WAGE-PRICE CONTROL

MYTH & REALITY

CIS READINGS 1

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Wage — Price Control
Myth & Reality

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Wage — Price Control Myth & Reality

Preface

The Centre for Independent Studies was set up with the object of providing a stream of readable commentaries on economic and social issues presented by independent authors. These commentaries will elucidate principles, not grind particular axes. In their analyses, the authors will emphasize the microlevel actions of individuals, and the further unintended consequences of these actions.

This first publication is offered as a contribution to the public debate on wage and price controls. These controls have been with mankind for well nigh 5,000 years. How is it possible to account for their recurrent popularity, with politicians, officials and the public?

The activities of businessmen (and trade unions) are visible and patent to all. Businessmen give orders, and these orders are followed by their subordinates. What, then, could be simpler than to order businessmen, in their turn, to follow certain quantitative regulations?

What is far less visible and obvious is that each firm's activities are only part of one small link in a vast chain of interlinked activities. The actions of a large number of

separate and separated firms (and individuals) contribute to the completion of any one product – from cars and tractors to pins and pencils. (Consider the origins and provenance of the thousands of items that go into a finished car – from windscreen to windshield wipers, from differential to seat covers, from tyres to screws and nuts and bolts. And then consider the origins and provenance of the steel, glass, rubber, plastic . . . etc. required to make these items. And then take into account the iron ore and coal, the ships and insurance . . .) Only a minute fraction of this enormous inter-related chain is visible to us in our daily activities. And inside each business, of course, order is the result of orders, from superiors to subordinates.

But this cannot be so of the entire chain of production linking all these companies together. The various firms and productive units, the different individuals and partnerships, all scattered over wide geographical distances, that co-operate together, in effect, to produce even a humble pencil, cannot all even know of one another. All these activities have to be co-ordinated by some other method than the giving of orders. They can be (and are) co-ordinated by means of price signals. These signals are needed to convey vital information – about what and how much to produce, where and when.

To understand economic phenomena, then, we have to view the world in terms of such chains of production – chains that include large numbers of companies and encompass innumerable production units. Individual companies (and trade unions) are then merely the most visible and obvious aspects of this vast invisible chain. Prices and wage rates can then be seen as similar to readings on gauges – visible indicators of an invisible and extraordinarily complex interconnected series of actions.

Price and wage controls are based on the assumption that prices and wages are determined entirely by individual companies and trade unions – prices and wages stand at certain levels **solely** because companies and unions so decide. In terms of what has been said above, this is rather like assuming that the readings on the dials and gauges of highly complicated machines are more or less arbitrarily determined by the engineers involved. To "fix" the gauges so they

perpetually point to the same set of readings does not do away with the intricate and extremely complex processes going on invisibly behind these visible dials. But these processes are now forced to manifest themselves in other ways – in the shape of mysterious "breakdowns" or "malfunctions" of this very complicated machinery.

The case studies in this book examine a number of instances, drawn from a wide variety of contexts, in which the problem of rising prices was tackled by ordering that prices should remain at certain specified levels or rise by only certain specified percentages. These price and wage-control policies were established on the assumption that businessmen and unions are directly responsible for price and wage increases. In many cases, administrative controls were supported by joint agreements with companies and unions not to raise prices, or to raise them by certain limited amounts. The record, however, shows that such policies and agreements failed to stop inflation: wages and prices continued to rise at faster rates than those aimed at.

It seems clear that there are other influences at work: in tackling companies and unions, governments fail to reach the fundamental cause of inflation. Prices do **not** rise because no-one had thought of ordering them to stop; nor do they rise because no-one had set official target rates for inflation.

Wage and price controls, however, **have** had other, unintended consequences. They have inhibited those relative price movements that convey vital empirical information. This dis-co-ordination has produced its own symptoms: labour shortages, difficulties in obtaining supplies, quality reductions. The influences that would have otherwise appeared as rising prices have taken on other shapes: wage drift, periodic re-classification of employees, charges made for services formerly rendered free, etc. etc.

