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WHY WAGE PRICE CONTROLS?

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Asked what we should do about inflation, economists give a lot of different answers. Some economists say government is the sole source; responsibility for inflation resides in Washington. Some say the real source is federal budget deficits. Others say that monetary policy alone is the cause of inflation. I think monetary expansion is the fundamental underlying cause. Some also say that the causes of inflation are social, with all groups continually trying to increase their share of the pie; this can't be realized, so we have inflation as a result.

One might ask "what does the public make of this?". If you ask them, "Should we impose mandatory wage and price controls?", more than one-half say "yes." That's an interesting phenomenon. It usually rises to more than one-half when we have increasing inflation, but we do need to recognize that it's very seldom very much below 50 percent of the public.

Maybe such a response is simply an indication that what they really want is somebody to "do something". Maybe it's an indication that they want the government to take some action that will be effective in reducing inflation. But it's also possible that they have certain views about the way the economy works. These views lead them to think mandatory wage and price controls might be a good answer.

Reasoning About Inflation

Now, what I want to do is to sketch some of the lines of reasoning that often appear in news commentary and columnists' articles on the question that may be in the minds of the general public when people are interviewed and asked about the causes of inflation. I want to do this, because I think these are important in understanding why, whatever we economists may think, the public so often seems favorably inclined toward wage and price controls, even when inflation is not all that much of a problem.

Special Factors

The first line of reasoning that's often given is that the kind of inflation that we are experiencing now is a new phenomenon. There are "special factors" that weren't there before and that inflation—rather than being some kinds of systematic phenomena, say associated with money supply growth—is the result of certain specific problems at the present time.

Take food for example. Food supplies are heavily influenced by bad weather here or there. This was an important factor in 1972-73. There also are cycles at work, particularly in the case of beef and pork. The point is usually made that the management of demand, monetary policy, or any general government policy can't be effective when things like weather or the beef cycle are the real cause of the problem.

Another often mentioned area as a "special factor" lying behind our inflation is energy. Now that we have OPEC involved in world oil pricing, it is said that oil prices are set by a group of Arab sheiks, and they essentially specify what price it is that we, the oil consuming countries, have to pay. What is often forgotten is the fact that, in the recent past, oil prices set on the open market and in short term contracts were higher, and OPEC pricing tended to follow that—suggesting maybe supply and demand are relevant there, too. But in any event, there is an element of validity in the argument that we face a very new world oil pricing situation.

Another "special factor" that's often mentioned is health care, which is increasingly important these days in terms of the fraction of GNP that it accounts for. Health cost inflation, it's often said, occurs because the market doesn't really function well. After all, who shops around for the lowest price at which he can get some sort of emergency surgery performed? There is no time or inclination for that. Who would even care, as a matter of fact, so long as the insurance company is paying the bill? So in this situation, the doctor tells you what to buy, and he indicates what you should pay for it. Experts choose what it is you need. Third parties pay the bill. Therefore, it's said, the market functions poorly and we need something to combat that newly emerging situation—health care cost inflation.

Another item that's often mentioned these days, is housing. It's said that rapidly rising housing prices lead to speculation. Speculation drives up the prices of existing houses, and that by itself of course, doesn't do anything to increase the housing stock. It's the prices of new houses that are most relevant for that. So it's said that speculation is an important factor in rising housing prices.

I suppose we ought to notice in this connection that windfall profits taxes have been proposed in the case of old oil, the logic

would seem to extend to old houses as well, probably even to old farmland that has been there even longer. Blaming "special factors" is, of course, something that has a long history behind it. People have attributed inflation to special factors for a long time.

Wage-Price Spiral

The second line of reasoning is different, in that it says inflation is an old phenomenon. What is involved here is a notion that we have a spiral of some sort that is supported by rigidities in the marketplace such as the exercise of market power. It's sometimes called the wage-price spiral, it's sometimes called the wage-wage spiral, it's sometimes even called a price-price spiral. But the notion is that it's self-perpetuating, and that it's self-perpetuating in a large part because of the exercise of market power on the wage side or the price side.

Let's look at the wage side for a minute. The wage side is really the essential ingredient in cost-push theory. The idea is that costs are pushing up prices. So it looks like cost-push to every businessman who finds his cost rising, even though he willingly may pay the increased cost. In that context, union power is often viewed as an important factor. The notion is that wages rise no matter what current market conditions are like and there are, of course, institutional reasons why this may be the case. Unions are often governed by long term contracts, their wages are set under long term arrangements. It's not surprising that when a different union contract with a different expiration date comes up for negotiation, one of the arguments about why they merit a wage increase of a particular size is that another union with a continuing, existing contract is getting wage increases of a particular size.

