

STATE AND LOCAL GOVERNMENTS HAVE A ROLE TO PLAY IN COMBATTING INFLATION

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How Radical Liberal Policies Have Driven Inflation to Historic Highs

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Chair Causer and members of the committee:

Thank you for the opportunity to testify today. My name is Veronique de Rugy, and I hold the George Gibbs Chair at the Mercatus Center at George Mason University, where I study tax and fiscal policy, the federal budget process, and the implications of government spending for economic growth.

I would like to offer the following three main takeaways:

1. The inflation Americans are experiencing today was to be expected. There were sufficient warnings that this inflation should not have been a surprise.
2. The inflation Americans are experiencing is the result mostly of expansive monetary and fiscal policy, rather than the result of global supply *chain problems, supply shocks, corporate greed, or other causes that are often suggested these days.*
3. Fiscal and monetary restraint are key to controlling inflation.

BACKGROUND

The Consumer Price Index in March 2022 showed its sharpest year-over-year spike in four decades,¹ catching the Federal Reserve (Fed) by surprise. Initially slow to recognize the inflation, the Fed first claimed that the inflation was transitory. When inflation persisted, the Fed said that prices were just catching up to prepandemic levels. As inflation persisted and prices began to exceed their prepandemic levels, the list of “causes” of inflation expanded to the point where it seems like inflation could be caused by nearly everything, from the restricted supplies of lumber, used cars, and other goods, to overall supply chain tangles.

1. Bureau of Labor Statistics, “Consumer Price Index—February 2022,” news release no. USDL-22-0145, March 10, 2022, https://www.bls.gov/news.release/archives/cpi_04122022.pdf.

Today, the argument that inflation is mostly the result of supply shocks such as the war in Ukraine, global supply chain problems, *or corporate greed* continues to be widespread.²

None of these putative causes, however, can explain the persistence of inflation or its scale compared with inflation in other countries. In particular, explanations about supply-shock-driven inflation seem to mistake inflation (i.e., an increase in the general price level—that is, of all prices and wages) with changes in relative prices (i.e., when only some prices rise, as when the price of cars rises relative to the price of other goods and to wages because of reductions in the supply of computer chips). Excessive focus on the supply side of this issue has resulted in a failure to recognize the overwhelming role played by the demand side, particularly the role of deficit spending accommodated by the Fed’s expansionary monetary policies. Many legislators, Fed officials, and experts have treated the pandemic- and lockdown-induced downturn as a demand-side shock and have responded with measures meant to raise aggregate demand. They should not be surprised that this inflation is demand pull rather than cost push.

GLOBAL SUPPLY CHAINS ARE NOT THE PRIMARY CAUSE OF INFLATION

Supply shocks in general and global supply chain weaknesses in particular have been identified as a cause of inflation. The policy proposed for controlling inflation is therefore to, among other things, pull in supply chains behind national borders. This proposal misunderstands both supply chains and inflation.

According to the World Trade Organization, trade in intermediate goods continued to rise during the pandemic, albeit at a slower rate than before, in spite of port and shipping bottlenecks.³ In other words, although there were chokepoints, supply chains were far from “cut off,” as the president recently claimed on national television.⁴ Most of the supply chain issues arose from the tremendous increase in demand rather than reductions in the economy’s ability to supply goods owing to supply-chain-specific issues.⁵

Furthermore, it is unlikely that moving supply chains to domestic producers will lower inflation. Global supply chains are global because every other available mode of production and distribution is more costly. Were the government to forcibly constrain and alter these supply chains, it would increase costs further—and as costs go higher, so would prices. Nor would it be a quick process.

Rachel Fefer, Andres Schwarzenberg, and Liana Wong, economists at the Congressional Research Service, write that

the United States, in particular, was a driving force in breaking down trade and investment barriers across the globe and constructing the open and rules-based global trading system that

2. Betsy Stevenson, “The Best Way to Tackle Inflation: Confirm Biden’s Fed Nominations,” *The Hill*, March 2022.

3. “Exports in Intermediary Goods Continue to Grow in Third Quarter of 2021,” World Trade Organization, February 4, 2022, https://www.wto.org/english/news_e/news22_e/stat_04feb22_e.htm.