It is impossible in practice to disentangle the allocative and informative function of prices from their propensity to rise. Wage and price controls do not achieve their set goals – instead they have the unintended consequence of disrupting the flow of accurate information. Such controls divert attention from yet another key question: that of **improving** the information carried by prices. There remains

considerable scope for **institutional** change in this direction, but wage and price controls add to the difficulties of inducing such desirable changes.

The Centre for Independent Studies is grateful to the original copyright-holders for permission to reprint the various essays included in this volume. The Centre's constitution requires it to dissociate itself from the conclusions reached by the authors here, but it strongly recommends these conclusions for serious examination by readers.

Sudha R. Shenoy

Foreword

This, the first book to be published by the Centre for Independent Studies, offers an interesting and comprehensive survey of state attempts to control directly prices and wages. A succinct condemnation of such attempts was given after the First World War by Ludwig von Mises, the teacher of Friedrich von Hayek at the University of Vienna.

> "The oldest and most popular instrument of etatistic monetary policy is the official fixing of maximum prices. High prices, thinks the etatist, are not a consequence of an increase in the quantity of money, but a consequence of reprehensible activity on the part of 'bulls' and profiteers; it will suffice to suppress their machinations in order to ensure the cessation of the rise of prices. Thus it is made a punishable offence to demand, or even to pay, 'excessive' prices."
>
> *The Theory of Money and Credit (English translation, 1934) p. 245.*

But such attempts have always failed, and are bound to fail.

> "Charging more than a certain price is prohibited, but producing and selling has not been made compulsory. There are no longer any sellers. The market ceases to function. But this means that economic organization based on the division of labour becomes impossible. The level of money prices cannot be fixed without overthrowing the system of social division of labour . . . A government that sets out to abolish market prices is inevitably driven towards the abolition of private property . . . It is gradually forced towards compulsory production, universal obligation to labour, rationing of consumption, and, finally, official regulation of the whole of production and consumption . . .
>
> During thousands of years, in all parts of the inhabited earth, innumerable sacrifices have been made to the chimera of just and reasonable prices. Those who have offended against the laws regulating prices have been heavily punished . . . The agents of etatism have certainly not been lacking in zeal and energy. But, for all this, economic affairs cannot be kept going by magistrates and policemen."
>
> *idem, pp. 247-249*

Chapter 1 of this book amply illustrates von Mises' remarks about the antiquity and persistence of attempts at price controls. Robert Schuettinger's survey ranges over the Ancient World from Egypt to China, the Roman Empire, the Middle Ages and 18th Century France and America. Chapter 2 reproduces Brittan's and Lilley's survey of English experience of such controls from the reign of Edward III to that of Elizabeth I, and also Horst Mendershausen's similar survey for Germany from 1945 to 1948. There the general freeze imposed by the occupying powers quickly led to a virtual abandonment of money and hence breakdown of the market economy. The German 'economic miracle' began only when such controls were scrapped.

In Chapter 3, Malcolm Fisher asks whether price and income policies can work. This perceptive contribution looks mainly at theoretical evidence but also notices empirical results. The conclusion is that the case for attempting

such policies is weak – their obvious use is to check inflationary expectations – and their practicability worse than doubtful. "We would need a lot of convincing that the resource-allocation role of markets – the key to the long-run prosperity of our country – should be tampered with in this way on the accumulated evidence".

Sudha Shenoy, besides selecting material for this book of readings and ably editing it, has herself contributed a chapter which summarizes European experience of price and income controls since 1950. Such controls have been attempted in diverse institutional and social conditions, and their results have been far from impressive.

In Austria and the Netherlands there have been 'tripartite' arrangements for representatives of government, unions and employers to determine policies for wages and prices and, in both countries, a considerable sentiment of national solidarity should have helped these policies. In Sweden, too, unions have shown much sense of economic responsibility although there the government did little more than indicate guidelines based on macro-economic forecasts. Nevertheless, from the late 1960's, Austrian and Dutch prices and wages rose more rapidly than those in Western Europe as a whole and the Swedish system was unable to prevent serious inflation. Denmark has also attempted tripartite arrangements, but much less successfully than Austria or the Netherlands, and its government has intervened more sporadically in labour markets. Since 1971 it has also tried various methods of freezing prices and profits. They did not prevent Danish prices rising more rapidly than the average for all OECD countries. France has found income controls impracticable and has tried to use an elaborate system of price controls. They did not, however, succeed in holding French inflation below the OECD average in the 1960's or the 1970's.

