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BOOK REVIEW

Law and Inflation

BY KEITH S. ROSENN*
UNIVERSITY OF PENNSYLVANIA PRESS, 1982

That inflation affects legal systems is obvious. It seeps through foundations of law like an acid-bearing water and corrodes much. Otherwise tightly-drawn contracts become ill-suited to commerce, tort compensation fails to compensate, long-term capital markets dissolve, the tax system warps.

Inquiry into a basic example is worthwhile. In an automobile accident a worker is injured, disabling him from future work. Legal principles would lead to his receiving an award of future earnings. But how should that award be calculated? Inflation will drive up the dollar value of those future earnings. Must judge and jury then become (or at least consult) economists who predict future inflation? Here we have the potential for a rich field of inquiry for the legal policy-maker: how the award ought to be calculated, what indices to consult, whether the matter can be turned into one of technical calculation. All are worthwhile questions.

In this instance, one could argue that the typical lump-sum award need not be adjusted. Why? Because the earnings on any investments made with the award are likely to reflect inflation in an amount roughly equal to the inflation in the worker's salary.[1] The legal policy-thinker relieves the court of complexity.

Or consider the problem of long- and medium-term contracting for financial payments. Over a period of time, annual payment of $10,000 in current value are to be made. How is inflation

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1. *See* Note, *Inflation, Productivity, and the Total Offset Method of Calculating Damages for Lost Future Earnings*, 49 U. CHI. L. REV. 1003 (1982). This view, that such lump-sum awards should not be adjusted has been accepted by two states. *See* Kaczkowski v. Bolubasz, 491 Pa. 561, 421 A.2d 1027 (1980); Beaulieu v. Elliot, 434 P.2d 665 (Alaska 1967). The Supreme Court, however, has recently held that, at least in federal maritime cases, lump-sum awards must be adjusted for inflation. *See* Jones & Laughlin Steel Corp. v. Pfeifer, _ U.S. _, 103 S. Ct. 2541 (1983).

to be accounted for? Here once again the problem disappears in part. If the parties are reasonably sure that inflation will be about 10% annually, the payments can be adjusted up front: $10,000, $11,000, $12,000, $13,310, etc. The matter becomes knotty only to the extent they are uncertain as to what future inflation will be *and* want to shift the risk that future inflation deviates from the expected inflation. In other words, the parties may adopt the 10% per annum increasing schedule, and have the payor bear the risk of a below-10% rate, while simultaneously the payee bears the risk of an above-10% rate.

The fixed sum schedule will do fine in reflecting such an attitude toward uncertainty. When the parties want to shift all the risk to one party, then complications arise. An index must be used. But as aficianados of inflation and index-construction know, there is no index that measures a "pure" inflation rate. Each index calculates the value of a basket of goods under certain assumptions. That is all. Different baskets produce different numbers. Different assumptions produce different numbers.

On such matters Professor Rosenn is perhaps at his best. Without miring the reader in statistical detail (although properly directing the reader desirous of doing so to appropriate sources), he explains the concepts and problems. For example, consider an index of food. Iceburg lettuce, which constituted 10% of the food budget, rises in price so substantially that consumers buy less of the product, allocating it only 5% of the food budget. Ought that price rise be reflected in the index in full or ought only one-half of the rise be reflected in the index by halving lettuce's weight in the index? By doing so, one learns, one is choosing between Laspeyres and Paasche indices.[2]

The book first surveys the economics and statistics of inflation: its causes, proffered cures, and measurement. Next comes a 35-page history of money. The succeeding several chapters are the core of the book — a discussion of inflation and contract. Rosenn uses this section of the book to approach the problem from several angles: a comparison of civil law and common law attitudes,[3] a contract-draftsman's guide,[4] and a discussion of special contract-based responses to inflation.[5] The last half of the book is a grab-bag of

2. K. Rosenn, Law and Inflation 4-5 (1981).
3. *Id.* at 72-129.
4. *Id.* at 130-66.
5. *Id.* at 167-219.

inflation topics: inflation and compensation systems, inflation and international payments, inflation and tax. The book concludes with Rosenn's prescription: more, but not total, indexation.

