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The Price-Wage Stabilization Program

THE CRITIQUES OF THE WAGE and price control program that have been offered by the Brookings panel are, compared with many heard of late, rather mild.

From the conceptual standpoint, what might be termed the theoretical criticisms are of two principal types. The first argues that large firms and labor groups, because of their oligopolistic power to determine prices and wages without regard to market conditions, are the basic source of the inflationary problem. The aim of the control program is, therefore, wrong because it provides broad coverage instead of targeting only on the few dominant economic units.

The second viewpoint admits of no inflationary problem that cannot be traced directly and wholly to fiscal and monetary policies, and faults the control system because it treats only the symptoms of inflation, thereby diverting attention from its underlying causes. Accordingly, the program can have no impact on the rate of inflation; any slowing of the price rise that does occur would have been brought about anyway by slack conditions in the economy.

The Brookings papers are representative, in part at least, of these two views. Although I concur with some of their reasoning, my own position is substantially different.

The underlying causes of our present inflationary situation were, I believe, the monetary and fiscal policies of the middle and late 1960s, which created a very serious demand-pull inflation. By 1970, however, the economic excesses and overindulgences were behind us. The economy was operating below full employment in terms of both the labor market and productive capacity. Yet, in 1970 and through the summer of 1971, inflation continued apace. The acceleration of the price indexes was halted, but no significant progress was made in slowing the rate of inflation.

During that period the economy entered a cost-push inflation—a spiral of rising wages and prices, based not on union or corporate market power, but on the widely and deeply ingrained expectations of endless rapid inflation that were being cemented into the institutional framework within which price and wage decisions are made in our economy.

Thus the problem was not structural; it was not limited to merely a few large firms or labor unions or industries, but it was rather a condition that was pervasive throughout the economy. The price disease with which we had been infected during the 1960s was not being cured by the normal market forces because of the widely diffused psychological expectations of workers and managers for a continuing inflationary spiral.

The basic problem of 1971, therefore, was to subdue this inflationary psychology. If the economy had stayed in a slack condition long enough, no doubt the inflationary expectations would have been eliminated. But that was not a satisfactory solution; the process was taking much too long. Something had to be done to bridge this gap, to shorten the time between the emergence of excess capacity and the return of reasonable wage and price stability. This something was the economic stabilization program that was undertaken on August 15, 1971.

Implications of the Program

This view of the conceptual basis of the economic stabilization program has a number of implications. Without going into detail, and without offering a forecast for the future, I offer some of them:

First, the stabilization program should be a temporary one. Once the inflationary expectations are eliminated and the price-wage performance is substantially improved, the program, at least in its mandatory aspects, should end.

Second, the program is not a substitute for responsible demand management by fiscal and monetary policy. Correspondingly, the stabilization effort should end before the economy returns to full employment. It is highly doubtful that the program could suppress prices that were under significant demand pressure for any length of time. In addition, it is just at that point that the distortions and maladjustments of any mandatory price and wage control program would begin to have a damaging impact.

Third, the program should aim for a lasting and durable diminution of inflation. Thus it should not suppress legitimate income claims, either on the wage side or on the profit side. "Legitimate income claims" means wage increases that are on average equal to trend productivity plus inflation, and profit margins that on average remain constant except for normal cyclical movements. If price restraint takes the form of holding wage and profit gains below their normal and justifiable increments, these claims will be waiting in the wings to make up for lost ground when the program ends, at which time they would produce a burst of price and wage increases that might well set in motion a new inflationary spiral.

Fourth, because we are dealing with a cost-push-expectations situation, the cornerstone of the program is the work of the Pay Board. Essentially the program seeks a reduction of the rate of advance of wage rates, which is then translated into reductions in the rates of price increase without a change in income shares between labor and capital other than what would normally take place in a cyclical recovery of the sort we are now having.

Fifth, the Price Commission's primary function is to make sure that the reduction in wage inflation is translated promptly, directly, and appropriately into a reduction in price inflation. There is no need for "cost absorption" of the type Gardner Ackley describes on the wage side. For this reason the general Price Commission policy of cost pass-through is appropriate. A second function of the commission is to weed out of the economic structure any institutional arrangements that have incorporated the inflationary expectations of recent years; for example, into regulatory procedures or into long-term purchase contracts.