Western Germany has been more successful than any of these countries in controlling inflation. Its comparative success has been achieved without recourse to official price or income controls although, from 1965, there were tripartite discussions which tended to accept government benchmarks for wage increases. Miss Shenoy attributes most of

West Germany's success to strong use of general monetary and fiscal policies, and her concluding remarks suggest that the comparative failure of direct controls in the other countries was due to weakness of such policies. And, if they had been strong enough, the price and income controls could have been advantageously dropped; for, as von Mises observed, they lead to increasing distortion of relative prices thereby damaging efficient allocation of resources between different economic activities and fostering social tensions.

Michael Parkin, in Chapter 5 draws lessons from the repeated, increasingly half-hearted attempts at wage and price controls in Britain after 1945. This chapter goes beyond historical illustration to consider more deeply von Mises' basic criticism of the irrationality of such controls. Parkin shows that they were generally ineffective in regard to their primary objective of price stability and had most damaging side effects: misallocation of resources, arbitrary redistribution of income, worsened industrial relations and a corrosive disrespect for the rule of law.

Chapter 6 has a number of studies of wage and price control in the United States during Richard Nixon's Presidency. Michael Darby regards it as "little more than a huge public relations scheme" and Jackson Grayson, who was Chairman of the Price Commission in Phase II of Nixon's Economic Stabilization Program, damagingly concludes that "to the extent that wage and price controls permit excessive monetary expansion in the short-term, they are counter productive and against the public interest"

Lee Eckermann gives a useful account of economic developments in Australia from 1950 to 1970, and a closer look at recent changes, more particularly the work of the Prices Justification Tribunal and the Arbitration Commission's applications of wage indexation. He suggests that the former has depressed profits and hence investment, without having much effect on price increases, but that the latter has set a floor rather than a ceiling to wage increases. To this Peter Samuel adds a pungent journalistic comment in which he explains how the 1977 fiasco of a freeze "could be adopted without any expert economic advice whatsoever"

The book then takes us back to Brittan and Lilley

who have also discussed the general case against wage and price controls but with special reference to Britain. There controls were too weak to have much effect on prices or shortages but they did damage investment by making future profits uncertain. Nor was there much profit-push in British inflation. The real problem was wage-push and wage controls were politically impracticable without economically superfluous price controls. Experience moreover, shows that wage controls are more quickly eroded than price controls.

Finally comes a brief excerpt from Milton Friedman's address during his welcome visit to Sydney in 1976. With characteristic vigour he reiterates von Mises' warning that "there is nothing that will destroy private enterprise more certainly than the imposition of wage control and price control". The two must go together yet neither singly nor in combination are they a cure for inflation. Indeed, they have always tended to make it worse because governments impose these controls in order to continue inflationary policies instead of reversing them.

I hope that this brief account of the book brings out the perennial threat of policies to control prices and income by magistrates and policemen – or their modern substitutes. We still have dangerous remnants of such policies in Australia, and can never be confident that they will not be quickly extended because of the influential advocacy of etatists or because of government refusal to curb such basic causes of inflation as monetary and fiscal expansion or unduly rigid exchange rates. Here the reader will find ample reasons, both theoretical and practical, for rejection of these policies as economic panaceas. He will also see that, quite apart from their proven superfluousness, impracticability, and immediate damage to the economy, any vigorous attempt to impose them threatens the foundations of a liberal and open society.

C.G.F. Simkin

December, 1977 **University of Sydney**

PART A

HISTORY

1. Wage — Price Control
   The First 5000 Years

2. A Second Look at
   Three Episodes

CHAPTER 1.

