INDEXATION: A Reasonable Response to Inflation

Who Controls What in the U.S. Economy?
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A REASONABLE RESPONSE
TO INFLATION

Brian Horrigan

... Far from being the cause of inflation, indexing wages, taxes, and transfer payments to the price level makes inflation easier to put up with and easier to get rid of.

WHO CONTROLS WHAT
IN THE U.S. ECONOMY?

Timothy Hannan

... The best evidence suggests that control of the economy has not become more concentrated in recent decades.

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Indexation:
A Reasonable Response to Inflation
By Brian Horrigan*

"Until I was eight, I got a five dollar bill every year for my birthday from Grandpa. Then, because of inflation, the amount rose to ten dollars. On my next birthday, I expect it to rise to twenty dollars." — Ben, nine years old, quoted in FORBES.

With fifteen years of historically high and variable inflation behind them and with anti-inflation programs showing less than the hoped-for success, Americans are looking for ways to protect themselves from inflation. One of the more widely discussed approaches is indexation—pegging wages, transfer payments, and even taxes to changes in the cost of living as measured by a price index.

Indexation has its detractors—those who argue that it tends to perpetuate inflation and that it leads to more unemployment when productivity unexpectedly drops. But many economists favor indexing on the grounds that it preserves the after-tax purchasing power of wages and transfer payments, mitigates the undesirable side effects of anti-inflationary monetary and fiscal policies, and reduces the government’s incentive to expand via inflation.

On balance, indexation appears to hold a lot of promise as a means of reducing the costs of inflation while at the same time reducing the costs of eliminating inflation, provided a way can be found to make sure that its desirable effects predominate.

INDEXATION ON THE RISE

Indexation has become quite common in the United States. About 9 million workers—some 10 percent of nonagricultural civilian employment—are covered by cost-of-living-adjustment (COLA) clauses. Over 35 million people who receive social security or government pensions, and over 16 million food stamp recipients, have their benefits linked to a price index.

Indexation is extensive in the rest of the

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world, too. In the Scandinavian countries, as well as in Britain, Belgium, and Italy, and even in stable Switzerland, virtually all wages, welfare payments, and taxes are indexed. Indexation rarely is total, though; usually, wages are adjusted only by some fraction of the increase in the cost of living.

The Brazilian experiment in monetary correction (as indexation sometimes is called) has attracted a lot of attention as an example of how it is possible to reduce inflation rapidly with minimal economic disruption. In 1964, Brazilian inflation was running at about 90 percent per year while the real economy stagnated under controls. At that point, the Brazilian government reduced the growth rate of money, eliminated many controls, reduced the size of the government deficit, and instituted partial indexation. The inflation rate dropped to about 30 percent in three years and fell further to about 15 percent in 1973, while real income per capita grew at about 7 percent per year from 1968 to 1973. ¹

The inflation situation in the U.S. is not as severe as Brazil’s was, but many economists are convinced that the U.S. should pursue a similar policy: reduce the deficit and money growth, eliminate price controls, and index wages, taxes, and transfer payments. They contend that indexation can minimize the economic slowdown that usually accompanies a reduction in the inflation rate.

**HOW INFLATION HURTS**

In a decentralized market economy, prices provide both information and incentives to producers and consumers for rational economic planning. Inflation—a rise in the average of all prices—distorts the relations among the prices of various goods and services, and in the process it makes those relations less stable. When people get confused about the state of the economy, they make mistakes about investment, purchases, and employment; resources are misallocated and society is less well off in the face of increased uncertainty.

The degree of misallocation of resources depends largely on how much inflation is anticipated by the public. The cost of unanticipated inflation—an increase in the price level that catches the public by surprise—is far greater than that of anticipated inflation—an increase that the public expects and can prepare for. If everyone could forecast the inflation rate perfectly—and people do spend a lot of time and effort trying—much of the misallocation of resources caused by inflation and much of the hostility toward inflation would end. A foreseen inflation rate would be built into all contracts and agreements.

