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Wage-Price Controls: Where Do We Go from Here?

THE ACCELERATION OF INFLATION since Phase II was replaced with Phase III on January 11, 1973, has generated widespread concern. Unhappily, it now seems likely, in my view, that controls at least as comprehensive as those of Phase II will be reimposed, perhaps preceded by another wage-price freeze. The nation cannot, however, return to Phase II; given what has happened since August 15, 1971, the inevitable next step is a Phase IV, even though its external form—the underlying legislation and the administrative machinery—may closely resemble that of Phase I or Phase II.

My hope is that the end of Phase III will be marked by the passage of legislation denying the President the authority to impose wage-price controls of any type whatsoever. For reasons discussed below, I regard an unequivocal end to controls as both desirable and, in the end, inevitable. Without such legislation, adoption of a set of tight controls is highly probable. But I am convinced that a new set of controls as tight as, or tighter than, the Phase II variety will eventually break down in a decisive, and

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probably disruptive, manner. If I am correct, then it is better to go directly to the no-controls era now rather than to reach it after another set of "phases."

This position rests on my interpretation of events since August 15, 1971, and on my predictions of what will happen if controls are reimposed. The discussion below consists, therefore, of a look back and a look forward.

A Look Back

Newspaper accounts suggest that Phases I and II are widely regarded as having been successful. Econometric evidence also suggests that controls had an effect; wages and prices apparently rose less rapidly during the controls period than would have been predicted from equations estimated on precontrols data.[1] Given the accuracy of the predictions of wage and price equations before August 1971, however, the econometric studies do not inspire much confidence. Although I am skeptical of the claims for the effectiveness of Phase II, I am quite willing to argue my case on the assumption that controls did in fact depress the inflation rate by 1.5–2.0 percentage points over the period from August 1971 through December 1972.

I am not unhappy with this assumption; indeed, in the September 1971 meeting of the Brookings panel I argued that controls most likely would reduce inflation for a time.[2] I have always viewed the question as one of the duration of the effect of controls, not of their initial impact. Controls cannot be viewed as effective if their impact on the price level is temporary. What we have experienced in Phase III might be called the "exit problem" —how to emerge from the control regime, once it has been introduced.

Phase III was apparently an attempt to begin the exit from controls before control-induced distortions became severe. The exit, however, is proving difficult. Price increases during Phase III are being generated by three principal forces. First—still assuming that prices at the end of Phase II were below what they otherwise would have been—is the catch-up phenomenon. Second, aggregate economic activity has been rising very

1. See Robert J. Gordon, "Wage-Price Controls and the Shifting Phillips Curve," *Brookings Papers on Economic Activity* (2:1972), pp. 385–421. Hereafter, these volumes will be referred to as *BPEA*, followed by the date.

2. William Poole, "Thoughts on the Wage-Price Freeze," *BPEA* (2:1971), pp. 429–43, esp. p. 430.

strongly, creating demand pressures in an increasing number of sectors. Third, since the Phase III decontrol was not unequivocal, some price increases are likely to be motivated by anticipations of the imposition of a new set of tight controls.[3] These points will be discussed in turn.

The catch-up phenomenon was a predictable consequence of ending controls. It may be argued that the catch-up would have had no opportunity to manifest itself had Phase II (or something like it) been continued indefinitely. This view implies that controls can be effective indefinitely, a view discussed in the next section.

Another argument is that the catch-up need not have occurred at all. If the decontrol had been handled more skillfully, some will say, the gains from deflating wages and prices could have been retained. Needless to say, I am very skeptical about this argument. In any event, the catch-up phenomenon has not in fact been avoided. Price increases in early 1973 have been substantial. As a result, the annual rate of inflation as measured by the consumer price index (all items) over the period from August 1971 to March 1973 was 4.0 percent, only a little below the 4.4 percent rate from July 1970 to July 1971. If Phase III continues in its present form, it seems likely that by the end of 1973, at the latest, the price level will be unambiguously higher than it would have been had controls never been adopted.

The second factor now generating large price increases is the increasing number of sectors experiencing excess demand as a result of the vigorous economic expansion since August 1971. Some may argue that the controls have made this expansion possible, and that the reduction in unemployment is a major success for the controls program. Although the catch-up process may erode the price level gains of the control program, the claim will be that the employment gains are an obvious success.