Wage — Price Control: The First 5000 Years

Robert Schuettinger

THE AUTHOR

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Wage — Price Control: The First 5000 Years*

Robert Schuettinger

I INTRODUCTION

From the earliest times, from the very inception of organized government, rulers and their officials have attempted, with varying degrees of success, to "control" their economies. The notion that there is a "just" or "fair" price for a certain commodity, a price which can and ought to be enforced by government is apparently coterminous with civilization.

For the past forty-six centuries (at least) governments all over the world have tried to fix wages and prices from time to time. When their efforts failed, as they usually did, governments then put the blame on the wickedness and dishonesty of their subjects, rather than upon the ineffectiveness of the official policy. The same tendencies remain today.

The passion for economic planning, as Professor John Jewkes has cogently pointed out,[1] is perennial. Centralized planning regularly appears in every generation and is just as readily discarded after several years of fruitless experimentation, only to rise again on a subsequent occasion. Grandiose plans for regulating investment, wages, prices and production are unusually unveiled with great fanfares and high hopes. As

*from: Robert Schuettinger, "A Survey of Wage and Price Controls Over Fifty Centuries" in Michael Walker, ed, *The Illusion of Wage and Price Control*, Fraser Institute, Vancouver 1976, with additional material.

reality forces its way in, however, the plans are modified in the initial stages, then modified a little more, then drastically altered, then finally allowed to vanish quietly and unmourned. Human nature being what it is, every other decade or so the same old plans are dusted off, perhaps given a new name, and the process can begin anew.

II THE ANCIENT WORLD: EGYPT, MESOPOTAMIA, CHINA, INDIA, GREECE

1. In the land of the Nile

In the ancient world, of course, authority over the most important economic commodity, foodstuffs, was power indeed. "The man, or class of men, who controls the supply of essential foods is in possession of the supreme power. The safeguarding of the food supply has therefore been the concern of governments since they have been in existence" wrote Mary Lacy in 1922.[2] And as far back as the fifth dynasty in Egypt, generally dated about 2830 B.C. or earlier, the Monarch Henku had inscribed on his tomb, "I was lord and overseer of southern grain in this nome."

For centuries the Egyptian government strove to maintain control of the grain crop, knowing that control of food is control of lives. Using the pretext of preventing famine, the government gradually regulated more and more of the granaries; regulation led to direction and finally to outright ownership; land became the property of the monarch and was rented from him by the agricultural class.[3]

Under the Lagid dynasty (founded by Ptolemy I Soter in 306 B.C.) "there was a real omnipresence of the state . . .The state. . .intervened by employing widely all its public law prerogatives. . .all prices were fixed by fiat at all levels."[4] According to the French historian, Jean-Philippe Levy, "Control took on frightening proportions. There was a whole army of inspectors. There was nothing but inventories, censuses of men and animals . . . estimations of harvests to come . . . In villages, when farmers who were disgusted with all these vexations ran away, those who remained were responsible for absentees' production. . .(one of the first effects of harsh

price controls on farm goods is the abandonment of farms and the consequent fall in the supplies of food). The pressure (the inspectors) applied extended, in case of need, to cruelty and torture."[5]

Egyptian workers during this period suffered badly from the abuses of the state intervention of the economy,[6] especially from the "bronze law", an economic theory which maintained that wages can never go above the bare necessities for keeping workers alive. The controls on wages set by the government reflected the prevailing economic doctrine.

"After a period of brilliance," Levy concludes, "Egyptian economy collapsed at the end of the third century B.C., as did her political stability. The financial crisis was a permanency. Money was devalued. Alexandria's commerce declined. Workers, disgusted by the conditions imposed on them, left their lands and disappeared into the country. ."[7]

2. Sumeria

In his very instructive work, *Must History Repeat Itself?*, Antony Fisher* calls our attention to a king of Sumeria, Urakagina of Lagash, who reigned from about 2350 B.C. Urakagina, from the scanty records that have come down to us, was apparently a precursor of Ludwig Erhard, who began his rule by ending the burdens of excessive government regulations over the economy, including controls on wages and prices.