4. “ABC News Live Update: Biden’s Exclusive Interview with George Stephanopoulos,” interview by George Stephanopoulos, ABC News, video, accessed March 18, 2022, <https://abcnews.go.com/US/video/abc-news-live-update-bidens-exclusive-interview-george-76510757>.

5. “The nation’s overall productive capacity and its medical goods industries are generally healthy and that domestic industries and their supply chains have adapted during the pandemic to meet extraordinary demand.” Scott Lincicome, “The Pandemic Does Not Demand Government Micromanagement of Global Supply Chains,” Cato Institute, February 24, 2021, <https://www.cato.org/pandemics-policy/pandemic-does-not-demand-government-micromanagement-global-supply-chains>.

has enabled [global value chains] to proliferate. . . . For example, stronger linkages to the global economy force U.S. industries and firms to focus on areas in which they have a comparative advantage, provide them with export and import opportunities, enable them to realize economies of scale, and encourage knowledge sharing and innovation. In addition, households have been able to enjoy lower product prices and a broader variety of goods and services—some of which may not be produced domestically.⁶

Global supply chain constraints or port bottlenecks do exist, and Congress can address them in several ways, some of which I will mention later in this testimony. Indeed, the United States could get much more out of global supply chains by removing the many government-imposed barriers that have intentionally diminished US supply chain capacity, efficiency, and flexibility and thus made the supply chain crisis far worse than it ever needed to be.⁷

This is not to say that global supply chain constraints have not contributed to an increase in the price level. However, one needs to differentiate between supply constraints, which increase the price of some or even many goods relative to other prices, and inflation, which occurs when the prices of everything, including labor, eventually rise. Americans are now seeing the price of everything go up. Wages are also rising, albeit at a lower rate for now. Supply shocks and constraints do not cause that broad-based pattern. Indeed, individual price increases show up in measurements of inflation, but these increases in relative individual prices should not be confused with inflation. In addition, price-level hikes caused by supply-side shocks (such as supply chain chokepoints) are generally not ongoing, month-after-month price hikes. They are usually a one-time price-level jump, which eventually dissipates when the supply shock is over and which usually reverses, resulting in a period of measured deflation. All prices are rising, the inflation is persistent, and there is no sign of a reversal.

Similarly, a shift in demand from services (e.g., restaurant meals) to goods (e.g., TVs) can cause goods prices to rise, but it causes services prices to decline, with no effect on the overall price level. That is not what Americans are seeing.

By contrast, inflation, or a general increase in all prices including wages, and the associated fall in the dollar's purchasing power has a single source: the creation of too many dollars and the promise to print more dollars in the future.

THE MAIN CAUSE OF INFLATION

Government-induced demand is a key player in this burst in inflation. The US Department of the Treasury first issued \$3 trillion of new debt, which the Fed quickly bought in exchange for \$3 trillion of new reserves that the Treasury sent out as checks and other forms of payments to Americans.⁸ The Treasury then borrowed another \$2 trillion or so for the American Rescue plan to send out another round of checks and payments to Americans. Overall federal debt rose by almost 30 percent of GDP. *In*

6. Rachel F. Fefer, Andres B. Schwarzenberg, and Liana Wong, "Global Value Chains: Overview and Issues for Congress" (report no. R46641, Congressional Research Service, Washington, DC, December 16, 2020), 4.

7. Scott Lincicome, "American Sclerosis," *Dispatch*, November 10, 2021.

8. "COVID Money Tracker," Committee for a Responsible Budget, last updated May 23, 2022, <https://www.covidmoneytracker.org/>.

addition, during the pandemic, the Fed bought some \$1.3 trillion in mortgage-backed securities, as well as implementing other loan purchase programs and liquidity measures.⁹

This action was the product of a misdiagnosis of economic problems based on the belief that the pandemic-induced recession was mostly an aggregate demand shock, not one of aggregate supply. That means that sending money to people would have very little impact on output, especially because a large share of the economy was closed. It would, however, affect demand for durable goods.