So the combination of long-term contracts and some exercise of market power, tends to insulate the labor market—some portion of the labor market at least—from current market conditions. Now, we may ask, what is the evidence on this? Have wage increases responded to economic conditions at all or not? Let me give you some overly simplistic evidence that sometimes suggests that cost-push from wage increases is a major factor in inflation.

Over the past 10 years or so, hourly earnings have increased about 7% annually on average. In addition to that, the average absolute deviation from the 7% was 3/10 of one percent. That's a very small deviation. That excludes, of course, 1974, when prices were rising at a 12 percent rate. Then wages rose at 2½% percentage points more than 7%. If you look at the present time, when the inflation is between 12% and 15%, we find somewhat surprisingly the rate of wage increase on the order of 7½%. Superficially at least, that seems to suggest that there's a degree of stability in hourly labor cost increases that's independent of market forces. After all, the rate of

inflation during the past 10 years varied between 3½% and over 12%. The unemployment rate varied between 3½% and 8½%. So there was a great variation in economic conditions during a period of remarkable stability in the average rate of hourly wage increase.

On the price side, market concentration is often pointed out to be the problem. The fact that there are firms with a large share of industry output leads to oligopoly pricing under price leadership or whatever form you want to subscribe to. The industries that are singled out in this connection are usually steel and sometimes autos. Recently oil has been singled out as one. Now for food, interestingly the finger has been pointed at the middleman. Whether he is a food processor or retailer, and whatever his profit margins, the finger tends to be pointed at the middleman in the case of food pricing.

It is true, of course, that prices in relatively concentrated industries tend to be more stable than, for example, farm product prices at the farm level. They increase by less during a period of expansion, however, as well as decreasing by less when there is a recession. There is more stability over the cycle, and not necessarily a tendency for these prices to rise relative to other prices. In fact, when you look at the data you find that prices in concentrated industry tend to rise *less* on average.

Underlying Pressures

The third line of reasoning is quite orthodox, really, in that it says monetary expansion is important. The question is, however, why do we have excessive money creation? Why do we continue to print more money than would be consistent with stable prices if that's the basic cause of inflation? One answer that's given by those who have favored wage and price controls is that wage-price trends have their own momentum. They rise from the circumstances just described or other mechanisms that people might have in mind.

Rising wage and price trends will at least initially be accompanied by higher unemployment as a result of crimping down on the rate of monetary expansion. So unless monetary expansion is proportionate to the momentum that has been established, from somewhere, you will have for a period of time underutilized resources. This is, of course, politically awkward. It's an economist's lag, but it's a politician's nightmare. Accordingly there are strong pressures on the Federal Reserve Board, irrespective of whatever independence it may have institutionally, to try to make an accommodation. It may try to cut back a bit on the rate of monetary expansion, but it will accommodate, to some extent, existing trends and new developments such as oil price increases.

Some people feel that mandatory controls can perform a role here by reducing actual wage and price increases for a time. They may even reduce expectations of inflation, if people believe that the mandatory controls are effective. Now this argument tends to work

best when we haven't had mandatory wage and price controls for a while. Because people tend to remember, if it happened recently, that the rate of inflation when controls were over was worse than when the controls were imposed. Thus, it's an argument that needs to be used sparingly, with sufficient time for memories of past episodes to erode somewhat.

There is no real mystery about why it is that expectations that wage and price controls would do something to reduce inflation tend to be frustrated. In policy decisions there are always lots of competing goals and purposes. There is a tremendous temptation when one has mandatory wage and price controls to indulge in policies that would over time be inflationary, but which one wouldn't dare to pursue in the absence of the controls.

I recall during the period when we had mandatory wage and price controls in the early 1970s that there was often a drift in the meetings of the Cost of Living Council. At the beginning every member affirmed the truth that we should not let mandatory wage and price controls be an excuse for over-expansion. By the end of the meeting the discussion tended to drift away from that toward some of the things that it would be tempting, useful, and pleasant to do; after all we had wage and price controls which would help to curb whatever inflationary consequences might result. That is a tremendous temptation.

Indeed, to some extent policymakers have a less sensitive guide to what, in fact, is going on, when wage and price controls are enforced. It's very difficult to discover or determine, what's building up behind the dam. The situation is far more apparent when prices are free to rise.

