices of intermediate goods and materials (i.e., things that require further processing before they become finished goods) have also dropped, as shown in the second panel. The prices of crude materials have fallen even more, decreasing by 12 percent between August 1997 and August 1998 (see third panel). It is clear from the chart that the magnitude and duration of the downturn in all three of these producer price indexes, while not unprecedented, is highly unusual in the postwar period.

As further evidence, the price of oil dropped below $12 per barrel this summer, or half of what it cost 18 months earlier. The index of sensitive materials prices, which tracks the prices of a broad range of raw materials other than oil, has fallen 15 percent in the past year. The prices of copper, aluminum, iron, cotton, wool, and other materials have fallen sharply. Other prices have also fallen. Electricity is becoming cheaper in many parts of the country as a result of utilities deregulation. The price of gold recently hit a 19-year low. Prices for computers and other electronic products continue their long-term decline, and some of this year's new cars cost less than the models they are replacing.

As striking as these price decreases are, it may be noted that the prices of many other goods, and nearly all services, are still increasing. The rate of price increase for some things, such as medical care, actually accelerated in the past year. The general level of prices paid by consumers, as measured by the CPI, still is increasing. Even allowing for the possible overstatement of price inflation by the CPI, there is no evidence that the general price level is falling. Even if it were, would this constitute "deflation?"

### *"Good Deflation"*

It is seldom clear what analysts mean when they refer to deflation. Are they referring only to a decrease in the general level of prices? Or do they also refer to a downturn in wages, stock prices, real estate prices, and the nominal value of other things? Must falling prices also be accompanied by a decline in output, employment, and income?

Falling prices in and of themselves are not necessarily an alarming development. When the United States was on a gold standard, falling prices were as common as rising prices. (Although it may seem incredible now, the general price level in the 1920s was roughly the same as it was a hundred years earlier). During much of this period, the United States experienced rapid economic growth. Lower prices benefit consumers and most businesses. Falling prices become a problem only if, as a result of a lack of purchasing media adequate to satisfy the volume of goods and services brought to market, producer and/or consumer prices drop faster than the costs of production (which usually increase due to tight credit). Although the obverse of what happens when prices increase owing to the creation of excess purchasing media, the effects are the same: reduced output and employment. However, there is no evidence that this is happening now.

As to asset prices, a sharp or prolonged decrease in stock prices or real estate prices may be a hardship to individual investors, but unless it is accompanied by a similar decrease in the prices of goods and services, it would not constitute a "de-

Chart 1
**Change in Consumer Price Index and Selected Producer Price Indexes**
(percent change from a year earlier)

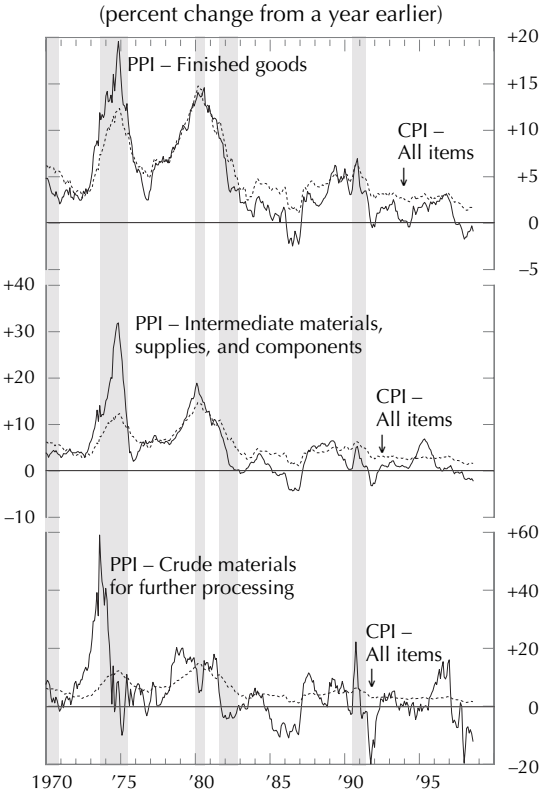
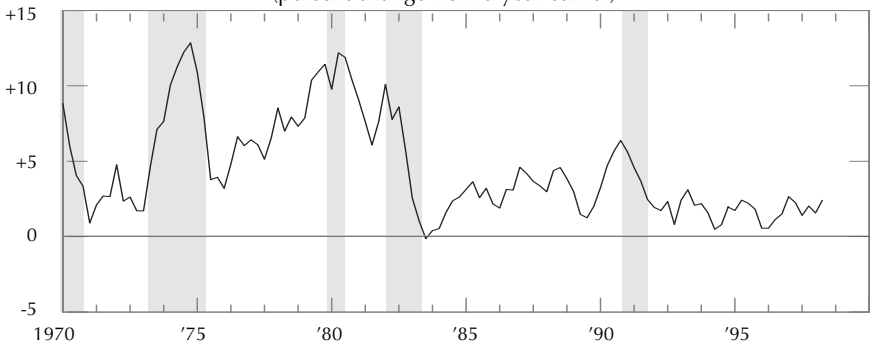


