The original documents are located in Box C3, folder "Presidential Handwriting, 9/19/1974" of the Presidential Handwriting File at the Gerald R. Ford Presidential Library.

approx.
9/19/74.

THE WHITE HOUSE

WASHINGTON

Hartmann – please handle.

THE UNIVERSITY OF CHICAGO
DEPARTMENT OF ECONOMICS
1126 EAST 59TH STREET
CHICAGO • ILLINOIS 60637

September 7, 1974

Dictated in Vermont
Transcribed in Chicago

Mr. Alan Greenspan, Chairman
Council of Economic Advisers
Washington, D.C. 20506

Dear Alan:

When I talked with President Ford briefly on Thursday after our session, he asked whether I had a brief description of the proposal for inflation-proofing taxes and for issuing purchasing power bonds. I said that I did and he asked me if I would get it to him by sending it to you for you to pass on to him.

It is clear that the earlier letter which I wrote to him, of which I sent a copy to you, never really reached him personally.

I enclose two things which I shall appreciate your passing on to the President: first, a copy of the letter which I wrote to him; second, a Newsweek column, "More on Living with Inflation," of October 29, 1973 on which I have marked the part which is a direct answer to his request.

I thought the meeting went surprisingly well with few of the political overtones or emotional appeals that were to be feared. Trust all continues to go well.

Cordially yours,

Milton gv

Milton Friedman
(Dictated but not read)

MF:gv

Enclosures

August 12, 1974

President Gerald R. Ford
The White House
Washington, D.C. 20500

Dear Mr. President:

Little did I think when we last met at the Time dinner for George Shultz that I would so soon be changing my mode of addressing you from "Jerry" to "Mr. President." The tragedy that has produced that outcome is also a challenge and an opportunity. I join my 200 million fellow citizens in welcoming your accession and offering prayers for your success.

But I write now less to record these heart-felt sentiments than to add one more to the hundreds of suggestions that you must be receiving for the conduct of economic policy.

We all know that the essential elements in cooling inflation are (1) avoiding price and wage controls; (2) reducing government spending; (3) restraining monetary expansion. I devoted my Newsweek column on your accession to stressing the urgency of cutting government spending.

The proposal I urge you to consider is a tax reform that will contribute to cutting government spending, not only today but increasingly in the future, that is demanded by considerations of equity, and that would be a dramatic public sign that you seek both objectives.

The proposal is to inflation-proof the personal and the corporate income taxes, so that inflation no longer drives individuals into higher tax brackets and no longer forces corporations to pay taxes on wholly fictitious profits.

The change would have no initial effect on revenue. But once in operation, it would deny Congress its present easy out: noisily voting bigger spending programs while silently raising taxes through inflation without ever voting to do so. It will not prevent Congress from legislating additional spending, but it will come closer than now to requiring Congress also to legislate the taxes to pay for the spending. The proposal therefore promotes true fiscal responsibility.

The change is not radical or unprecedented. Several countries, including Canada, have enacted similar measures. The proposal is embodied in Senate Bill S3396, introduced by Jim Buckley; and in House Bill HR15092, introduced by Phil Crane plus fifteen co-sponsors.

The proposal is not a panacea. But it is an important initiative that you can take, that eases the immediate problem and at the same time improves the fundamental structure of our budgetary system.

I am sending copies of this letter to Bill Simon, Kenneth Rush, and Alan Greenspan.

Sincerely yours,

Milton Friedman

cc: William Simon
Kenneth Rush
Alan Greenspan

MF:gv

BY MILTON FRIEDMAN

MORE ON LIVING WITH INFLATION

The hard truth is that we face continuing inflation at a substantial though uncertain rate. The hard truth is that it is extremely difficult for the ordinary man to protect himself from the ravages of inflation. The encouraging fact is that there are feasible innovations that would reduce the ravages of inflation. The sooner these are adopted the better.

The basic *principle* is simple: express all transactions that have a time duration in terms that eliminate the effect of inflation. The *application* of this principle is anything but simple—indeed, the great virtue of relatively stable prices is precisely that it makes such costly and cumbrous arrangements unnecessary.

CURRENT ARRANGEMENTS

The basic principle has already been applied to some transactions in this country and to a much larger number in other countries that have suffered more from inflation.

Wages. Many union contracts contain escalator clauses that adjust wages automatically to changes in the cost of living.

Interest rates. Loans to small businesses guaranteed by the government and many private loans are at interest rates that vary over the life of the loan with the prime rate—which produces a rough adjustment for inflation. Variable interest rates are being experimented with for mortgage loans and some bank certificates of deposit.