The arithmetic of the program, in a simplified form, works out to something like this: The Pay Board seeks to reduce to around 5½ percent the annual rate of wage increases, which early last summer was about 7 to 8 percent. The Price Commission's announced intention is to reduce price inflation, which had been running in the neighborhood of 4 to 5 percent, to an annual rate of around 2½ percent.

These aims make for a consistent set of standards: The standards are consistent with the President's goal of cutting the rate of inflation in half by the end of 1972; the 5½ percent standard for wages is consistent with the

2½ percent goal for prices when it is coupled with the 3 percent trend in economy-wide productivity; and both are consistent with income shares that are subject only to normal cyclical change—labor gets the sum of trend productivity and price inflation, while capital gets price increases equal to the underlying rise in unit labor costs plus a normal lifting of profit margins to the extent that productivity growth exceeds its trend.

Assessing the Program

I believe we cannot determine yet whether the stabilization program has been a success. As the accompanying table shows, on almost any measure, price and wage increases have been slower in the past seven months than they were in the six months before the program began. The most dramatic comparisons are those for earnings in constant dollars, which show that the average worker—despite the slower gain in nominal wage rates—has experienced a sharp improvement in the growth of his real purchasing power.

The post-August figures are not broken down between the freeze and Phase II periods because that breakdown cannot, in my view, be interpreted accurately. There was a significant bulge in prices at the beginning of Phase II, a part of the normal transition from the freeze. We do not know how much allowance to make for that post-freeze "bubble," nor just how long it lasted. Therefore, the only comparison that can reasonably be made at this time is between the pre-August period and the post-August period as a whole.

It is my belief that the program has reduced both price and wage inflation below what they would have been in the absence of the controls, but also that it is too early to assess the ultimate underlying impact of the Phase II program.

Distortions Arising from the Program

A major concern about any government attempt to control wages and prices is its potential for distorting the economy. Among the possible dangers are that the adjustment processes of the economy will be warped in a way that will generate inefficiency and a misallocation of resources. Those

Table 1. Price and Wage Changes before and during the Stabilization Program Initiated in August 1971

Percent change, seasonally adjusted annual rate

Price or wage measure	*Six months prior to the program: February–August 1971*	*During the program: August 1971–March 1972*
Consumer price index		
All items	4.1	2.8
Food	5.4	4.9
Commodities less food	3.7	1.2
Services[a]	4.5	3.5
Rent[a]	3.9	2.8
Wholesale price index		
All commodities	4.6	3.1
Farm products, processed foods and feeds[b]	2.3	6.7
Industrial commodities	5.7	1.8
Earnings of private nonfarm production workers		
Earnings in current dollars		
Adjusted hourly[c]	6.8	6.1
Gross weekly	6.1	7.0
Spendable weekly[d]	5.4	8.8
Earnings in constant dollars		
Adjusted hourly[c]	2.6	3.1
Gross weekly	1.9	4.1
Spendable weekly[d]	1.3	5.8

Sources: U.S. Department of Labor, Bureau of Labor Statistics, various issues of *The Consumer Price Index*, *Wholesale Prices and Price Indexes*, and *Employment and Earnings*, supplemented by unpublished data provided by BLS.

a. Not seasonally adjusted; data contain almost no seasonal movements.
b. Raw agricultural products are exempt from price controls.
c. Adjusted for overtime (manufacturing only) and for interindustry employment shifts.
d. Worker with three dependents.

of us involved in the stabilization effort have been sensitive to this question and have been watching the program closely to see what if any difficulties might develop.

My judgment is that to date such distortions and maladjustments have been neither pervasive nor important. At the moment we appear to be in no danger of upsetting the basic efficiency of the economy. We have, however, had a number of examples of distortions, all of them rather isolated, that seem to have been caused at least in part by the program, and that may be mentioned here as a reminder of the effects that controls can have.