In the course of investigating his general problem, Professor Rosenn has painstakingly put together much detail, often encyclopedic in scope, on subjects such as the history of money. (For example, the reader is informed that seven centuries before the first appearance of paper money in the West — when the Massachusetts Bay Colony issued bills of credit in 1690 — paper money was used in China as receipts for the difficult-to-transport iron coins used in Szechwan. The government eventually undertook the task of issuing the receipts and, in time, the inevitable inflation arose as too much paper was issued after the receipt-basis for issuance was relaxed and paper issued without underlying coin.)[6] Yet he reserves most of his attention and energy for a comparative law approach to the problem.

This approach focuses on two questions. First, what ought American legal policy-makers do about inflation in tort, contract and tax? Second, what have other nations done, particularly those in Latin America? Unfortunately, Professor Rosenn runs into a problem of finding an audience beyond those who, like myself, are interested in the answers to both of those questions. As inflation became a problem in the United States in the 1960's and 1970's, there were few sources in which to ground analysis and adaptation. Rosenn's early analysis looked to Latin America,[7] where the problem was old and persistent; where the legal institutions dealing with inflation were in place, and where, in some instances, the failure of those institutions could be analyzed. Yet as time went on, American scholarly analysis left the comparative approach in the dust. Empirical studies of the problems of inflation abounded;[8] de-

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6. *Id.* at 4-5.

7. *See, e.g.*, Rosenn, *Adaptation of the Brazilian Income Tax to Inflation*, 21 STAN. L. REV. 58 (1968); Rosenn, *Adjusting Taxation of Business Income for Inflation: Lessons from Brazil and Chile*, 13 TEXAS INT'L L. J. 165 (1978); Rosenn, *Expropriation, Inflation and Development*, 1972 WIS. L. REV. 845. I have also done the same and benefited from extensive correspondence with Professor Rosenn while doing so. Roe, *Finance, Rules and the Indexation of Brazilian Government Bonds*, 12 VAND. J. TRANSNAT'L L. 1 (1979).

8. *See, e.g.*, J. BOECKH & R. COGHLAN, eds., THE STOCK MARKET AND INFLATION (1982); A. MUNNELL, THE ECONOMICS OF PRIVATE PENSIONS 170-98 (1982) (Brookings study discussing inflation-induced problems on the funding and benefits of pension plans); Gultekin, *Stock Market Returns and Inflation Forecasts*, 38 J. FIN. 663 (1983); Hochman & Palmon, *The Irrelevance of Capital Structure for the Impact of Inflation on Investment*, 38 J. FIN. 785 (1983); Carleton, Chambers & Lakonishok, *Inflation Risk and Regulatory Lag*, 38 J.

ductive economists focused their minds on inflation,[9] and "bracket creep" became a political, economic and tax issue which needed no reference to Brazilian indexation.

Law and Inflation is an integration of the two approaches. I am unsure, however, whether an American audience retains interest in the details of what the Brazilians are doing about inflation, as a prescription for our own inflationary ills, which seem to have, if only temporarily, abated. More interest is now likely to come from fears as to what Brazilian economic problems could do to Brazil's creditors, such as Citibank, Chase Manhattan, and the Bank America.[10] I suppose many, uninterested in the comparative law approach, would prefer to read detailed inquiries into those recurring inflation problems that have been untouched or only superficially touched by others.[11] At times, Professor Rosenn set out to do this.[12] One hopes that such efforts are not at end. Given Rosenn's rather prodigious output,[13] one suspects they are not.

FIN. 419 (1983) (effect of inflation on public utility regulation); FED. RES. BANK OF NEW YORK, ed., READINGS ON INFLATION (1979); Fama, *Short-Term Interest Rates as Predictors of Inflation*, 65 AM. ECON. REV. 269 (1975); Hess & Bicksler, *Capital Asset Prices versus Time Services Model as Predictors of Inflation*, 2 J. FIN. ECON. 341 (1975); R. IBBOTSON & P. SINQUEFIELD, STOCKS, BONDS, BILLS AND INFLATION: YEAR-BY-YEAR HISTORICAL RETURNS (2d ed. 1979). Empirical Studies of American institutions will not tell us about a widespread indexation system. The United States does not have one. But one wonders about the prescriptive value of studies of economies that do, such as Brazil or Israel, when the economic systems studied are vastly different from the American. Perhaps the adjustments necessary to determine the prescriptive validity of the comparative approach are so fundamental that they do not provide much that is useful.