What if the actual inflation rate is different from what people expect? If a labor contract embodies one inflation rate and the actual inflation rate turns out to be higher than anticipated, laborers get stuck with lower real wages (the purchasing power of their wages is reduced). If the inflation rate is lower than expected, laborers get unexpectedly higher real wages—at the expense of their employers. To protect themselves from these redistributive swings in income, labor negotiators have sought to build more and more inflation insurance into their contracts in the form of indexation. And it’s not hard to see why many employers have been willing to go along.

**WHY LABOR CALLS FOR INDEXATION**

Indexation has an unmistakable appeal when the outlook for prices is highly uncertain. It gives the impression of slicing through inflation’s Gordian Knot in a single stroke. For all its promised benefits, however, indexation has to be used with a measure of delicacy if it’s to produce the desired result.

¹ During the mid-1970s, Brazil’s inflation rose as high as 89 percent, but not because of (or in spite of) indexation. The cause of this change was connected with the oil-price shocks caused by the OPEC oil cartel and with the relaxation of strict monetary and fiscal policies.
An Example. Suppose the American Widget Corporation (AWC) signs a three-year contract with the Widget Workers Union (WWU) specifying that wages will rise 3 percent a year for each year of the contract. Both management and the union expect consumer prices—including AWC's prices—to rise 3 percent a year. If worker productivity rises at about 2 percent a year and prices rise as expected, AWC should have no trouble meeting its payroll.

But what if, contrary to expectations, consumer prices rise at 7 percent a year, not 3 percent? Then real wages will drop at the rate of 2 percent a year (5 percent less 7 percent leaves a minus 3 percent), even though nominal wages rise. Meanwhile, AWC finds its revenues increasing faster than its payroll as unanticipated inflation transfers real income from workers to the managers and stockholders of the company. Because the workers' real wages are dropping, AWC finds it profitable to step up production and increase the number of employees and the number of hours worked. AWC has a boom, and if most of the companies in the economy are in the same position as AWC, the entire economy has a boom. Unanticipated inflation fools workers into working more hours than they would have if they had anticipated the lower real wage.

Suppose that when the contract expires after three years, the WWU negotiates a large initial raise plus an agreement to increase wages at 9 percent a year for three years. The wage settlement in this example is not inflationary; it is only a response to high inflation (see DOES INDEXATION CAUSE INFLATION?). The large initial

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**DOES INDEXATION CAUSE INFLATION?**

Some writers argue that wage indexation causes inflation. According to this point of view, indexation creates a built-in wage-price spiral in the economy: indexation forces wages up, which forces prices up, which in turn forces wages up through indexed contracts, and so on.

In fact, however, inflation is explained by other forces. The Federal government influences the level of aggregate demand by monetary and fiscal policies. If aggregate demand rises faster than aggregate supply, inflation results. The private sector does not produce a demand for inflation; only the government does.

Inflation produced by supply shocks is another matter. A shock to the supply side of the economy, such as an oil price increase, makes unemployment and inflation temporarily worse with wage indexation than without. Historically, though, prolonged high inflation—the only kind that produces indexation of labor-contracts—has been produced by monetary and fiscal policies, not by supply shocks. If supply shocks seem to be the cause, workers will do better with partial indexation than with none at all.

Some economists offer a different objection. They believe that the size of the budget and the size of the deficit directly affect the amount of inflation. These critics of indexation argue that as indexation automatically boosts government wages and reduces tax rates, the budget deficit will swell, creating more inflation. But indexation by itself does not create a budget deficit. Suppose all prices were to double. With perfect indexation, the government payroll, the prices of materials purchased, transfer payments, and tax revenues all would double. If the budget is balanced before the price level doubles (assuming that the national debt also is indexed), it will be balanced after the price level doubles. Thus indexation does not lead to larger real deficits or more inflation.

Overt indexation of government wages and transfer payments will cause larger deficits, however, so it is important that the government take care not to overindex. Whatever the merits and difficulties of wage indexation for stabilizing the economy and protecting workers, wage indexation cannot be accused of causing inflation. Only monetary and fiscal policies can create a sustained inflation.
raise simply restores real wages to where they would have been had unanticipated inflation not cheated workers of some of their real wages. And the high annual increase in future wages is designed to give the workers raises to match their increased productivity, after allowing for the expected 7-percent inflation rate.

