A less painful way to bring down inflation

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In my previous column, I described how the Federal Reserve could reduce the inflation rate by decreasing the money supply in order to increase the interest rate. This policy would work because a high interest rate discourages people from borrowing money and without this borrowed money they would want to purchase fewer goods and services. With less people clamoring to buy products, firms wouldn't be able to increase their prices without losing out on sales. As a result, prices would become stable and the era of high inflation would end. But as I also mentioned in that column, this "solution" has a painful side effect. It can decrease purchases enough to throw the economy into a recession or make an existing recession worse.

That column may have left you wondering whether the government should try to bring down the inflation rate. No one wants a recession. Luckily, the government has another way to tame inflation and this second approach won't throw the economy into a recession (or make one worse). This second approach just encourages firms to produce more output. When firms produce more output, there will be enough products to go around at existing prices. Firms wouldn't be able to get away with increasing their prices since consumers will only buy from the firms that keep the old prices.

There are several ways the government can encourage firms to produce more output. First, the government can lower corporate taxes. When these taxes decrease, firms will be able to earn more profit on each sale. Some production that had not been profitable at the old high corporate tax rate will become worth producing at the new lower corporate tax rate.

Second, the government can reduce regulation. Regulations increase the cost of production since they often cause firms to adopt inefficient production techniques. Removing some of these regulations will reduce firms' production costs. With lower costs, firms will find it profitable to produce more output. So then, at a given price, firms can earn a profit by producing extra output now that their costs are lower.

Third, the government can encourage firms to produce more output by making more workers available. Currently, our nation is experiencing a labor shortage. Firms have cut back on their production simply because they cannot find enough employees. The solution is simple: the government can allow more immigrants to legally come into the United States. These workers can begin to fill vacant jobs. When firms become fully staffed, they can increase their production.

I have only mentioned a few options available to the government. All of these options encourage firms to increase the supply of output. These supply-side proposals are another approach the government can take to reduce inflation and they have an advantage over the demand-side proposal I discussed in my last column. The demand-side proposal, remember, may cause or exacerbate a recession. The supply-side proposals mentioned in this column do have some drawbacks, but they are minor compared to the cost of experiencing a recession. The supply-side proposals may result in lower tax receipts for the government, distasteful unregulated behavior by firms, and problems that occur as an influx of immigrants struggle to assimilate. But I will take these problems over a recession any day.