Social security. A recent law provides that payments shall be automatically adjusted to the cost of living.

Insurance. The face value of some property policies is automatically adjusted for inflation. Variable annuity retirement and life insurance policies have spread rapidly, but they are linked to the stock market, which offers a highly imperfect protection against inflation.

Though this list is far from exhaustive, such arrangements apply as yet to only a tiny fraction of all transactions. We need to go much farther.

PRIVATE MEASURES

The most important private measures would be the inclusion of escalator clauses in a much wider range of employment contracts and the issuance of purchasing-power bonds.

A wage escalator clause is familiar to most of you. A purchasing-power bond is much less familiar. Like an ordinary bond, it consists of a promise to pay a certain amount in interest each year and to repay the principal at the end of a definite period. Unlike an ordinary bond, the annual interest and the terminal repayment are not stated as a fixed number of dollars but are adjusted for changes in a price index. For example, such a bond might pay each year a sum equal to $4 times a price index and repay at the end of ten years $100 times a price index. If prices rose by 5 per cent in the first year that such a bond was outstanding, the interest payment would be $4.20, not $4. If prices rose a further 10 per cent the next year, the interest payment would become $4.62, and so on. If prices doubled over the ten-year life of the bond, the amount repaid would be $200, not $100.*

I conjecture that the time is ripe for private purchasing-power bonds. A breakthrough awaits only an imaginative bond underwriter.

The issuance of purchasing-power bonds on a large scale is a prerequisite for any extensive issuance of price-escalated life insurance, in order to provide the appropriate assets to match such liabilities.

GOVERNMENT MEASURES

The most critical governmental measures are inflation-proofing the income tax and issuing purchasing-power securities.

Income tax. Suppose your income goes up by 10 per cent when prices go up by 10 per cent. You have no more purchasing power than before. Yet you will pay a larger fraction of your income as income tax because the personal exemption will mean less and you will be pushed into higher tax brackets.

The simplest way to inflation-proof the income tax is to express both the personal exemption and the limits of the tax brackets as a number of dollars times a price index. For example, if prices rise by 10 per cent, the personal exemption should become $825 instead of $750, the first bracket taxed at 14 per cent should become 0 to $550 instead of 0 to $500. This adjustment can be incorporated in the printed tax returns so that it does not complicate the taxpayer's task.

*An alternative is to have the annual interest rate equal a fixed number plus the rate of price rise but to make the terminal repayment a fixed number of dollars. In effect, this involves gradual amortization of the real value of the bond during inflationary periods.

In addition, the base for capital gains and for depreciation of assets should be redefined as the present base multiplied by a price index. If you bought a house in 1960 for, say, $20,000 and sell it now for $30,000, you will be taxed on a $10,000 capital gain, even though prices have risen by 50 per cent in the interim. You have only a paper capital gain, not a *real* gain, and should pay no tax at all. Similarly, business enterprises are required to calculate depreciation on machines at original cost rather than at today's higher replacement cost.

Purchasing-power bonds. If you have invested your savings in Treasury savings bonds, you have been taken for a ride. The sum you get for the bonds when they mature will buy less at today's prices than the amount you paid for the bonds would have bought at the earlier prices. To add insult to injury, you are required to pay taxes on the so-called "interest"!

High government officials have urged citizens to buy savings bonds to help the country and themselves. At the same time, the government has produced inflation. The result has been to fleece innocent and patriotic citizens on a scale that no bucket-shop operator has ever approached.

Personally, I regard this confidence game as no less destructive of faith in the democratic process than Watergate. Congress should end this disgraceful practice by mandating that the Treasury issue purchasing-power securities, thereby giving the small saver a way to protect his savings from inflation.

The Congressional tax committees that are now considering tax measures have been urged by a number of legislators to give pride of place to inflation-proofing the income tax and to requiring the Treasury to issue purchasing-power securities. If the tax bill that comes out of committee does not embody these reforms, Sen. James Buckley has said that he will offer them as amendments.

These reforms deserve wide support. They would reduce the harm done by inflation and would ease the withdrawal pains from reducing inflation. They would also lower the revenue that the government gets from inflation and hence the government's incentive to engage in inflation. This is at one and the same time a major argument in their behalf and the chief obstacle to their enactment.

THE WHITE HOUSE

WASHINGTON

September 19, 1974

ADMINISTRATIVELY CONFIDENTIAL

MEMORANDUM FOR: L. WILLIAM SEIDMAN

FROM: JERRY H. JONES JHJ

The attached was returned in the President's outbox and is forwarded for your handling.

Thank you.