I cannot agree. Both the employment problem and the inflation problem must be viewed in a longer-run context than simply the past eighteen months. What the nation must avoid is the boom-recession-boom roller coaster. Little is to be gained from less unemployment now at the expense of more unemployment later. If anything, the expansion in economic activity has been somewhat too vigorous over the past six quarters. It is not clear that the current boom can be slowed without causing another recession.

If another recession does start by mid-1975, it will indeed appear that the

3. A possible fourth point is that price indexes have begun to reflect, in part, increases that occurred during Phase II but were not accurately measured at the time due to such factors as faulty reporting by firms and subtle deterioration in product quality.

economy would have been better off under somewhat less expansionary monetary and fiscal policies than those followed since late 1971, which would have permitted moderately expansionary policies over a longer period of time. I see no reason to retract my September 1971 suggestion that "controls may have the effect of hiding the genuine short-run conflict between full employment and price stability and lead to monetary and fiscal policies that are more expansionary than is consistent with progress toward the objective of sustainable economic stability."[4]

The third factor underlying price increases during Phase III is widespread anticipation of a new set of controls. Businessmen know that a Phase IV—possibly another wage-price freeze—is a very real possibility. It is obviously in the interest of every businessman to push his prices as high as possible to secure an advantage in the event of another freeze. To some extent businesses are forced to act in this way for fear that their prices will be frozen at levels that are relatively low compared to those of their suppliers. Anticipating a freeze, firms selling perishable goods may even take spoilage losses rather than sell at lower prices.

The importance of anticipations is also suggested by the relative behavior of the wholesale price index (WPI) and the consumer price index (CPI) in the months of Phases I and II. Over this period, the WPI rose substantially faster than the CPI, contrary to the historical relationship revealed in Table 1. The larger increase in the WPI—an index based on list prices—than in the CPI—an index based on transactions prices—over the controls period may be the result of market weakness that prevents increases in list prices approved by the Price Commission from being passed through to actual transactions prices.[5]

To the extent this argument is correct, Phase II had less impact on prices than appears on the surface. Furthermore, by the end of Phase II many firms apparently had obtained approvals from the Price Commission that would permit increases in transactions prices when markets strengthened further. Leaving aside the question of evasion, by December of last year the stage was set for an acceleration of inflation even if the Phase II regulations had continued in force.

I am convinced that there is no stable halfway house for the American economy between tight controls and no controls. Continuing anticipations

4. Poole, "Thoughts on the Wage-Price Freeze," p. 439.

5. The evidence from the price indexes admittedly is not very strong. It does, however, tend to confirm the Washington scuttlebutt that the phenomenon in question did exist.

Table 1. Average Rates of Change of Consumer and Wholesale Price Indexes and of Major Components, 1950–70 and 1971–72

Percent per year

Index and components	*1950–70*	*August 1971– December 1972*
Consumer price index		
All items	2.4	3.2
All commodities less food	1.6	2.0
Wholesale price index		
All commodities	1.5	5.3
Industrial commodities	1.7	2.7

Sources: U.S. Bureau of Labor Statistics, official price series.

that tight controls will be reintroduced will foster additional inflation, waste resources by distorting relative prices, and generate unnecessary political conflict. If there is no halfway house, the alternatives are a return to controls, or an end to our involvement with them.

In summary, then, a look back gives good reason for believing that the U.S. economy is now in more difficulty than it would have been had the pre-Phase I policies of no controls and moderately expansionary monetary and fiscal action been continued. The distortions and administrative costs of controls, and the extensive uncertainty attending the exit process, have bought at best minor and temporary gains in reducing inflation. I suspect that these uncertainties will worsen the short-run trade-off between unemployment and inflation. The legacy of controls will make it more difficult to achieve economic stability over the next few years.

A Look Forward

Viewing Phase II as a success, many want to bring back that type of control machinery. If we go back, I predict that the machinery will appear at first to be operating successfully, but will break down decisively in a relatively short period of time. The apparent success will stem from the fact that price changes during Phase III will have eased some of the strains that developed during Phase II. However, the honeymoon is likely to be shorter than it was last time because Phase III is producing its own distortions and because the economy is now operating with much less excess capacity than it was in August 1971.

The public pressure for a new set of controls has, to a considerable extent, resulted from large increases in the prices of food, especially meat. These increases cannot be attributed to monopoly power in the private economy. Taken together, agriculture, food processing, and wholesale and retail food distribution constitute one of the most competitive sectors of the U.S. economy.