The size of fiscal stimulus was also an issue. Even by Keynesian economics standards, the \$5 trillion injected into the economy was larger than any plausible output gap, at any level of multiplier. The same can be said of the \$1.9 trillion American Rescue Plan, which was passed in March 2021. Around early 2021, the Congressional Budget Office projected that the output gap would be \$700 billion through 2023,¹⁰ the period when most of the \$1.9 trillion in spending would take place. \$1.9 trillion was two or three times more than needed to fill the gap.¹¹

Whereas everyone from monetary experts to the Fed chair to President Joe Biden's Council of Economic Advisers spent most of 2021 explaining this burst of inflation without any mention of the role played by fiscal and monetary policies, economists such as Larry Summers and Jason Furman, who had advised earlier Democratic administrations, and Olivier Blanchard of the International Monetary Fund were sounding the alarm. As some of the best Keynesian economists out there, they recognized that the \$1.9 trillion American Rescue Plan was excessive and would cause an excessive increase in aggregate demand, followed by inflation.

A series of new studies confirms the demand-side effects on inflation.¹² The World Trade Organization's chief economist Robert Koopman also estimates that increased demand for goods was a major factor behind supply chain issues, accounting for anywhere between two-thirds to three-quarters of supply shortages.¹³ In other words, there wouldn't be "supply chain" problems without the massive increase in demand for durable goods fueled by government spending.

The government has been borrowing money for decades, and the Fed has been buying Treasury securities and turning the debt into reserves for a decade without causing inflation. What was different this time around? First, Americans have seen for a decade or so prices rise in assets from housing to land to the stock market, but the increase didn't spread to broader prices until now.

9. "COVID Money Tracker."

10. Calculations of the Committee for a Responsible Federal Budget based on Congressional Budget Office, *An Overview of the Economic Outlook: 2021 to 2031*, February 2021. "America Faces a \$380 Billion Output Gap," Committee for a Responsible Federal Budget, February 1, 2021.

11. Veronique de Rugy, "The Not-So-Stimulative \$1.9 Trillion Package," *National Review*, March 19, 2021.

12. Francois de Soyres, Ana Maria Santacreu, and Henry Young, "Demand-Supply Imbalance during the Covid-19 Pandemic: The Role of Fiscal Policy," VoxEU, Center for Economic Policy Research, March 1, 2022, <https://voxeu.org/article/demand-supply-imbalance-during-covid-19-pandemic>; "Global Supply Chains: Risk, Repair and Restructuring," Morgan Stanley, February 17, 2022, <https://www.morganstanley.com/ideas/supply-chain-disruption-outlook>; "Demand Shock behind Global Bottlenecks Should Ease in Months-WTO," *Reuters*, February 14, 2022. A recent study by the International Monetary Fund estimates that, in the second quarter of 2021, in the United States, about 45 percent of changes in producer prices were driven by supply shocks and 55 percent were driven by demand shocks. Oya Celasun et al., "Supply Bottlenecks: Where, Why, How Much, and What Next?" (working paper no. WP/22/31, International Monetary Fund, Paris, February 2022).

13. "Demand Shock behind Global Bottlenecks Should Ease."

Second, as economist John Cochrane explains, the large money printing and deficit spending alongside the absence of discussion about paying down the debt once this crisis is over is what produced this inflation. As long as everyone understands that current Treasury borrowing will result in higher taxes or lower spending in the future, the debt will not cause inflation. However, as Cochrane points out, “the 2020–2021 borrowing and money episode was distinctive because, evidently, it came without a corresponding increase in expectations that the government would, someday, raise surpluses by \$5 trillion in present value to repay the debt.”¹⁴

The Fed has the tools to control inflation today by raising interest rates. However, the amount of America’s debt may make fighting inflation harder than in the past. Federal debt held by the public is now \$23 trillion, or 100 percent of GDP, and a large share of that debt is short term (30 percent has a maturity of a year and over 60 percent a maturity of four years).¹⁵ Therefore, any increase in interest rates sufficient to fight inflation would quickly lead to a large increase in interest payments.

In addition to being politically unpopular, higher interest rates—if they are paid with borrowed money rather than higher taxes—may add fuel to the inflation fire. As Cochrane explains, if people believe that the government will fail to undertake the fiscal measures needed to offset the increased deficits, debt, and interest payments, the result is fiscally driven inflation, which the central bank combats by increasing interest rates, which makes inflation worse.¹⁶

WHAT NEEDS TO HAPPEN NOW?