Suppose now that policymakers decide to end inflation by taking restrictive monetary and fiscal measures. Aggregate demand rises more slowly and inflation tapers off at the same time that AWC must give a 9-percent annual wage hike to its employees. Since the new inflation rate is lower than anticipated, the real wages of the workers are higher than expected. With revenues rising more slowly than anticipated and real wages rising faster, AWC must cut back production and lay off workers. If many companies are in the same position as AWC, the entire economy slides into a recession, even though inflation still rages. When the contract expires, workers will have to accept a reduction in their real wages to be re-employed.

The Benefits of Indexation. These dislocations need not occur if labor contracts with a fixed wage increase are replaced by contracts containing a COLA clause. Unanticipated variations in the inflation rate produce far less economic disruption when wages are indexed to consumer prices than when they are changed contractually without an explicit link to the inflation rate (see IN SEARCH OF AN INDEX). With COLA, for example, an initial contract is negotiated for a small fixed-percentage wage increase—reflecting productivity increases—plus a cost-of-living adjustment. If the fixed portion of the increase were, say, 2 percent and the inflation rate were 7 percent, indexed wages would rise by 9 percent. If inflation is 3 percent, wages rise 5 percent. With full indexing, the real wage rate is not affected significantly by the inflation rate. Therefore, if all the labor contracts in the economy were indexed, the temporary boom that accompanied an unanticipated increase in inflation would not occur. And the recession that accompanies an unanticipated decrease in inflation wouldn’t occur either. Thus if the main reason government won’t implement the monetary and fiscal policies necessary to end inflation is that it is afraid to cause a recession (as some have suggested), then indexation facilitates an anti-inflationary program by reducing its costs.

If wage indexation promises to reduce both the undesirable effects of inflation and policymakers’ incentives for letting inflation continue, it would seem appropriate to index to the high, adjusting wages with each upward (or downward) tick of the chosen price index. But as with most policy actions, wage indexing can produce certain unwanted results alongside the desired ones.

Supply Shocks Complicate the Issue. The prices of goods and services reflect both supply conditions and demand conditions. Expansionary monetary and fiscal policies increase prices by increasing demand. Changes in supply-side factors, such as the cost of raw materials or labor productivity, also change prices. Over the last decade, the U.S. has undergone several sharp supply shocks which boosted the price level, and indexation gives unfortunate results when used in an environment of supply-induced inflation.

In particular, while indexation moderates fluctuations in employment induced by demand-caused inflation, it aggravates fluctuations in employment occasioned by inflation brought on from the supply side. The reason is that though a demand shock increases the price level, it does not change worker productivity. Hence employment need not change when wages are indexed. But a supply shock does reduce worker productivity, so real wages must fall if employment is to stay the same. Since real wages cannot readily adjust downward with productivity when wages are indexed, supply shocks produce a drop in employment.
IN SEARCH OF AN INDEX

The main technical difficulty with indexed contracts concerns the choice of a proper price index. Measuring inflation is no simple task; compiling price indices is difficult and there is a large margin of error. Using a price index that does not measure inflation accurately reduces the advantages and increases the disadvantages of indexing.

The Consumer Price Index is the most widely quoted and often-used price index in the United States. The CPI measures the change in the cost of buying a representative market basket of goods and services over time. The Bureau of Labor Statistics, which issues the CPI, derived its representative market basket from a massive survey of consumer buying habits in 1972-73. It estimates the inflation rate for subsequent periods by updating the prices of the goods in that market basket.

The market basket purchased by the representative American family, however, changes constantly not only in price but in composition. As consumer preferences shift, as new products are introduced, and as supply conditions change, consumers substitute one component for another. By failing to capture the changes in consumer buying habits, the CPI overstates the inflation rate. In 1979, for example, the price of gasoline rose 81 percent, and as a result, consumers cut down their use of it; the share of total real consumption allotted to gasoline fell from 3.2 percent to 2.6 percent. Yet the CPI calculates the change in the cost of living as if the share of gasoline were 3.2 percent, and consequently it overstates the rate of inflation.