A major cause of rapidly rising food prices is the expansion in demand for food spurred by increases in personal income. Because of the lags in agricultural production, the supplies now reaching the market were determined by planting and livestock decisions made twelve to twenty-four or more months ago. For example, meat production (carcass weight, inspected slaughter) rose only 1 percent from the fourth quarter of 1971 to the fourth quarter of 1972.[6] If the economic expansion had proceeded more slowly, demand pressures and price increases would have been smaller and production would have had more time to respond.

Supply factors have also contributed to the problem. First, fears of a poor harvest, aroused by corn blight, forced up corn prices in the summer of 1970, and spilled over into concern for the 1971 crop as well. The resulting worry over high feed prices probably curtailed planned expansion of livestock herds. Second, government farm policies discouraged increased grain production in 1972. As shown by Table 2, 1972 production was below that in 1971 for barley, corn, oats, rice, rye, and wheat. Third, exports, especially of wheat and corn, rose substantially in 1972.[7] Fourth, the recent Food and Drug Administration ban on including the possibly carcinogenic growth hormone diethyl stilbestrol (DES) in livestock feed has raised the costs of producing meat.

With rapidly rising demand and a substantial decline in grain available for the domestic market, food prices had only one way to go. Price ceilings on meat and other products will do nothing to expand production; indeed, by reducing incentives for higher output, controls will tend to hold production below what it otherwise would have been and to encourage increased exports to more lucrative markets abroad.

The widespread pressure for controls on food prices suggests how little the public understands such controls. My earlier paper repeated the standard arguments concerning the distortions introduced by controls. These

6. *Survey of Current Business*, Vol. 53 (February 1973), p. S-28, and Vol. 52 (August 1972), p. S-28.

7. The figures in Table 2 actually understate the impact of exports since commitments were made in 1972 to export substantial amounts of grain in early 1973.

Table 2. United States Grain Production, Exports, and Stocks, 1969–72

Millions of bushels; except rice, millions of pounds

Grain	*1969*	*1970*	*1971*	*1972*
Barley				
Production	424	416	464	424
Exports (including malt)	8	55	53	61
Production less exports	416	361	411	363
Stocks, end of year	427	380	392	361
Corn				
Production	4,583	4,152	5,641	5,553
Exports (including meal and flour)	554	572	512	886
Production less exports	4,029	3,580	5,129	4,667
Stocks, end of year	4,316	3,769	4,700	4,718
Oats				
Production	950	917	881	695
Exports (including oatmeal)	8	21	7	25
Production less exports	942	896	874	670
Stocks, end of year	885	922	943	780
Rice				
Production	9,080	8,380	8,580	8,520
Exports	4,183	3,828	3,252	4,447
Production less exports	4,897	4,552	5,328	4,073
Stocks, end of year	1,965	1,830	1,835	2,053
Rye				
Production	32	37	49	30
Stocks, end of year	30	41	55	55
Wheat				
Production	1,460	1,352	1,618	1,545
Exports (including flour)	489	689	627	817
Production less exports	971	663	991	728
Stocks, end of year	1,534	1,410	1,547	1,393

Source: *Survey of Current Business*, Vol. 51 (June 1971) and Vol. 53 (February and April 1973).

arguments still hold. The distortions, evasions, and inequities of controls ensure that they cannot solve the inflation problem. The same factors will, I predict, eventually stir a profound public reaction against controls.

Phase II provides two illustrations of the evasions and distortions generated by controls that are perhaps more forceful than the abstract arguments against them. One is the lumber industry. Here price control was rendered largely ineffective by evasion. A second is the oil industry, where price control was probably effective, but only at the cost of significant distortions.

The attempt to control lumber prices during Phase II was largely unsuccessful, because for the most part the controls, where binding, were evaded. The examples of evasion described below may be considered "unconfirmed reports," precisely because confirmed reports probably would have resulted in legal prosecution of the firms involved.

Several devices were employed to evade the controls. First, since the regulations permitted higher prices when services were added to products, plywood producers performed the "service" of cutting ⅛ inch off plywood sheets and sold the sheets for substantially higher prices. The dimensions of lumber products were also shaved as a device to obtain effective price increases.

Second, since the Price Commission could not control foreign producers, and import prices were thus uncontrolled, producers in the Pacific Northwest exported lumber to Canada and reimported it at substantially higher prices. In some cases the transactions involved dummy exports: export and import papers were processed while the lumber sat in a U.S. warehouse.