First, the Fed needs to fully step back from its expansionary policy and raise interest rates significantly to tame inflation. With inflation at 8.3 percent, even the Fed’s promise to raise interest rates to about 2 percent leaves the real, after-inflation cost of borrowing at a stunning –6.3 percent. The rule of thumb is that to tame inflation, the Fed must raise nominal interest rates by more than the inflation rate, so that real interest rates rise. Current Fed policy will only achieve that goal if almost all of today’s inflation miraculously melts away on its own.

Congress needs to do its part too. Without fiscal consolidation, the government’s interest costs on the debt will rise. Unless fiscal policy tightens to pay those interest costs, raising interest rates just makes deficit-induced inflation worse.

Empirical evidence confirms that fiscal contraction is a key element to lowering persistent inflation. For instance, legislators implemented fiscal consolidation (by raising revenue—through progrowth tax and regulatory reforms that increased the tax base—decreasing spending, or both) during each of the four latest victories over inflation: in the late 1940s, after the 1980–1982 Recession, in the late 1980s, and in mid-1990s. Unfortunately, this critical link between fiscal and monetary expectations is too often overlooked in conventional inflation debates, with fiscal authorities acting as though inflation outcomes are independent of fiscal policy.

14. John H. Cochrane, “Fiscal Inflation” (paper presentation, Cato Institute 39th Annual Monetary Policy Conference, Washington, DC, December 22, 2021), https://static1.squarespace.com/static/5e6033a4ea02d801f37e15bb/t/61d3c86e0797d1326136230b/1641269358431/Cochrane_Final_12.pdf, 4.

15. “Most Recent Quarterly Refunding Documents,” US Department of the Treasury, accessed June 2, 2022, <https://home.treasury.gov/policy-issues/financing-the-government/quarterly-refunding/most-recent-quarterly-refunding-documents>.

16. John H. Cochrane, “Fiscal Inflation,” *Grumpy Economist*, January 3, 2022.

Also, higher real interest rates would increase household wealth through lower inflation (increasing the real value of wealth) and higher interest receipts (raising household income flows). Thus, although the central bank is aiming to lower inflation, its efforts could backfire by boosting demand for goods and services. Higher levels of debt work to amplify these (demand-driven) inflationary pressures if there are no plans for fiscal consolidation (e.g., tax hikes to offset the wealth effect).¹⁷

Second, Congress needs to get its fiscal house in order above and beyond the need to tame inflation. Perpetual deficits and a looming entitlement crisis will increase the national debt and increase political pressure to finance this growing debt with inflation. The good news is everyone knows what types of fiscal adjustments would effectively reduce the US debt-to-GDP ratio. Alberto Alesina and others have shown that fiscal adjustment packages based on spending cuts—preferably reforms to programs that are the drivers of future debt: Social Security and Medicare—rather tax increases are the most effective way to reduce the debt. Such packages are also less likely to cause short-term recessions and, if they do cause short-term recessions, those recessions are mild and short, unlike those caused by adjustments based on tax increases.¹⁸

Third, reducing the existing barriers to supply would solve much of the long-term structural problems with the global supply chain and allow many prices to go down. Some of these changes are legislative, so Congress should get to work on them. Here are a few:

- Eliminate the Jones Act (Merchant Marine Act of 1920).¹⁹
- Reform the Foreign Dredge Act, which requires that dredging barges comply with the Jones Act.²⁰
- End punitive tariffs, duties, and quotas, which inflate costs and reduce the supply of goods that are essential for alleviating supply constraints.²¹
- Ease immigration restrictions.²²
- End the ban on Mexican trucking companies' operation on US roads.²³

17. Eric M. Leeper, "Shifting Policy Norms and Policy Interactions" (paper presentation, Jackson Hole Economic Symposium: Macroeconomic Policy in an Uneven Economy, Federal Reserve Bank of Jackson Hole, WY, September 8, 2021), https://www.kansascityfed.org/documents/8357/Leeper_JHPaper.pdf.

18. Alberto Alesina and Veronique de Rugy, "Austerity: The Relative Effects of Tax Increases versus Spending Cuts" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, March 2013).

19. Under the act, all freight moved between US ports must use US-built, US-crewed, and US-flagged ships to move all freight between US ports. This requirement makes shipping more costly and puts more pressure on inland transit (trains and trucks). Thomas Grennes, "An Economic Analysis of the Jones Act" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, May 2017); Nita Ghei, "The Jones Act and the Growth of Regulatory Barriers in the US Shipping Industry," Mercatus Center at George Mason University, April 4, 2017; "Project on Jones Act Reform," Cato Institute, accessed March 18, 2022, <https://www.cato.org/project-jones-act-reform>.