The CPI does an especially poor job with the cost of owner-occupied housing. It includes the purchase price of new homes and the current mortgage rate along with the price of haircut and bread is the market basket. But it leaves out the expected capital gains of home ownership, which must be subtracted from mortgage costs in order to arrive at an accurate estimate of the net cost of occupying a home. As a result of the re-measurement of housing costs, the CPI overstates the inflation rate during periods of rising mortgage rates and rising home prices. The BLS is considering new ways to figure the CPI and has constructed five experimental measures which embody different treatments of housing costs.

An alternative index is the Personal Consumption Expenditures (PCE) Deflator issued by the Bureau of Economic Analysis of the Department of Commerce. The PCE offers some advantages in the measurement of housing costs and it adjusts the representative market basket for changes in consumer buying habits. But the PCE has disadvantages too, connected with its sampling techniques and its currency (it is issued quarterly with a two-month lag, whereas the CPI comes out monthly and is available three weeks after the end of the month of record).

The choice of a price index is not merely an academic matter; the differences in estimates of the inflation rate conveyed by different price indices tell different stories about consumer welfare. For 1979, for example, the CPI measure of the inflation rate was 12.8 percent, while the Personal Consumption Expenditures Deflator measured the inflation rate at 10.2 percent. In an economy in which tens of millions of people are covered by indexed labor contracts and transfer payments, even a small change in measured inflation shifts billions of dollars around. Thus the search for an index that measures the effect of price changes on human welfare more accurately should continue.

Suppose that a supply shock (such as a sudden, dramatic increase in the price of oil) causes worker productivity to drop. AWC finds that its labor costs per widget have risen. The company will continue to employ the same number of workers only if real wages decline. If the workers are not covered by a COLA clause, their real wages will drop, so fewer of them (or none) will have to be laid off. If workers are protected against inflation by a COLA clause, though, their real wages can't drop, so AWC will have to lay some of them off. Thus the effect of indexing on employment depends crucially on whether inflation is demand-induced or supply-induced.
Looking at it another way: If an increase in the scarcity of some commodity such as oil, steel, or wheat requires a reduction in real incomes throughout the economy, inflation will help to spread the shock by reducing real incomes everywhere. With perfect indexation, everyone tries to keep the same size slice of the pie even though the whole pie is smaller. The only way to trim workers’ income down to size after a supply shock in an indexed world is simply to lay off workers—or else break the contract and renegotiate. Thus supply shocks make the chances of success for indexation somewhat more tenuous. But even with a demand-induced inflation, it’s still a good trick to find the level and technique of indexing that will capture most of the achievable benefit while incurring the least possible cost.

Optimal Indexation One way to get a fix on how much to index is to see how workers protect themselves against inflation under a system of nonindexed labor contracts.

Shortening the duration of contracts is one method they use to reduce the costs of miscalculating the inflation rate. If inflation is fluctuating, frequent renegotiation of labor contracts will keep the real wage rate more nearly constant than long-term contracts can. Indeed, during hyperinflation (those exceeding 100 percent per week), contracts longer than a week vanish from the economy. But shortening the labor contract is an expensive way to cope with inflation because negotiation costs can be formidable. Also, the more frequently contracts are renegotiated, the higher union militancy and worker discontent appear to be. The inflation rate in the United States, for instance, is correlated positively with strike activity. Internationally, high worker militancy in Britain and Italy (both with chronically high inflation rates) and lower worker militancy in Switzerland and West Germany (both with relatively low inflation rates) are consistent with the view that inflation causes strikes.