Third, Price Commission regulations that permitted normal markups at each stage of distribution spawned shipments of lumber from one wholesaler to another; each added a normal markup but did not perform all of the usual wholesaler functions.

Finally, at least for a time, the regulated price on two-by-fours was relatively high as compared with boards; thus, logs were turned into two-by-fours and a shortage of boards developed. Other distortions in the product mix no doubt also occurred.

The lumber and wood products category of the WPI rose by about 13 percent from December 1971 to December 1972. Since this index is based on list prices obtained from firms, the true increase was probably much higher: Firms evading price control are not likely to report prices accurately to a government agency. Even though substantial price increases were permitted by the control regulations, lumber has been a constant source of difficulty. To a considerable extent the controls have simply ratified what market pressures were accomplishing anyway; where the ratification was incomplete, evasion finished the job of bringing prices into line with market realities, albeit with some distortions.

In the case of oil, price control compounded difficulties caused by the restriction of imports, concern over the environmental implications of new refineries, and the long-standing regulation of the price of natural gas. During Phase II, the price ceilings on fuel oil and gasoline established in Phase I remained in force.

The problem of petroleum products prices has two components. First, the prices of refined products were not permitted to rise sufficiently to restrain rapidly growing demands and to stimulate extra production. Second, the ceilings were set in such a way that the price of gasoline rose relative to the price of fuel oil. Refineries biased production toward the more profitable product, and shortages appeared in fuel oil in the fall of 1972.

Figure 1 shows the price of fuel oil (light distillate) relative to gasoline and relative to gas fuels (mostly natural gas) over the past four years. Sharp changes in the price of fuel oil relative to gasoline occurred in 1969 and 1970 in response to changing demand and supply conditions. But the August 1971 freeze came at the time of seasonal weakness in the price of fuel oil and seasonal strength in the price of gasoline. Accordingly, the former could not rise in its usual seasonal pattern in the winter of 1971–72, but shortages did not result because stocks were at normal levels before the freeze. In August 1971, the price index for light distillate was 105.4, and it remained at this level until March 1972, when it rose to 106.3.

The gasoline price index stood at 102.0 in August 1971, fell seasonally to 99.7 in February 1972, and then rose steadily into the summer. The resulting decline in the price of fuel oil relative to gasoline over most of 1972 is clear in Figure 1.

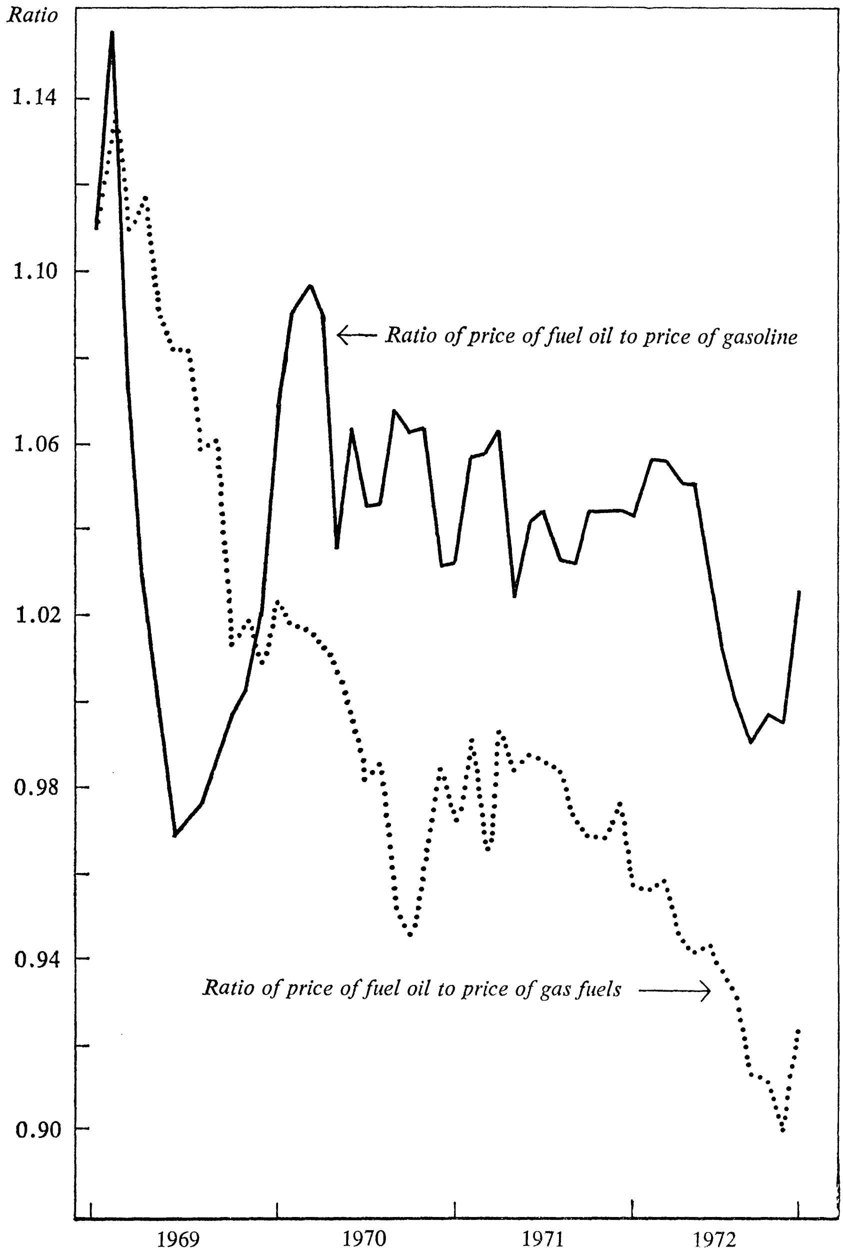
The fuel oil problem was aggravated by substantial increases in the price of natural gas, a price long controlled by the Federal Power Commission. In response to physical shortages and the rising price of natural gas, industrial users who had a choice switched to fuel oil, further depleting these stocks.