9. *See, e.g.*, M. FELDSTEIN, INFLATION, TAX RULES, AND CAPITAL FORMATION (1983); Bulow, *The Effect of Inflation on the Private Pension System, in* INFLATION: CAUSES AND EFFECTS 123 (R. Hall ed. 1982); Brealey & Schaefer, *Term Structure and Uncertain Inflation*, 32 J. FIN. 277 (1977).

10. *See, e.g.* Kilborn, *Brazilians Look to West to Help Debts*, N.Y. Times, Oct. 23, 1983, at 21, cols. 1-6; Ulman, *Brazil's Rough Road Back to Democracy*, Wall St. J., Oct. 21, 1983, at 29, cols. 4-6 (Brazilian legislature balks at complying with IMF condition to loan that wage increases be indexed at only 80% of the reported inflation rate).

11. Studies of tax and inflation from nonexperts seem unnecessary. The Brookings Institution, for one, has devoted considerable energies to the subject, *see* INFLATION AND THE INCOME TAX (H. Aaron ed. 1976), as has the Federal Reserve, see Concoran, *Inflation, Taxes, and Corporate Investment Incentives, in* READINGS ON INFLATION 157 (Fed. Res. Bank of New York ed. 1979), and the National Bureau of Economic Research, *see* R. HALL, ed., INFLATION: CAUSES AND EFFECTS (1982).

12. Rosenn, *Protecting Contracts from Inflation*, 33 BUS. LAW. 729 (1978); Rosenn, *The Constitutional Guaranty Against Diminution of Judicial Compensation*, 24 U.C.L.A. L. REV. 308 (1976).

13. In about a dozen or so years, over a half-dozen articles. In addition to those cited *supra* notes 7 and 11: Rosenn, *Controlled Rents and Uncontrolled Inflation: The Brazilian Dilemma*, 17 AM. J. COMP. L. 239 (1969); Rosenn, *The Effects of Inflation on The Law of Obligations in Latin America*, 2 B.C. INT'L & COMP. L. REV. 269 (1979), the survey book

To cover the extent to which inflation alters legal institutions would require infinite expertise and investigation. So only a few, such as Rosenn's study of contracts and judicial salaries, can be done carefully and thoughtfully by one person. Given my current particularized interests, corporation reorganization, I would like to see some work on inflation's effect there. For example, the Bankruptcy Code provides that interest shall not accrue on unsecured claims during a reorganization. When interest rates skyrocketed in recent years, did bankruptcy become attractive to owner-managers because it effectively gave them an interest free loan during the few years of reorganization? This might not have been worth the candle when interest charges were 5% per annum. Did the calculus change when rates went to 20% because the value of money was declining approximatley 10% annually? Could an empirical study sort out other volatile factors (e.g., an economic recession) to ascertain the significance of inflation and the nonaccrual rule?

In contrast to unsecured creditors, secured creditors may receive interest during bankruptcy if their security is sufficiently valuable to support repayment of both principal and interest.[14] Has this made creditor demand security from weak debtors more frequently as inflation drove up interest rates?

Actual results uncovered by investigation may be counter-intuitive. For example, conventional corporate finance theory maintains that debt-financing is cheaper than equity-financing because interest payments are tax deductible while payments on equity are not. The value created by debt is represented as the present value of the tax deductions. Higher nominal interest means more deductions, which one ought to think would lead to more debt. (Higher interest due to inflation does not represent a higher real payment. An interest rate of 20%, coupled with an inflation rate of 10%, results in no real after-tax interest for the 50% bracket taxpayer.) But at least one empirical study suggests that debt is not in-

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under review, a co-authored textbook (K. KARST & K. ROSENN, LAW AND DEVELOPMENT IN LATIN AMERICA (1975)), and an unpublished textbook (LAW AND INFLATION).