Shortening and indexing contracts both are imperfect and costly ways of coping with inflation uncertainties. But despite their costs, they are attractive to both labor and management, though in different mixes under different conditions. When inflation is induced primarily by pumped-up demand, indexation will get the most emphasis in labor contracts. When supply interruptions are chiefly responsible for a round of inflation, negotiators will rely more heavily on shortening labor contracts. There is no one formula that’s best for dealing with all cases of uncertainty about inflation; the best combination of index and contract length will vary from country to country, from industry to industry, and from time to time. With their relative incomes at stake, though, both management and labor will try hard to find the formula that meets their needs best.

Should government get involved in this process? Given the complexities of labor negotiations, which are occasioned by wide variations in shocks to various industries, mandating a single economy-wide indexing scheme or prohibiting indexation would not be socially beneficial. An unfettered market seems best able to consider the large amount of information required to decide what kind of labor agreement works best in a given instance.

As wage indexing in the private sector becomes more common, however, it raises questions of both efficiency and equity for government, since government must compete for workers in the private labor market. Should wages in government be linked to those in the private sector? And if wages are indexed, how about transfer payments and taxes? These are issues that government can’t avoid addressing.

INDEXING IN GOVERNMENT

In the Federal government, wages by turns have risen faster than wages for comparable work in the private sector and have been capped without regard to market pressure. Transfers have moved with the CPI, but tax
rates have not been adjusted for inflation. Recently, however, policymakers have looked more closely at tying all three to the same driver, and in the case of taxes the Congress has spoken fairly clearly.

Wages and Transfer Payments. Government faces the same issue with its employees as does a private employer: unexpected inflation erodes the real value of their wages. If government workers don't receive periodic cost-of-living adjustments, their real wages drop, affecting morale and turnover. The best workers leave government for the private sector or refuse to join the government if wages there lag too far behind the private sector.

But there is a danger of overindexing government wages. If government wages grow faster than private wages, taxpayers bear an ever-increasing burden and private employers may face ever-increasing labor costs as they try to compete with government. Some degree of indexing seems both equitable and efficient, but how much and what kind of indexing?

The best way, it seems, to index government wages is to index them to private wages on a total-compensation basis, including both salaries (or wages) and benefits. A well administered indexing program of this kind can keep government wages from racing ahead of private wages (burdening the private sector) and from falling behind private wages (imposing a burden on government workers and yielding inefficient turnover).

Also, the Federal government dispenses hundreds of billions of dollars each year in transfer payments, particularly to the elderly, the poor, and the handicapped. If transfer payments are fixed in nominal terms, these people can be hurt badly by inflation. One approach to protecting them—already implemented in many cases—is to index transfer payments.

But indexing transfers raises new questions of equity: Should those dependent on transfer payments be protected from supply shocks? Should recipients of social security, for example, be protected from inflation caused by a foreign oil cartel? Should those on retirement or on welfare maintain their real incomes even when the real incomes of workers drop?

Government has the alternative of indexing transfer payments to wages or to the price level. This issue cannot be settled by economic logic alone. How to index social security and other transfer payments is a political question about what transfer payments are intended to do. If the function of transfer payments is to maintain a constant real standard of living for those on the receiving end, then price indexing is appropriate. If the purpose of transfer payments is to keep the standard of living of transfer recipients in line with that of workers, then indexing transfers to wages is appropriate.

Tax Indexation. As incomes rise just to keep up with inflation, people find themselves in higher and higher tax brackets, because the current progressive tax code does not distinguish a real increase in income from a purely nominal increase in income. The marginal tax rate of a married taxpayer with a $40,000 salary and standard deductions, for example, is 32 percent. (The marginal tax rate measures the extra tax paid on each extra dollar earned.) If the inflation rate is 10 percent and the taxpayer's salary rises by 10 percent to $44,000, the taxpayer finds himself in the 37-percent marginal tax bracket: the taxpayer pays higher real taxes even though his real income before taxes is unchanged. It has been estimated that if the price level rises 10 percent, tax revenues rise 15 percent; with tax indexation, tax revenues would rise only 10 percent.