The top panel of Figure 2 makes it plain that refineries responded to the decline in the relative price of fuel oil by switching more of their production to gasoline. The solid line in the top panel shows the ratio of fuel oil to gasoline production month to month; the horizontal bars give the yearly averages.

As shown by the bottom panel of Figure 2, the result was that fuel oil stocks rose much less rapidly than usual over the first ten months of 1972. By June it was clear that shortages would appear unless production rose substantially.

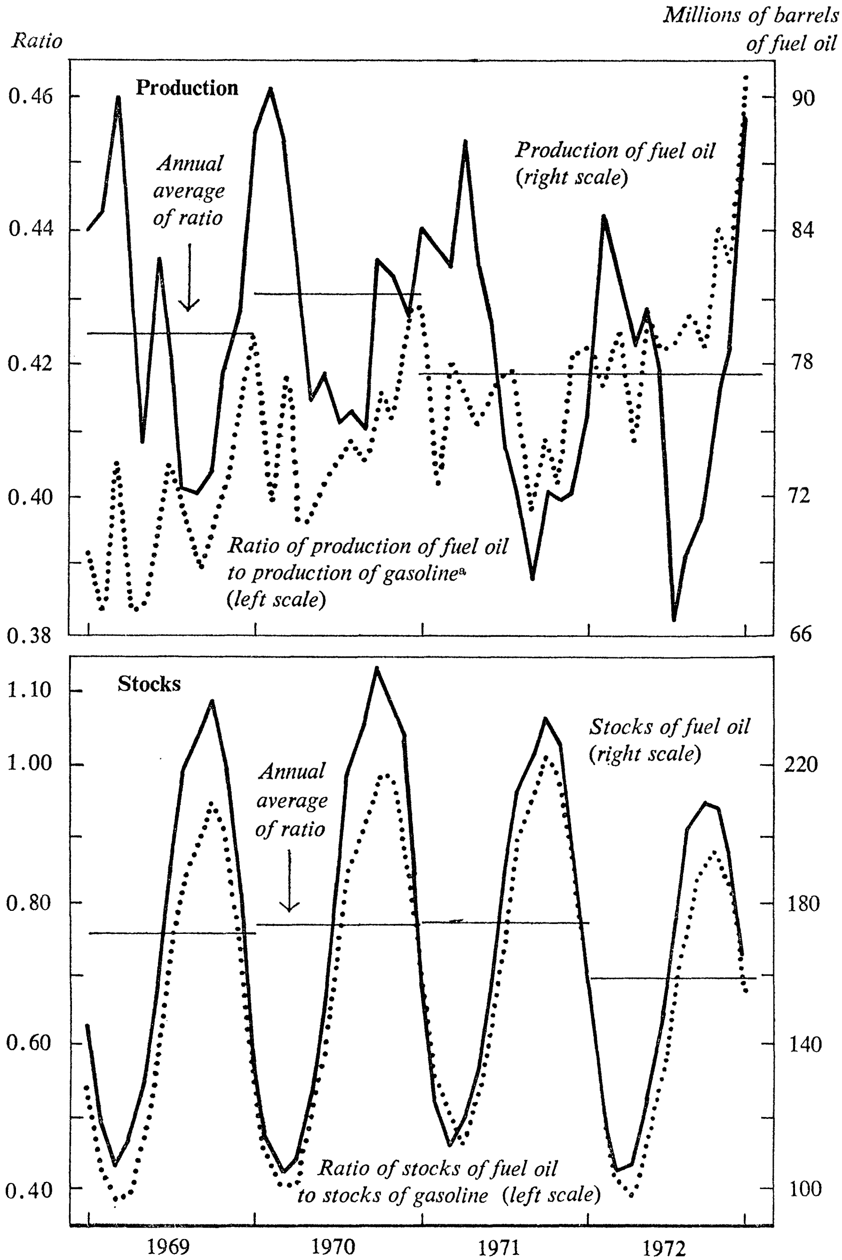
Shortages did in fact appear in the late fall and early winter, and would have been worse and more widespread had not the winter been a mild one in most parts of the country. Denver schools had to be closed for a time because of the shortage of heating oil. In some places part of the corn crop was lost for want of oil to operate corn dryers.