Early in the program, for example, some scattered evidence appeared of alterations in business practices in response to the freeze. One instance involved steel fabricators who had not adjusted their prices before the freeze was instituted on August 15 to reflect the price hikes made by the steel producers in early August. The normal practice is for the fabricators to buy the steel, process it, and charge the customer a single price covering the cost of both the steel and the processing. Because the freeze prevented them from raising prices, they started asking their customers to buy the steel that was to be processed, and then have it delivered to the fabricator who would charge only for the processing.

Another example comes from the part of the meat industry called "beef breaking." This is an intermediate process in meat packing in which the carcasses are cut into a small number of relatively large components for sale primarily to restaurants and institutions. Ordinarily the components are sold separately, but during the freeze the "breakers" started selling all the pieces together as a carcass again until it was ruled illegal under the program. They did this because shifts in the relative prices of the individual cuts (which were free to decline, but not to rise above their ceilings) made it to their advantage to do so.

A more recent example relates to the people who clean large nonresidential buildings. Outside contractors for building maintenance claim that they are at a relative competitive disadvantage vis-à-vis a landlord who directly hires his own employees to perform this function. If the landlord is able to raise wages by more than 5.5 percent (which is permissible under the "catch-up" and several other provisions of the program), he may pass the increased costs through to his tenants in the form of higher rents, since nonresidential buildings are exempt from the control program. If, however, the outside contractor increases wages by more than 5.5 percent, he is prevented by the Price Commission's rules from passing the added cost through in the form of a higher charge for his services. The contractors, therefore, are attempting to hold the line on wage increases. But where workers in this trade are scarce, there is reported to be a shift away from outside contractors to landlords.

There are also isolated instances of distortions in areas where strong demand-pull inflation exists for some products, even amidst the overall slack in the economy today. Cowhide prices, for example, have increased very sharply, because Argentina embargoed exports and because of increased foreign and domestic demand. With the housing boom, a similar situation has developed in lumber. In these cases, vague stories—none of them based on hard facts, apparently—have been heard of black markets and illegal transactions, involving either prices above their ceilings or deterioration in product quality. We have also heard reports of dummy exports and reimports, that is, transactions that occur only on paper: Lumber or hides are supposed to have gone to Canada, and then been repurchased (and shipped back) at a higher price, while in fact the products never left the United States.

Occasionally the controls program creates anomalies because the foreign price has gone up while the domestic price is constrained. One instance concerns the two-tier pricing system that has developed for zinc sold in this country. The world price for zinc is above the permissible domestic price, and thus sellers of imported zinc get a higher price than domestic producers (who might prefer to export their production at the higher price but evidently do not because of commitments to their domestic zinc customers). The situation is aggravated by the fact that the domestic price of zinc cannot rise to ration its use and to draw out the greater supply that would be forthcoming if the market could operate normally.

In some cases the rules of the stabilization program have a differential impact among companies. For example, a multiproduct company may experience a rise in material costs for one of its many product lines, but may be prevented from increasing the price of that product because of rising profit margins on others that bring it up against the profit margin limitation on its total sales. However, a competing firm that has only a single product line and experiences the same rise in material costs—and that would be permitted to raise its prices for that product—would be unable to do so in face of the competition from the multiproduct firm. In such an instance, the profitability of the single-product firm would be reduced. Such cases have been reported recently in both cotton goods, where the price of raw cotton has skyrocketed because of reduced crops here in the past couple of years and the failure of the Egyptian crop this year, and in yeast manufacturing, where several raw materials have increased in price.

Limitations on wage increases have created other examples of a differential impact among companies. During the freeze, a company complained that its employees were being lured by higher wages to a competitor's plant down the road, but that it was prevented from increasing wages to meet the competition and stop the pirating of its work force.

None of these cases provides convincing evidence of serious economic maladjustments or distortions. The evidence available to date shows them to be widely scattered instances with no common pattern throughout the economy or even throughout any one industry. Nevertheless, they do illustrate some of the ancillary costs of price and wage controls. While at present they do not represent a widespread problem, they are indicative of what might develop should the controls remain in place for an extended period.