Now another answer to the question of why is there too much money expansion comes from the credit market side. That is to say, people give emphasis in their explanation to federal budget deficits. Financing federal budget deficits means that borrowing needs to occur from somewhere in order to finance the deficit, or money needs to be printed by the Federal Reserve in excess of what is borrowed, in order to finance the deficit. If deficits are large, and there is pressure from private borrowing, it's easy to see the temptation to raise monetary expansion a bit above what would be consistent with price stability in order to make room for a bit of extra borrowing and to avoid large increases in the interest rate. It is thus, an indirect route that people give emphasis to when they point to the credit side of the cause of monetary expansion.

Another dilemma here is that if we let inflation rise, then there is pressure for more government spending, and perhaps larger deficits, in order to do things for the poor that we would want to do given the impact of inflation on their level of living. If instead we say we are going to have a stringent monetary policy and we have a

recession, that will by itself operate in a mechanical way to increase the size of the deficit, both through reduced receipts and through higher expenditures for programs like unemployment compensation. So that line of reasoning has suggested to many that what we need to do is avoid both the recession and the inflation, and have mandatory wage and price controls. This will help to avoid inflationary circumstances leading to excess money creation in the economy.

Resource Underutilization

The fourth line of reasoning is essentially that we should avoid worrying too much as economists about market efficiency, about economic efficiency. What we should worry more about instead is underutilization of resources. We should worry more about the kind of waste that is presumed to come from operating the economy at less than full capacity. We should worry less about distortions in the economy and inefficiencies in the economy that may result from wage and price controls. Under stringent controls these usually become quite evident. After all, according to this reasoning, we shouldn't regard ourselves as having a freely competitive market anyway. A little bit of "informal controls" probably wouldn't impede the competitive process all that much.

One can point to things like the kind of economic regulation we have for trucking, for airlines (until recently), for railroads, barges, for electric utilities, for natural gas, now for petroleum, for pipelines and for other utility bills that people pay. All of these areas are subject to price regulation. In addition, of course, we have price supports for many farm products, such as grains, milk, sugar, and so on. In addition, we also support prices in indirect ways by import limitation. We have trigger prices for steel, voluntary arrangements for textiles, shoes, and TV sets. And we have explicit import arrangements for cheese, beef, and non-fat dried milk. Now, of course, we also have in the offing a limitation on crude oil imports.

In addition to these forms of price regulation, we often tell our firms a great deal about how they should go about producing things, even what kinds of things to produce. It's often said, for example, that automobiles, by and large, are designed in Washington not in Detroit. NHTSA tells them what the safety standards are, EPA tells them what kind of pollution standards they need to meet, and the Congress tells them what their mileage standards on average need to be (which essentially translates itself into the weight and size of the automobile). In that sense, it's not consumer sovereignty so much as government regulation that determines the character of the products that we buy.

In addition to that, government tells firms a great deal about how to go about producing such products. OSHA, for example, has been the subject of some ridicule directed to its health and safety

standards prescribing the number of knots per rung of a ladder and the form of toilet seats. The number of hospital beds is subject to review by states or other organizations. The number of CAT scanners and open heart surgery centers and so on are subject to review by professionals concerned with these matters. Hospital cost containment legislation is being considered in the Congress and, of course, the administration has supported it.

I mention all of these areas, because they are often brought forward in a line of reasoning that says since so much of the economy is already subject to so much regulation, why not remove this last irritant of inflation and bring it all subject to price regulation, and have mandatory controls. That way we wouldn't have to worry about inflation anymore.

Legal Fairness

A fifth line of reasoning is from a legal perspective essentially. We now have, and we have had in the past on various occasions, a so-called voluntary scheme—guidelines or standards. Now one view is that mandatory controls would at least be more fair under some definitions of fairness. The AFL-CIO has taken a position favoring mandatory controls rather than the voluntary guidelines we now have. There *is* something unfair about these voluntary guidelines, of course. One thing is that the non-volunteer, those who choose not to volunteer, stand to gain. Those who do volunteer, on the other hand, tend to lose. Now economists who tend to emphasize maximizing decisions regard that as an anomalous framework, and everybody else probably thinks it's sort of unfair.