Figure 1. Price of Distillate Fuel Oil Relative to Gasoline and Gas Fuels, 1969–72



Sources: U.S. Bureau of Labor Statistics, *Wholesale Prices and Price Indexes,* various issues.
a. The ratios are computed from the wholesale price indexes for light distillate fuel oil (1) relative to gasoline and (2) relative to gas fuels (mostly natural gas).

Figure 2. Stocks and Production of Distillate Fuel Oil Relative to Gasoline, 1969–72



Sources: *Survey of Current Business*, various issues, pp. S-35, S-36.
a. Excludes aviation gasoline.

An increase in the price of fuel oil was permitted in December, and further increases occurred in the early days of Phase III. Spurred by higher prices and governmental prodding, refineries expanded their production of fuel oil. Now the talk is of gasoline shortages in summer 1973. But gasoline shortages, in the sense of dry pumps at filling stations, can be avoided if the price of gasoline is permitted to rise. Less essential uses of gasoline will be curtailed by price increases, and refineries will squeeze out extra production.

These examples illustrate what can be expected on a much wider scale if tight Phase IV controls are established. In my earlier paper I emphasized the importance of relative price movements. There I showed that in the year ended June 1971 substantial changes in relative prices had taken place, as indicated by the dispersion of changes in various components of the WPI. Perry replied: "Thus Poole's reported dispersion in price behavior makes a good case for flexible controls and intelligent price guidelines. But it does not persuade me that suppressed excess demand would be a problem. We could, of course, create that problem for ourselves—say, by trying to hold the price of lumber in the midst of the current housing boom. But that straw man should not be the subject of discussion."[8]

Why did lumber not turn out to be a straw man? The answer is that price control is both an economic and a political problem. By "political problem" I mean not only the problem of maintaining controls in the context of partisan politics but also, and more important, the problem of maintaining broad public support for the control program. Public support was important because the program was based primarily on voluntary compliance.

Except for the correction of economically improper relative prices, the ideal control program would depress each individual price and wage by the same relative amount below what it otherwise would have been. Controls, then, would not change relative prices from their levels in an uncontrolled environment, but would simply depress the absolute price level below what it otherwise would have been.

The difficulty, in my opinion, is the inherent impossibility of predicting the required relative prices; thus, the most intelligent and disinterested control process available will not produce satisfactory results. Economists often find it impossible to explain the causes of changes in relative prices after they have occurred; and even when the basic causes are understood,

8. George L. Perry, "After the Freeze," *BPEA* (2:1971), p. 447.

there is no way of knowing why relative prices changed by the exact amounts they did. Moreover, a price control agency confronts the more difficult problem of predicting the appropriate relative prices, and must adopt various criteria in an attempt to guess at what prices would have been. During Phase II these criteria have included (a) cost pass-through; (b) profit margins; (c) evidence of shortages; and (d) the price change from a base period. These criteria are defective in both theory and practice. In practice firms have powerful incentives to juggle the accounting numbers in order to meet the criteria for price increases. When increases are not granted, evasion occurs; when controls are effectively enforced, the costly distortions predicted by economic theory occur.

