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Thoughts on Phase II

IT WILL BE A LONG TIME before we can say with any confidence whether the introduction of direct controls on wages and prices has been followed by a significant slowdown in their rise. Some good months and some bad months have occurred under the controls, just as good months and bad months occurred prior to their institution. I expect some slowdown in the inflation, but that will not settle the question, for the cause may be the controls or simply the delayed effect of the considerable slack in the economy. This will be a subject of debate in the coming years, just as there was a long debate over whether the investment tax credit actually stimulated investment.

No matter how this academic debate comes out, some form of direct controls is likely to be with us for some time. The establishment of direct controls was widely welcomed and the program is still generally popular despite its uncertain achievements to date. The controls are not likely to be abandoned soon unless they run afoul of some important pressure group, and that has not happened so far, despite some grumbling among union leaders and consumers.

Aside from public acceptance, another reason why controls probably will not disappear soon is that inflationary pressures are hardly likely to become less intense as the economy moves closer to capacity operation. If controls are in order when the unemployment rate is 6 percent, they will be no less needed when unemployment drops to a sustainable level. The controls of World War II or the Korean War had a natural termination date, but the present program does not. Unless the growth rate of real output increases markedly from recent figures, the rapid growth of the money supply combined with the usual lags virtually guarantees the preservation of inflationary pressures at least well into 1973. In recent decades, the growth rate of nominal gross national product has generally exceeded that of the money stock by about 3 percentage points. The recent year-to-year expansion of the money stock could therefore sustain a growth of money GNP at about 10 percent per year—far more than the expected growth of real GNP. The 3 percentage point difference may conceivably be attributable to interest rate effects as some have argued, but since there is little indication of a drastic turnaround in interest rates we cannot put much hope in that factor.

If my prognosis is correct, what will controls actually achieve? The modest reduction in the rate of inflation officially set as a goal, even if attained, does not provide much justification for this drastic departure from our generally successful economic traditions. It may be that in the future the Pay Board and Price Commission will serve increasingly as watchdogs over big business and labor. The three-tier classification of firms points in this direction, as does the recent exemption of most small enterprises. The Pay Board already spends much of its time on collective bargaining wage settlements.

A strong case can indeed be made for better supervision of the labor unions. In the last few years, the United States has moved toward the situation already prevailing in the United Kingdom, where unions have been able to obtain wage increases regardless not only of productivity but also of the state of the labor market. Since our laws have been inadequate to deal with this problem, the power of the unions may have to be constrained in other ways. Neither the Pay Board nor the Construction Industry Stabilization Committee has so far demonstrated much effectiveness in curbing wage increases, but they may yet learn to do so. Perhaps the introduction of an official link between unemployment and wages—an institutionalized Phillips curve—would lead to better results. But systematic regulation of collective bargaining may continue to be necessary as long as labor laws are not reformed.

There is ample precedent for fearing that regulatory boards can easily come under the control of the sector they are supposed to regulate. The departure of most of the labor members from the Pay Board does not necessarily disprove this possibility; they may have been convinced that the Pay

Board would be responsive to the unions even without their overt participation. If the Pay Board continues to favor organized over nonorganized labor, union membership will become more attractive and unions more powerful. Such regulation is therefore not likely to improve the workings of the labor market.

For somewhat different reasons, much the same holds for the Price Commission. If it concentrates on big business, there is little danger that large firms will gain undue influence over it, partly because large firms are more numerous than unions and their interests are more diverse. On the contrary, the danger is that the Price Commission will hold down the profit margins of the more efficient large firms to such an extent that marginal firms, who are frequently small, will be squeezed. Even if these small firms can avoid bankruptcy, they will then have difficulty in attracting capital. The more the controls emphasize profits, the greater this danger will be.

Many economists believe that price controls should be confined to large firms, and recent political trends also favor this development. There may well be a more immediate favorable effect on prices if firms with large profits are forced to roll back their prices. But that will put pressure on the prices of their less profitable competitors, forcing down their profits, and perhaps putting them out of business. Therefore, in both the labor market and the product market, this kind of price-wage control is likely to promote increased concentration.

The present policy, if pursued, may well bring about what John Kenneth Galbraith has called "The New Industrial State." I disagree with Galbraith's view that this term is already a good description of our economy. But government wage-price controls may lead to it, and reduce the effectiveness of the natural safeguards of a free market.

There are two main alternatives to the current program. One is a pro-competitive strategy. Most economists favor such a strategy, but it is very hard to achieve because our political system puts a heavy weight on the preservation of special privileges at the expense of overall economic performance.

The other alternative is to let inflation continue. Slowing down inflation has to hurt somebody, whether it be small firms or firms that, by one means or another, have succeeded in carving out a protected position. Neither the control strategy nor the pro-competitive strategy is painless. If our political system will not let anyone important be hurt, we may just have to live with inflation. The many calculations that have been made indicate that inflation does not seriously hurt any major group. Our economy is well adjusted to it. In fact the Brazilian experience suggests that economies can adjust to much higher inflation rates than we have experienced. Maybe the anti-inflationary efforts are all misplaced, and we should emphasize peace, which means leaving people alone. I personally favor the pro-competitive strategy, but I am not optimistic that it will ever be seriously implemented.