Further, inflation creates illusory profits that are subject to taxation as if they were real profits. In calculating profit, the tax code does not adjust capital gains, the value of inventories, or depreciation allowances for inflation. Thus it overstates current taxable income and increases the effective tax rate. The higher the inflation rate, the higher the effective tax on corporate profits.³

Finally, certain deductions, exemptions, and allowances in the tax code are not adjusted for inflation. To the extent that the personal exemption, the standard deduction, the low-income allowance, and the dividend and interest exclusion are stated in nominal terms, inflation reduces their real value and increases real taxes on the same real income.⁴

Indexing the whole tax system would neutralize the effect of inflation on real taxes by adjusting all nominal values in the tax system annually. If the inflation rate were 10 percent over a year, then at the end of the year a $1,000 personal exemption would become a $1,100 personal exemption, the $1,000-$2,000 tax bracket would become the $1,100-$2,200 tax bracket, a 5-cent a gallon gasoline excise tax would become a 5½-cent tax, a 25-percent capital gain would become a 35-percent capital gain, and so on.

Recently, the Congress instituted partial indexing of the tax code based on the CPI. Effective in 1986, income tax brackets, the zero bracket amount, and the personal exemption will be adjusted annually by the amount of inflation. Tax bracket creep will cease to be a burden on the American taxpayer.

But important parts of the tax code remain unindexed. The real value of depreciation allowances, of capital gains taxes, of excise taxes, and of interest taxes varies with the rate of inflation even after the new indexing law takes effect. If inflation persists, the Congress may well consider further indexing of the tax code for the sake of its equity and efficiency.³

**CONCLUSION**

Indexing is, at best, a necessary evil. Indexing is costly to administer and it makes the economy more sensitive to supply shocks. It would be far better to have no inflation and no indexing than even a little of either or both. But given the prospect that...

³Feiststein and Summers, two economists who have studied the interaction of inflation and corporate taxation, conclude:

*The overall effect of inflation with existing tax laws was to raise the real 1977 tax burden on corporate sector capital income by more than $32 billion. This extra tax represented 69 percent of the real after-tax capital income of the non-financial corporate sector, including retained earnings, dividends, and the real interest receipts of the corporations’ creditors. The extra tax raised the total tax burden on nonfinancial corporate capital income by more than one-half of its noninflation value, raising the total effective tax rate from 43 percent to 66 percent.*  


⁵This inflation-induced extra burden on capital income probably reduces the level of investment.

⁶There is one way inflation reduces real taxes: Excise taxes are fixed in nominal terms and decrease in real value during inflation. The gasoline excise tax licenses the highway system; highway construction and maintenance may have been hurt by the reduction in real gasoline excise tax revenues caused by the inflation.

⁷The alternative to indexing is annual legislative review to make inflation adjustments. Annual review has the advantage that the legislature can keep government wages, transfer payments, and taxes from becoming too high or too low. Unfortunately, annual review produces constant political controversy and thus absorbs a very large amount of legislative time. Furthermore, inflation makes it easy for the legislature to let real transfer payments fall via inflation. (Similarly, inflation creates tax bracket creep which allows taxes to rise without explicit legislation.) It seems preferable for the legislature periodically to set the level of real government wages, transfer payments, and taxes it desires and let indexing preserve their value on a year-to-year basis.
inflation will continue, indexation is a lesser evil than no indexation.
When inflation disappears, indexation will vanish with it from the private economy. But
until it does, Americans and others will look to indexation as one of the few tools they
have to protect their economic well-being.

SUGGESTED READING
A reader interested in learning more about indexation would do well to read Essays on Inflation
and Indexation (Washington: American Enterprise Institute for Public Policy Research, 1974),
which includes Friedman’s classic defense of indexation. A shorter version of
Friedman’s essay can be found in Fortune Magazine, July 1974. Another valuable source of
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BIG GOVERNMENT, a pamphlet written by Lawrence C. Murdoch, Jr., Vice President at the Philadelphia Fed, traces the growth of government in the United States and puts recent calls for reducing the size of government into perspective. Copies are available without charge from the Department of Public Services, Federal Reserve Bank of Philadelphia, 100 North Sixth Street, Philadelphia, PA 19106.