Because the rationale for price control is to reduce aggregate inflation, and because the public lacks understanding of the functioning of the price system, criterion (d) has been raised to a "more equal" status. To retain wide popular support, price control will inevitably come down hard on large and visible price increases, no matter how fully they may be justified by the state of excess demand in a particular industry.

It was, therefore, essentially impossible for the Price Commission to avoid leaning on lumber and petroleum product prices. Both industries have been highly visible, the former because of the size of recent price increases, the latter because of its concentration and the sheer number of motorists visiting gasoline pumps every day. Given the lack of economic knowledge and the essentially political nature of price control, distortions in relative prices are inevitable.

In spite of these difficulties, some now advocate maintaining wage and price control, simply accepting shortages in some cases and turning to rationing where necessary—gasoline and meat, for example.

Rationing would be a mess. If it is adopted, we can expect continuous conflict over who gets the ration tickets. Charges of improprieties, and worse, would surround the distribution of tickets, and a large bureaucracy would be required to administer it. Consumers would haggle over what sort of tickets, and how many, they were entitled to, and stand in endless lines to obtain them. Lost or stolen tickets would impose hardship on some, and others would discover that additional tickets could be obtained by falsely claiming such hardship. I predict that a few months' experience with a rationing system would simply be a prelude to the end of both rationing and price control.

Shortages will fall particularly hard on the poor and the weak, those who are supposedly most injured by open, unsuppressed inflation. Those with unconventional appearance and beliefs will be particularly vulnerable. Available supplies will go to the well connected and to those willing and able to wait in line. Workers on peculiar schedules will find certain items unavailable by the time they get to the store.

Although the discussion so far has ignored wage control, I believe the same basic principles apply to it. Like price control, wage control will tend to produce distortions,[9] although it seems likely that the effects on relative wages will appear more slowly. There are many possible techniques to evade wage control, as explained in my earlier paper.

Some advocates of wage control urge it on the grounds that wage increases are at the heart of the inflation problem. At the extreme, they contend that prices would take care of themselves if only wages could be controlled. They then advocate price control merely as a tactic to obtain political support for wage control. I cannot believe that, assuming wage control were effective in damping price inflation at all, it would in fact work very long; rather, the major impact would be an increase in business profits. Nevertheless, if for political reasons wage control must be accompanied by price control, we cannot avoid the problems created by price control.

Inflation is undeniably a problem, but I am convinced that controls will only compound our difficulties. The uncomfortable fact seems to be that the only way to reduce inflation is to pursue monetary and fiscal policies that retain a margin of unemployment and excess capacity in order to exert downward pressure on the rate of inflation. Once the rate of inflation has been reduced to an acceptable level, it will be possible to return to a fully employed economy with price stability. Structural reforms of the type mentioned in my previous paper can probably speed up the process, but there should be no illusions that even then disinflation can proceed rapidly. We will only dig ourselves into a deeper quagmire if we accept the argument that controls are needed for a few months until the next harvest is in, or to get by the next round of labor bargaining.

9. The argument that wage control has improved the structure of relative wages in the various construction trades may have considerable merit. I conjecture, however, that this improvement has come at the expense of strengthening the building trade unions, which were responsible for distorting relative wages in the first place. My guess is that both the wage distortions and the union power were being eroded by market forces. If in fact the gains were being made by nonunionized construction firms paying lower wages at the expense of unionized firms, then wage control may have increased the problems of excessive union power in the long run.

Have I conjured up a straw man with my fears of extensive distortions and rationing? I sincerely hope so. Advocates of controls do not want to suppress needed adjustments in relative prices. In September 1971 George Perry said: "I want limited and flexible controls because I do not want more. . . . I am against comprehensive controls just as Poole is and for the same reasons."[10] My concern is that limited controls are an unstable half-way house on the route to comprehensive controls, with their economically damaging and politically disruptive results. This is the reason I advocate an immediate legislated end to controls.

10. Perry, "After the Freeze," p. 447.