Why the Inflated Concern about Price Deflation?
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We have been hearing a lot recently about the threat of deflation, doubtlessly inspired by recent falls in indexes of consumer and producer prices. The Great Depression of the 1930s comes to mind when people speak of deflation. No one wants another Great Depression. Nearly everyone would prefer the double-digit inflation of 20 years ago. This preference is reasonable, but it does not follow that deflation is bad. Whether deflation is bad or good depends on why prices fall.

The Great Depression of the 1930s is the prime example of the bad kind of deflation. The Federal Reserve allowed the supply of money to shrink by 35 percent between 1930 and 1933. This gigantic destruction in the supply of money sabotaged markets throughout the land. Consumers could not afford to buy products, businesses could not sell their output, and workers could not find jobs. All if this happened because the Federal Reserve failed in its fundamental task of keeping the stock of money intact. This kind of demand-side deflation is clearly an economic scourge of major proportions.

Deflation can also result for supply-side reasons. This type of deflation is a radically different type of animal, and is a good one to have around. It is the kind of deflation that occurred in our economy after the Civil War, pretty much continually until the creation of the Federal Reserve in 1913. As productivity increased, consumer prices fell. Workers did not receive the continual wage increases that they have received during our recent inflationary times. Their well
being increased nonetheless. Steady wages with falling prices is a fine recipe for progress. This is, moreover, a recipe that works to the advantage of retired people on fixed incomes. With moderate deflation, a fixed sum for retirement goes ever farther because deflation allows these people to share in the gains from rising productivity.

There is all the reason in the world to avoid a demand-side deflation. There is no reason at all, however, to oppose a supply-side deflation. No reason, anyway, for ordinary citizens to oppose supply-side deflation. It may be different for politicians and government officials. They are in a different situation with respect to deflation than are ordinary citizens. Inflation allows for increases in government budgets that would never be possible under deflation. Sustained inflation entered the American economy only with the creation of the Federal Reserve in 1913. Until then, the federal government claimed less than ten percent of the output of the American economy. It was only after steady inflation became a way of life that government's share in the economy grew and now approaches 50 percent.

There are many reasons that inflation promotes a growth in government. One of them is that inflation increases the share of total income that is collected through ordinary taxes. A ten-percent increase in income increases collections of income tax by something on the order of 12 percent. This ability of tax rates to rise with inflation is referred to as “bracket creep.” Inflation pushes people into higher rate brackets, where they pay larger shares of their income in taxes.
Besides bracket creep, inflation is also a type of tax in its own right. The inflation tax is a form of public counterfeiting that goes by the technical name “seigniorage.” Seigniorage is the difference between the value of the money the government creates and its cost of creating that money. It is the government’s profit from creating money, and it is of the same character as the profit that a private counterfeiter makes. It costs almost nothing for the government to print another $100 bill, but this new bill is as valuable as all other $100 bills.

To be sure, the collection of this seigniorage tax works differently in different nations. In some nations, the Treasury and the central bank are joined. In those places, the government can finance its activities directly by creating money. It is different in America because the Treasury and the central bank are distinct. The government can still finance its activities by creating money, only this happens indirectly in two stages. In the first stage the government runs a deficit; in the second stage the Federal Reserve buys government bonds. The end result is indistinguishable from the Treasury directly creating money to finance its activities.

Supply-side deflation would put an end to the government’s ability to finance its activities through monetary expansion as well as through bracket creep. It would also eliminate the need for all of the various forms of indexing that have arisen to deal with inflation. The only losers from deflation would be those who live off the tax revenues that inflation generates.