There is also the matter of legal fairness. That is to say, a voluntary scheme tends to be backed up by coercion, and coercive powers that aren't granted through the passage of legislation are not really consistent with the kind of government we have. Unless action taken by government is authorized by legislation, we regard government actions as essentially out-of-bounds. One thing this means is that when a citizen feels that he is being harmed by government action in this quasi-voluntary area, he has no recourse.

He can't take someone to court for something which is not really based on any legal processes in the first place. Instead actions are based on broader, political considerations and based on the amount of leverage that the government has in a particular case. The "legal" case for mandatory controls is that it would make these so-called voluntary guidelines that we often have in the economy legal. If the government feels that it is able to specify what every wage and price increase should be, then it might as well make the controls mandatory and thus more effective.

Mandatory Wage and Price Controls

I've sketched out what I think are five general lines of reasoning that are often pointed out to make a case for support of mandatory wage and price controls. These are: First, the "special factors" argument. Second, the wage-price spiral arguments. Third, the view that there are political and economic factors underlying excessive monetary expansion. Fourth, there is the view that we ought to worry less about market efficiency and more about getting closer to the potential output of the economy. Fifth, there is the legal fairness case.

Now most of these, as you will notice, really describe some facet of what is going on. They don't really address themselves to what the underlying causes of inflation are, but recounting these processes does suggest to people that these descriptions may themselves constitute something of a causal explanation.

Having sketched out these lines of reasoning, we should ask; will mandatory wage and price controls work? The answer to that question would seem to most reasonable people to be either yes or no. Economists, of course, tend to answer questions like that by saying "that depends". Well what does it depend on? We can look back at a couple of years during World War II, when wage and price controls really did keep the overall price level quite stable. There was some quality deterioration, certainly, but generally speaking wages and prices were quite stable. This, of course, was a period in which we had rationing coupons for a number of commodities. We had lines, we had black markets, and we had a very big bureaucracy trying to police the system. What's probably more important though, is that our attention wasn't mainly focused on economic matters at all. It was mainly focused on what was regarded as an overriding consideration, winning World War II. I think this is an important factor that made us willing to overlook many of the inefficiencies.

There is one thing that economists can say for sure—one of the few things they can be certain about—and that is that if you hold prices at ceilings that are below market clearing levels you are surely going to have shortages. People tend to appreciate that fact better when actual shortages occur and give them some experience, but it certainly is a well demonstrated fact. Shortages are one way of accomplishing allocation. That is, one way to allocate resources of various kinds of goods and services is by letting lines build up. We saw a certain amount of that during the past summer in the case of gas lines. We tend to be very irritated by standing in lines and by having goods unavailable, but I should say that across the world, really in most societies and most economies, it's quite a common phenomenon.

In the Eastern European economies, in the Soviet economy, lines are extremely common and perform a role in allocating goods

that are available. It is a way of allocating them that's a feasible alternative to using prices. If we as a society prefer that way of allocating resources, that is a possibility. We need, however, to recognize that we can't have both an absence of lines or allocation systems and binding wage and price controls.

I suppose another question to ask in connection with wage and price controls and the case for them is; will other policies work? Here I think if one looks at previous history, episodes of inflation, episodes of falling prices, episodes of price instability, the answer is clear that responsible, monetary and fiscal policies will work. They will be effective. But there is another way to pose the question as well. That is, will it be possible to persist with responsible monetary and fiscal policies and in that process avoid turning to wage and price controls, or will there be a political reaction generated by disappointed expectations, by rigidities that at least initially, lead to a period of higher unemployment than might otherwise occur? Will persistence be politically possible?

I think that this will depend to a large degree on what the nature of public understanding is about the economy and about what role wage and price controls could play. I suggest that there are two ways in which public understanding about that will be generated. One way is if economists and others who do analysis and communicate are able to somehow address the five or more rationales for wage and price controls, show where there are flaws and why they are fallacious, and point out what the upshot of mandatory wage and price control would be. The other way in which public opinion will determine whether wage and price controls are taken seriously as a proposed solution is that we will again have an experience with another failure of the controls themselves that will change people's views.

I think we need to recognize that any policy to be successful needs to command a certain amount of consensus based on public understanding of what is at issue and what the consequences of alternatives are. At the present time the public seems not be convinced that wage and price controls are undesirable and ineffective. I suppose any consensus that would be formed would be likely to be a shaky one. Probably it should be labeled "use well before shaking" instead of "shake well before using". Because it would surely take a period of time in which there would be significant strains that would be experienced under policies to reduce rates of inflation in a process that leads toward more price stability.