Chart 2
**Index of Unit Labor Cost, All Persons, Business Sector**
(percent change from a year earlier)




flation." During most episodes of falling asset prices, general prices have *not* decreased. In the late 1960s and again in the early 1970s, for example, stock prices declined but consumer price inflation accelerated. In the early 1990s, real estate prices plummeted in some regions of the country, but the general price level continued to increase. Periods of weakening asset prices, then, are not necessarily "deflationary."

### *Genuine Deflation*

We conclude that "deflation" must refer to a prolonged period of decline in nominal general prices *and* in output, sales, employment, and nominal wages. In the past 50 years there have been periods when some of these conditions prevailed. Output and employment have declined during recessions, and the prices of some commodities, assets, and other things have sometimes fallen sharply. However, there has not been a deflation — a period when all these developments occurred together — in the Unites States since the Great Depression.

Currently, the only part of the deflation scenario that has occurred is that the prices of commodities and some goods have fallen. Incomes and wages are not falling. The index of labor cost per unit of output in the business sector, a measure of production costs, has increased throughout the 1990s and the rate of increase has recently accelerated (see Chart 2). In the manufacturing sector, labor cost per unit of output declined through mid-1997 — cited by some as a possible sign of deflation — but this trend reversed a year ago. Manufacturers' unit labor costs are now rising, and the rate of increase has accelerated over the past year. For the economy as a whole, output, income, and employment continue to increase. The unemployment rate is 4.6 percent, close to a thirty-year low.

Deflationists counter that we are still in the early stages of deflation, that we are at the beginning of the downward spiral of prices and economic activity. They point to the financial and economic problems in the rest of the world, and warn that the United States is not immune from these problems.

On this latter point they are probably correct. As Fed Chairman Alan Greenspan told Congress in September, "it is just not credible that the United States, or for that matter Europe, can remain an oasis of prosperity unaffected by a world that is experiencing greatly increased stress." However, the effects of international stress on the U.S. economy are highly uncertain. Deflation is just one possible outcome. Other possibilities — in our view, more plausible ones — include an economic slowdown, an outright recession, continued moderate price inflation, and smaller stock market gains. In other words, a lack of immunity to economic problems abroad does not imply that deflation is the likely outcome.

### *Why It's Unlikely*

In our view, the probability of deflation is small mainly because monetary policymakers have a ready weapon to fight it — namely, a fiat dollar that they can create at will. And unlike policies designed to fight price inflation, "anti-deflation" policies would not inflict much pain on consumers or businesses, at least in the short run.

Fighting an increase in price inflation requires tightening the money supply. In the short run, this usually results in higher interest rates and tighter credit — and, depending on business-cycle conditions, possibly recession and higher unemployment. In contrast, fighting deflation requires increasing the money supply — which begets (again, in the short run) lower interest rates and easier credit — though, again depending on business-cycle conditions, not necessarily increased production and employment. As medicine goes, this is pretty pleasant stuff. Instead of taking away the punchbowl, policymakers refill it — albeit with uncertain results.

It is possible that policymakers would fail to do this, but it seems unlikely. The lesson of the past sixty years is that when the economy weakens, the government acts. The politicians (pretend to) cut taxes and (really) increase government spending, and the Fed adopts an easier monetary policy and lowers interest rates. The chief constraint on such policies in recent decades has been concern over bigger budget deficits and higher price inflation. But it is widely believed that the budget is now in surplus and price inflation is low, so the perceived downside to intervening in the economy is less now.