20. This significantly inflates the costs of dredging US ports, preventing expansions that could accommodate more and larger ships. There has been no container terminal expansion since 2009 (Charleston).

21 For example, section 301 tariffs have drastically reduced the supply of truck chassis in the United States, worsening truck shipping bottlenecks. "Tariffs Could Be Part of Why We're Short on Chassis," *Flexport*, October 28, 2021.

22. Immigration restrictions have "removed at least 1 million potential (and lawful) workers from the U.S. labor market, putting acute pressure on labor-intensive industries like warehousing. (And backed-up warehouses make it more difficult to clear containers that are stacked up at various ports.)" Lincicome, "American Sclerosis."

23. The ban keeps "the largest and closest supply of potential US truck drivers' out of the country *and* reduc[es] the number of *American* trucks available for inland work because they're picking up cargo at the border from Mexican truckers who have to drop it there." Mark Szakonyi, "Western Countries Waking Up to Freight Infrastructure Needs: DHL CEO," *Journal of Commerce*, October 14, 2021, quoted in Lincicome, "American Sclerosis."

State and local governments have their own role to play in removing supply chain obstructions. Local zoning, land use, and environmental rules have stopped ports and other companies from building or expanding warehouses and other container structures.

These rules and many others explain why there is no American port among the 50 most efficient in the world. One can, however, find the largest US port, in the Los Angeles area, near the bottom of some measurements of the 351 global ports. Easing restrictions would significantly help improve American ports and, in turn, increase the flow of supplies.

Economists fittingly call these ideas “supply side” reforms, and they are beneficial far beyond specific issues with supply chains. For example, reforming land use and zoning rules would also expand the supply of housing, reduce home prices, increase labor mobility, and reduce income inequality. Other supply-side ways to improve labor mobility at the state level are removing some occupational licensing rules and many childcare licensing requirements and regulations.

WHAT NOT TO DO

There is a temptation to offset inflation with subsidies, to have the government borrow more money to help Americans pay for gas, housing, childcare, and more. Such fiscal largesse is the source of the problem, and these efforts make the markets for these goods and services more inefficient. This approach threatens a greater stagnation spiral and is a temptation to be resisted.

Similarly, policymakers need to resist the lure of price controls as a way to address the increase in prices, even in food or energy. Such measures ignore the complex factors that determine prices in the economy, making the cure worse than the disease.

The lessons of the 1970s price controls remain true today. An increase in money stock triggers inflation, requiring price controls, which lead to shortages, which then require government intervention for allocation of the limited supply.

Those who argue that price controls are necessary to address inflation mistakenly assume that prices have no impact on consumer demand for goods because monopolies are everywhere, and most goods are so indispensable that consumers will continue to buy them at any price. They also mistakenly assume that a government ban on price increases will have no negative impact on producer willingness to supply goods, so the only impact of price controls is to decrease the prices consumers pay while having no effect on consumption or production.

These assumptions are incorrect. When prices rise, consumers reduce their demand for goods (unless inflation expectations come into play and consumers increase purchases today to avoid even higher prices tomorrow). Also, companies prohibited by law from raising their prices reduce their supplies, thus creating shortages such as those in the 1970s.

Also incorrect is the argument that inflation is caused by corporate greed. Inflation is a general and ongoing increase of all prices, including wages. For inflation to be the product of corporate greed would require that all companies be greedier simultaneously and that all workers demand—and successfully

obtain—a raise in their wages. For the corporate greed argument to hold, one would have to believe that greed leads companies to raise prices without being powerful enough to resist workers' demands for higher wages.

CONCLUSION

Inflation is not caused by corporate greed or supply constraints; it is caused by excessive government deficit spending fueled by loose monetary policy. Getting rid of inflation requires raising interest rates higher than the current level of inflation, and it requires fiscal discipline. Reforms, such as deregulation, that promote faster growth in the supply of goods and service also help.

What America does not need, but what it likely will get, is more government spending and more debt accumulation. The result will only fuel the inflation fire. I hope that policymakers at least avoid making matters even worse with price controls.