An historian of this period tells us that from Urakagina "we have one of the most precious and revealing documents in the history of man and his perennial and unrelenting struggle for freedom from tyranny and oppression. This document records a sweeping reform of a whole series of

*For more very useful information on the sorry history of government interventions in the economy of all sorts (not only of wage and price controls) consult Antony Fisher's Must History Repeat Itself?, Churchill Press, London, 1974. Mr. Fisher himself has accomplished a good deal for the cause of liberty around the world by being instrumental in the founding of several scholarly centers for the study of the effects of government regulations of the economy, including the highly respected Institute of Economic Affairs in London.

prevalent abuses, most of which could be traced to a ubiquitous and obnoxious bureaucracy . . . it is in this document that we find the word "freedom" used for the first time in man's recorded history; the word is *amargi*, which. . .means literally "return to the mother" . . . we still do not know why this figure of speech came to be used for "freedom".[8]

3. Babylon

In Babylon, some 40 centuries ago, the Code of Hammurabi, the first of the great written law codes, imposed a rigid system of controls over wages and prices. Remembering the somewhat limited nature of the ancient economies (particularly those as ancient as the Babylonian) it is interesting to note the extent of wage controls imposed by the Hammurabi Code, and the explicit way in which they are recorded. A few of the Articles of the Code will suffice to illustrate this:*

257. If a man hire a field-labourer, he shall give him eight gur of corn per annum.

258. If a man hire a herdsman, he shall give him six gur of corn per annum.

261. If a man hire a pasturer for cattle and sheep, he shall give him eight gur of corn per annum.

268. If a man has hired an ox for threshing, twenty qa of corn is its hire.

269. If an ass has been hired for threshing, ten qa of corn is its hire.

270. If a young animal has been hired for threshing, one qa of corn is its hire.

271. If a man hire cattle, wagon, and driver, he shall give 180 qa of corn per diem.

272. If a man has hired a wagon by itself, he shall give forty qa of corn per diem.

273. If a man hire a workman, then from the beginning of the year until the fifth month he shall give six grains of silver per diem. From the sixth month until the end of the year he shall give five grains of silver per diem.

* Partially legible provisions have been omitted.

274. If a man hire a son of the people,

Pay of a potter	five grains of silver,
Pay of a tailor	five grains of silver,
Pay of a carpenter	four grains of silver,
Pay of a ropemaker	four grains of silver,

he shall give him per diem.

275. If a man hire a (illegible), her hire is three grains of silver per diem.

276. If a man hire a makhirtu, he shall give two and a half grains of silver per diem for her hire.

277. If a man hire a sixty-ton boat, he shall give a sixth part of a shekel of silver per diem for her hire.[9]

It is arguable that these controls blanketed Babylonian production and distribution, and smothered economic progress in the Empire, possible for many centuries.[10] Certainly the historical records show a decline in trade in the reign of Hammurabi and his successors. This was partly due to wage and price controls, and partly due to the influence of a strong central government which intervened in most economic affairs in general. W. F. Leemans describes the recession as follows:

> "Prominent and wealthy tamkaru (merchants) were no longer found in Hammurabi's reign. Moreover, only a few tamkaru are known from Hammurabi's time and afterwards . . . all . . . evidently minor tradesman and moneylenders."[11]

In other words, it appears that the very people who were supposed to benefit from the Hammurabi wage and price restrictions were driven out of the market by those and other statutes.