The recent actions of the Fed underscore that a downward deflationary spiral would not occur in a policy vacuum. The Fed has cut short-term interest rates twice in the past month in response to the global financial crisis. When the crisis threatened to wipe out Long-Term Capital Management, a large hedge fund, the Fed quickly arranged for private-sector bailout of the fund. Looking further back, when the balance sheets of households and businesses were strained by high debt loads in the late 1980s and early 90s, resulting in a "credit crunch" and slower economic growth, the Fed responded by pushing interest rates to their lowest level in decades. Today's deflationists seem to assume that the Fed will ignore future such events, but the record suggests otherwise.

Another argument for deflation is that even if the politicians and monetary authorities take action against deflation, their policies will not work. They might underestimate the problem and their response might be too little, too late. In addition, nobody, not even Fed officials, knows what the full effects of any policy action will be, especially in periods of heightened economic uncertainty. The long term consequences may be quite different from the short and intermediate term effects. (One could argue, for instance, that the Fed's effort to reduce interest rates in the early 90s helped alleviate the short-term problem of excess debt, but also set the stage for a speculative bubble in the stock market.)

If policymakers do err, however, we expect them to err on the side of inflating. Alan Greenspan has made clear that he believes in monetary restraint to limit price inflation — *until* a recession appears likely. The weaker the economy is perceived to be, the more the Fed and government officials will do to counteract this. This does not mean that there will be no recessions, credit crunches, bank failures, or other economic problems. Policymakers influence the economy but they do not control it. However, if developments suggest that the punchbowl is less full than they thought, they are likely to try to refill it that much quicker. Why wouldn't they? What is to stop them, as long as they can print fiat money and create fiat reserves at will? ❑

## 'TIL DEATH (OR THE IRS) DO US PART

*Many married couples would pay less Federal income tax if they divorced and many single persons would pay more if they married. This perverse incentive of the tax structure reflects attempts to reconcile the conflicting principles of equity (that persons in similar circumstances should pay similar taxes) and progressivity (that those who have more should pay at higher rates).*

When income tax rates were low and were applicable only to those with the highest incomes, one's marital status could affect one's income tax liability; but it was not a major issue. This changed with the imposition of the income tax on most wage earners and steeply progressive rates (up to 90 percent) during World War II. The issue at that time was not a penalty for being married but a "marriage bonus."

### *The Origins of the Marriage Bonus*

For several decades after its inception in 1913, the income tax was levied only on individuals, according to their incomes. This remains the situation in most countries of the world today. Spouses with little income might be claimed as dependents, thereby reducing the taxes of married taxpayers; but, in general, the ability of most married persons to reduce taxes was limited to those who were in a position to shift income to spouses by retitling assets, putting the spouse on the payroll, etc. (This phenomena was perhaps the beginning of the increasingly prevalent belief that the "rich" are able to manipulate the tax code to their advantage.)

However, in "community property" states (of which there were 7 in 1941), married taxpayers could claim that half of all earnings and other income of one spouse belonged to the other. Such income splitting by married residents of community property states on their tax returns was upheld by the courts.

Congress considered this situation as early as 1941, when it was proposed to tax married couples on the same rate schedule as individuals. This proposal would have taxed two-earner married couples in higher brackets. For this reason, the proposal was attacked as "striking at the institution of marriage" and rejected.

The total income tax paid by a couple varied not only according to their marital status, their residence in community property or common law states, but also, in the latter, according to how the income was distributed between husband and wife. It was estimated that the disparity in the tax paid by couples with identical incomes could be as large as 40 percent. Several states moved to adopt community property status (and 3 actually did so); but, in 1948, Congress allowed married couples to file "joint" returns, paying 2 times the individual tax on half their combined incomes.

This change extended the marriage bonus to taxpayers in all states and income levels, and, until 1969, married persons never paid more than they would have as individuals. Usually, they paid less.

### *What Happened in 1969?*

The joint tax return solution was not applauded in all quarters. It meant that a single person could pay significantly more tax (again, as much as 40 percent more) than a married person with an identical income and a non-earning spouse. One of the most energetic agitators for "relief" for singles was one Vivian Kellums, founder of an organization of single women called War Widows of America, who asserted that the men they might have married were killed in World War II. In Congressional testimony Ms. Kellums said that "there are not enough husbands to go around, " and she asked "What do you do if you can't get a husband? Should you be taxed for that?"[1]

In 1969, in response to this and other well-publicized testimony (notably from six-time married actress Gloria Swanson, who told the Committee that she had been "single most of my life"), Congress provided "relief" for single taxpayers — a larger standard deduction and wider tax brackets than applied to married persons. Married couples with approximately equal incomes began to pay more than they would pay "living in sin," and filing as individuals. The marriage tax was born.