14. Secured creditors can be stayed form seizing their collateral as long as they receive adequate protection. Bankruptcy Code § 361. Inability of the collateral to support, or of the debtor to make, interim interest payments does not necessarily mean adequate protection — a term of art in bankruptcy — has been given. *In re* American Mariner Industries, Inc., 10 B.R. 711, 714 (Bankr. C.D. Cal. 1981); O'Toole, *Adequate Protection and Post Petition Interest in Chapter 11 Proceedings*, 56 AM. BANKR. L.J. 251 (1982). *But see In re* Anchorage Boat Sales, Inc., 4 B.R. 635, Bankr. E.D. N.Y. 1980) (dictum).

creased.[15] During the 1970's, interest increased but the level of corporate debt did not. It would seem that one could not, at first, explain these results by deductive reasoning. The best explanation may be that some of the same forces for inflation created so much free-floating uncertainty that managers preferred not to increase financial risks. The early 1970's oil shocks affected inflation and increased the perceived riskiness of many enterprises. Inflation made debt's tax value rise, but, increased systematic risk made managers wary of increasing debt burdens.

One problem not adequately discussed in this book is how the courts should respond to statutes that are denominated in fixed dollars, when the original value of which has been warped by time. The problem is not limited to tax statutes nor to penalty or fine statutes. For example, in the 1950's Congress set, and later routinely re-enacted, a liability limit of about $500 million on accidents arising from nuclear accidents. In the late 1970's, a suit reached the Supreme Court arguing that the liability limit, among other things, was an unconstitutional "taking" of property. One of the bases for the suit was that the enormous interim inflation had eroded the value of the original limit. Did Congress intend to maintain a limit of constant economic value? Or did it want the limit expressed in fixed dollars so that in real terms it would decline over time? Or, more realistically, did Congress simply not anticipate the problem and, as such, what ought the courts do? Revalue the express liability limit of the statute? Leave the sum as expressed, in fixed dollars, although the courts knew full well that the inertia of inaction would mean congressional inattention until some serious problem (likely to be *unrelated* to the indexation issue) forced the legislature to reconsider the entire matter?[16]

This is a window that opens to a jurisprudential issue of some consequence: what should courts do with statutes that have worn poorly with age? The most egregious will obtain legislative attention, but many will sit for decades "on the books" without legislative revision. Should courts update the statutes or refuse to enforce them? In many instances, the aging will be due to the expression of dollar amounts in fixed dollars. Here courts could update with indexation. There is much to be said for such judicial action. But readers will have to look to jurisprudential works to see the issues

15. Gordon & Malkiel, *Corporation Finance, in* HOW TAXES AFFECT ECONOMIC BEHAVIOR 131, 158-62 (H. Aaron & J. Pechman eds. 1981).

16. Duke Power Co. v. Carolina Environmental Study Group, Inc., 438 U.S. 59 (1977).

in detail.[17] This may be because Rosenn sees a clear solution (indexation) to many of these inflation-induced problems. Since the "cleanest" and swiftest implementation of the solution would be by legislation or contract (although one wonders why the solution has not yet arrived), Rosenn has no special desire to examine the judicial, second-best alternative.

One last point ought to be made about using foreign experience for American lessons. Rosenn sees a potential, although limited, usefulness in foreign experience.[18] Although I have directly examined little that is relevant, my research causes me to be much less confident than Professor Rosenn that, say, the Brazilian experience provides us with useful lessons. My own examination of the Brazilian government bond market does reveal spectacular growth of that market once indexing began. Nonetheless, some rudimentary, though time-consuming, empirical work casts doubt on the value of that observation. Yes, the market for indexed bonds expanded greatly. Most of the takers of the bonds indexed to the inflation rate were, however, either Brazilian government agencies or those required or induced by regulation to take the bonds.[19] Neither constitutes much of a market nor much of a lesson. Maybe the government bond market is an exception and the rest would provide lessons. But more data would be necessary.

If an American audience interested in inflation is unlikely to have much interest in a comparative approach, then the audience must be that small group of those interested in the details of how others, principally in developing economies try to cope with inflation. Here Rosenn has, with much care and attention to detail, gone through statutes, cases and regulations from several nations and told us the legal story.

MARK J. ROE**

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17. *See* G. CALABRESI, A COMMON LAW FOR THE AGE OF STATUTES (1982).

18. K. ROSENN, *supra* note 2, at 389-96.

19. Roe, *supra* note 7, at 16-22, 63-65. Only when the index was tied to the cruzeiro-dollar exchange rate was there much market-based interest in the bonds.

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