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Controls and Income Shares

I AGREE WITH SO MUCH of what Gardner Ackley has written about the Phase II program that I hesitate to take issue with his paper at all. Since the end of the freeze, prices have risen too rapidly, and the goal of bringing the inflation rate below 3 percent will not be reached unless the Phase II authorities get tougher. Some of the operating procedures of the Price Commission should be revised to accomplish this improvement; and I agree, in particular, that the commission should not rely on term-limit pricing arrangements and on cost estimates supplied by firms themselves. But I do disagree with Ackley's treatment of cost absorption. And that point is so central to the issue of income shares under Phase II—an issue that, in turn, is so emotionally charged that it threatens to disrupt support for the overall program—that a comment is in order.

Ackley defines concepts of "cost absorption" for both labor and business and uses them to show that unless there is cost absorption by one or the other, inflation will not slow down. He then argues that present procedures require no cost absorption by business, while they do require it from labor. He concludes that the program should be restructured to require some cost absorption by business, and suggests that a vigorous enforcement of the overriding profit margin regulation be used to accomplish this.

This analysis implies that the present program is unfair to labor in principle. However, this conclusion follows from a definition of cost absorption by labor that I find inappropriate. A "fair," or neutral, program can be reasonably defined as one that does not change the relative shares of in-

come going to profits and wages from what they would have been without the program. But it can be shown that requiring cost absorption by business would lead to a reallocation of income shares from profits to wages, while without cost absorption by business, shares would be unaffected by the program. Yet inflation would still slow down if the rate of wage increase slowed.

Let me use Ackley's model, and his notation, and generalize it slightly to allow for any degree of cost absorption by business or labor on his definitions. For wages,

$$(3^*) \quad W_t = W_{t-1} (1 + p) \left[1 + q \left(\frac{P_{t-1}}{P_{t-2}} - 1 \right) \right],$$

where q is the "pass-through" ratio (equal to 1 minus the absorption ratio). When $q = 1$, prices are fully passed through into wages and we have Ackley's equation (3). For prices,

$$(5^*) \quad P_t = P_{t-1} \left[1 + r \left(\frac{W_t}{W_{t-1} (1 + p)} - 1 \right) \right],$$

where r is the pass-through ratio of costs into prices. When $r = 1$, we have the pricing relation implied by Ackley's equations (5) and (2).

Substituting (3*) into (5*) and simplifying yields

$$(6^*) \quad \frac{P_t}{P_{t-1}} = rq \left(\frac{P_{t-1}}{P_{t-2}} - 1 \right) + 1.$$

If there is no absorption by business or labor, so that $r = q = 1$, inflation will not slow down, which is Ackley's result. But now the twin labels "absorption" are misleading. For it makes quite a difference whether inflation slows by bringing r or q below 1. Neutrality does not imply that r and q be made smaller together.

Labor's share, L_t , is given by

$$(4^*) \quad L_t = \frac{N_t W_t}{O_t P_t},$$

and with Ackley's equation (2) specifying the productivity trend,

$$(7^*) \quad \frac{L_t}{L_{t-1}} = \frac{W_t / (1 + p) W_{t-1}}{P_t / P_{t-1}}$$

is the ratio of labor's share from one period to the next. With equations (3*) and (6*) above substituted for wage and price changes,

$$(8^*) \quad \frac{L_t}{L_{t-1}} = \frac{1 + q \left(\frac{P_{t-1}}{P_{t-2}} - 1 \right)}{1 + rq \left(\frac{P_{t-1}}{P_{t-2}} - 1 \right)}$$

Thus, if there is no business cost absorption ($r = 1$), these shares are unchanged ($L_t = L_{t-1}$) regardless of the value of q , while if business absorbs some costs ($0 < r < 1$), labor's share grows as a result of the program ($L_t > L_{t-1}$) regardless of the value of q .

Thus, cost absorption by business and labor, as they have been defined here, are quite different things. Bringing either q or r below 1 slows the inflationary treadmill. But bringing q below 1 does not affect relative shares, while bringing r below 1 increases labor's share. This result should not be viewed as specific only to the simple model described by Ackley and the equations just presented here. The basic wage-price-productivity rules of Phase II correspond to equations (3*) and (5*). Although not stated in these terms, the wage rule allows increases equal to trend productivity growth plus a fraction of past price increases; while price increases are allowed only to the extent of cost increases—represented in equation (5*) by wage changes adjusted for the trend growth in productivity.

Nonetheless, there are many ways in which the real situation confronting the Phase II administrators can differ from the models described here. At the start of the program, some workers whose wages are changed only at lengthy intervals had fallen behind the price increases that had occurred. Some firms whose prices had not responded promptly to cost changes had also been left behind. We know that the Pay Board made allowances for wage increases in excess of the normal standard in cases where wages clearly had fallen behind price increases that had been experienced up to the start of the program. While the basic guide for price increases during Phase II should probably be cost increases incurred since the start of the program—a rule that would conform to equation (5*) with $r = 1$ —occasional exceptions could be made just as they are on the wage side. It is hard to see how a few "last cows into the barn" on either the wage or price side can make a great deal of difference. And it seems unlikely that a whole herd of price increases would seek to be justified in this way. Indeed, to argue that many

price changes will be justified by cost changes that occurred before the start of the program is equivalent to saying that prices lag wages substantially and that the wage share was ahead at the start of the program. In this case, as far as shares go, the presumption would be to allow such price increases merely to get back to "neutrality." However, I doubt that this is a realistic case to consider. All in all, I know of no evidence that either wages or prices were noticeably ahead on average at the start of the program.

At another time, some cost absorption by business might have seemed both more necessary and more appropriate than it seems now. In early 1968, I proposed a new guidepost formula that called for absorption, as defined here, by both labor and business.¹ At that time, wages under the large number of long-term wage contracts that were coming up for negotiation clearly had fallen behind in the inflation that started in 1966. To ask a slowdown from wages in this environment was clearly to ask for a sacrifice, and some cost absorption by business seemed necessary as the other half of the bargain. Today's situation is not the same.

None of this addresses the crucial questions that Ackley has raised about how well the Price Commission has actually done its job. His criticisms and concerns are well founded and I share them. But I would prefer that the commission get tough on a correct set of rules rather than adopt new ones on the view that the existing program is, in principle, unfair. As a basic underpinning, this means price changes, both up and down, geared to realistic estimates of productivity trends. I would like to see the Price Commission, in implementing that basic rule, settle all close calls on the side of price stability. But doing so will still involve cyclical gains in margins, and a small cyclical shift in shares toward profits, in a year of rapid expansion such as 1972. Because of the substantial variability in the year-to-year productivity and profit margins of individual firms, it could also mean that many firms would exceed their base period margins even though their price increases since the base period have not exceeded the trend growth of their costs. And this makes the profit margin ceiling a very clumsy substitute for the productivity rule in enforcing price standards.

1. See "Statement of George L. Perry," in *The Wage-Price Issue: The Need for Guideposts*, Hearing before the Joint Economic Committee, 90 Cong. 2 sess. (1968), pp. 12-19.