In 1972, the Treasury estimated that 85 percent of married taxpayers continued to benefit from filing joint returns. The 15 percent that did not were concentrated in the upper middle income brackets — the marriage tax was largest (about $4,500) for couples who each earned about $35,000 (equivalent to a combined income of over $250,000 in 1998 dollars). Those with very large income were subject to the top rate no matter what, while those with low incomes were typically in one-earner households and benefited from income splitting on joint returns.

### *Subsequent Developments*

The marriage tax first received wide publicity from a Maryland couple named Boyter, who began an annual ritual of divorcing while on vacation in the Caribbean in December and remarrying in Maryland in January. In newspaper interviews and on TV talk shows they cheerfully asserted that their tax savings more than paid for their winter vacations. The IRS eventually challenged the validity of their divorces (even though the generally murky tax code is quite unambiguous on the question) and the Boyters eventually decided to remain divorced to limit possible penalties. In 1980 they were called before the Senate Finance Committee, where the following interchange occurred:

> *Sen. Dole*: "You are divorced now?"
> *Mr. Boyter*: "We are divorced now and have been for several years."
> *Sen. Dole*: "You live together though?"
> *Mr. Boyter*: "That's right. The IRS told us that that was preferable to getting married every year and then divorced."
> *Mrs. Boyter*: "My mother didn't think so, but the IRS did."

Participation of women in the labor force increased markedly during the 1980s. More married couples became subject to the marriage tax and fewer benefited from filing joint returns. The 1981 tax act provided some relief in the form of a deduction of up to $3,000 of the second earner's income. This reduced or eliminated the marriage penalty and even increased the marriage bonus in some instances.

As part of the broad-based tax reform of 1986, the second-earner deduction was abandoned. But enlargement of the standard deduction on joint returns and replacement of 14 tax brackets with only 2 (15 and 28 percent) served to curtail the marriage penalty for most couples — the flatter tax structure meant that addition of a second earner was less likely to make a couple pay at substantially higher tax rates.

Progressive rates and wider tax brackets for individuals than for joint returns are not the only villains in the situation. At low income levels, these are not even the major reasons why couples may lose out when they marry.

### *The Earned Income Tax Credit*

To increase the incentives to work rather than collect welfare, Congress enacted the Earned Income Tax Credit in 1975. This offsets any income tax due on wages, and, more significantly, it is "refundable," *i.e.,* if the credit is larger than the income tax due, the difference is paid to the taxpayer.

---

[1] This and other Congressional testimony quoted below has been taken from *The Decline [and Fall?] of the Income Tax,* by Michael J. Graetz, New York, W.W. Norton, 1997.

The amount of the credit varies with the number of dependent children and it is phased out as the amount of income increases. Although the complexity of its calculation rivals that faced by the highest-income taxpayers resulting from other provisions of the tax code, and despite reportedly widespread errors and fraud in its calculation, the EITC is generally believed to have achieved the goal of mitigating welfare's disincentives to gainful employment.

However, because the income levels used to determine the EITC are the same for individuals as for married couples, it creates a marriage tax for low income workers. The potential loss to two low-income individuals receiving the EITC if they marry can be far greater in relation to their incomes than higher-income taxpayers who marry lose from the smaller standard deductions and narrower tax brackets available to married persons.

### *Recent Changes*

In 1990, Congress added a third tax bracket of 31 percent and, in 1993, additional brackets of 36 and 39.6 percent. The 1993 act also enlarged the EITC (which was not affected by various welfare reforms enacted in 1997). These changes increased the marriage tax for both low-income and high-income taxpayers.

An extreme example at the low end, for example, would involve two persons each earning $12,000 with two dependent children each. They would lose about $6,000 if they married. On a joint return, only two of the children would be used in the EITC calculation and the couple's combined incomes would not only become subject to income tax but also would be well into the phaseout range for the EITC. This is not a common situation; but even in the presumably far more common situation in which only one had two dependent children, a low income couple would lose about $3,000 by marrying.

At the other end of the income spectrum, the income threshold is the *same* ($278,450) for both individual and joint returns. This means that the potential marriage tax for two high-income individuals is today much larger than it was when the top rate was 28 percent for all taxpayers.

In addition, a wide variety of so-called means-tested tax provisions allowing or denying credits, deductions, and exemptions on the basis of income can create or add to marriage taxes (and occasionally result in a marriage bonus), depending on the income levels at which they are phased-out. These include child care credits, the reduction of personal exemptions and itemized deductions at high income levels, taxation of Social Security benefits, and allowable deductions for IRA accounts.

At present, an estimated two thirds of married couples would pay less tax (or receive a larger refundable EITC) if they divorced, while one third benefit from the income-splitting provided by joint returns. Presumably, the proportion of cohabiting singles who would have less rather than more if they married is even larger, but there are no estimates of this. Generally, at any given level of income, it is the distribution of income within the couple that is the major factor. The biggest marriage tax will be paid by couples with a 50-50 split, and the biggest marriage bonus will be received by those in which one spouse receives all the income.

### *Current Proposals*

Several Congressional bills have addressed the issue of the marriage tax. All of these would retain or enlarge marriage bonuses, but none would eliminate the marriage tax in all circumstances (especially those arising from the EITC).

Proposals include reinstating the second earner deduction, enlarging the standard deduction on joint returns to twice that on individual returns (this was enacted by Congress in 1995, but the bill was vetoed by President Clinton), and reducing tax rates.

These would reduce taxes for *all* married taxpayers, and would no doubt prompt the same complaints from singles that created the marriage tax in the first place.

Another proposal would allow married couples the option of filing as two individuals (using the individuals rate schedule) on the same tax return or filing jointly as under present law. Such "optional filing" status[2] would eliminate all marriage taxes arising from differences in standard deductions and tax rate thresholds, while leaving marriage bonuses as they are. Optional filing would not eliminate marriage taxes related to the EITC and certain other means-tested tax provisions for which phaseout levels would continue to be based on combined incomes, but none of the others would do so either.

A major advantage of optional filing would appear to be that it would not increase marriage bonuses — joint returns would not be more (or less) advantageous than they are now. Thus optional filing would not only be less likely to promote a backlash from single persons but less "costly" in terms of Federal revenues than some of the other proposals. Under current rules, Congress must offset any tax cuts with tax increases or spending cuts. This may account for Congressional inaction to date, but, as always, the proposals have generated opposition because the largest dollar tax reductions would go to those who now pay the largest dollar taxes (the "rich"). It has also been asserted that optional filing, in particular, would add to the complexity of the tax code.

### *An Impossible Task*

The taxation of married persons provides an excellent example of the impossibility of fairly taxing incomes at progressive rates. If the tax code favors married one-earner couples, then single people are disadvantaged as are working spouses. If the latter are granted tax relief, then many people pay will pay more if they marry. The tax code can't force people to marry just as it can't prevent people from cohabiting. Unless tax rates are low and broadly-based, there is nothing that lawmakers can do to keep tax minimization off the short list of favorite indoor sports. More significantly, attempts to deal with perceived injustices and to use the tax code for "social engineering" only serve to hasten the day that the tax code will collapse of its own weight. As Angela Boyter told Congress 18 years ago:

> "In 1948 you convinced single tax payers that the system is unfair. In 1969 you added the two earner families. If you continue adding complexities and favored groups to the tax code, you will eventually convince the majority of the system's unfairness and they will feel justified in making their own adjustments. Needless to say, at that point we will no longer have largely voluntary tax compliance."

Maybe we have passed that point by now. ❑

[2] This should not be confused with the current "married, filing separately" option, which is mainly of use to estranged spouses wishing to avoid problems with the IRS and seldom serves to reduce taxes from what they would be on a joint return except in unusual or even bizarre circumstances.

**PRICE OF GOLD**

| | *1996* | *1997* | *—— 1998 ——* | |
|---|---|---|---|---|
| | *Nov. 7* | *Nov. 6* | *Oct. 29* | *Nov. 5* |
| Final fixing in London | $378.60 | $312.05 | $294.00 | $290.60 |

***Research Reports*** (ISSN 0034–5407) (USPS 311–190) is published twice a month at Great Barrington, Massachusetts 01230 by American Institute for Economic Research, a nonprofit, scientific, educational, and charitable organization. Periodical postage paid at Great Barrington, Massachusetts 01230. Sustaining memberships: $16 per quarter or $59 per year. POSTMASTER: Send address changes to ***Research Reports***, American Institute for Economic Research, Great Barrington, Massachusetts 01230.