The trade restrictions laid down by "Hammurabi, the protecting king . . . the monarch who towers above the kings of the cities . . ." as he called himself, were, to some extent, built upon the foundations of the social system developed under his predecessor, Rim-Sin. There was a remarkable change in the fortunes of the people of Nippur and Isin and the other ancient towns which he ruled, which comes in the middle of Rim-Sin's reign. The beginning of the economic decline corresponds exactly with a series of "reforms" inaugurated by him. It appears that the noble monarch, after

a series of impressive military victories, succeeded in having himself worshipped as a god and henceforth took more political and economic power for his own administration and broke the influence of wealthy and influential traders. From thence, the number of tamkaru and wealthy men mentioned in the extant documents declines markedly. The number of property transactions for which records exist also diminishes. The number of administrative documents, which today we should call bureaucratic paper-work, simultaneously increases at a precipitous rate.[12]

4. The other side of the world

On the other side of the world, the rulers of ancient China shared the same paternalistic philosophy which was found among the Egyptians and Babylonians and would later be shared by the Greeks and Romans. In his study, *The Economic Principles of Confucius and His School,* the Chinese scholar, Dr. Huan-Chang Chen, states that the economic doctrines of Confucius held that "government interference is necessary for economic life and competition should be reduced to a minimum." [13]

The Official System of Chou, for instance, was a handbook of government regulations for the use of mandarins of the Chou dynasty under which Confucius (born 552 B.C.) lived. According to Dr. Chen, there was detailed regulation of commercial life and prices were "controlled by the government". There was a large bureaucracy entrusted with this task; Dr. Chen relates that there was a master of merchants for every twenty shops and his duty was to establish the price of each item sold according to the cost. "When there is any natural calamity," he writes, "the merchants are not allowed to raise their price; for example, during a famine grain should be sold at the natural price (that is, at the price believed to be "natural" by the government) and during a great epidemic coffins should be sold in the same way." [14]

The officials of the ancient Chinese empire expected to do what members of their class have perennially attempted before and since; to replace the natural laws of supply

and demand with their own judgment, allegedly superior, of what the proper supply and demand *ought to be*. According to the official system of Chou (about 1122 B.C.) a superintendent of grain was appointed, whose job was to survey the fields and determine the amount of grain to be collected or issued, in accordance with the condition of the crop, fulfilling the deficit of the demand and adjusting the supply. Indeed, lengthy economic "textbooks" on the subject of sensible grain management still exist from that time.

Dr. Chen comments laconically on this system in a footnote. "In modern times this policy has been changed to the opposite. During a famine, the price of grain is raised to induce merchants to bring in more grain." [15]

The regulations cited above, according to Dr. Chen, "were the actual rules under the Chou dynasty. In fact, in the classical time, the government did interfere with the commercial life very minutely." [16]

However, the results were not very favorable. "According to history," Dr. Chen notes, "whenever the government adopted any minute measure, it failed, with few exceptions . . . since the Ch'in dynasty (221-206 B.C.), the government of modern China has not controlled the economic life of the people as did the government of ancient China." [17] Apparently, the Chinese mandarins did learn from experience.

Even in the classical period of Chinese history, however, there were a number of perceptive economists who saw the futility of government regulation of prices as a means of controlling inflation. In fact, they placed the blame for high prices squarely on the shoulders of the government itself. The economist Yeh Shih (A.D. 1150-1223), for instance, anticipated the principle known as Gresham's Law in the West by several centuries. "The men who do not inquire into the fundamental cause," he wrote, "simply think that paper should be used when money is scarce. But as soon as paper is employed, money becomes still less. Therefore, it is not only that the sufficiency of goods cannot be seen, but also that the sufficiency of money cannot be seen." [18]

Another economist of about the same time, Yuan Hsieh (A.D. 1223) saw the principle even more clearly. He wrote:

"Now, the officials are anxious to increase wealth, and want to

> put both iron money and copper money in circulation. If money were suddenly made abundant during a period of scarcity, it should be very good. But the fact never can be so. Formerly, because the paper money was too much, the copper money became less. If we now add the iron money to it, should not the copper money but become still less? Formerly, because the paper money was too much, the price of commodities was dear. If we now add the iron money to the market, would the price not become still dearer?
>
> . . . When we look over the different provinces, the general facts are these. Where paper and money are both employed, paper is super-abundant, but money is always insufficient. Where the copper money is the only currency without any other money, money is usually abundant. Therefore, we know that the paper can only injure the copper money, but not help its insufficiency." [19]

Looking back at what we know to be the ineffectual history of government attempts to control inflation by regulating prices and wages, it is clear that these two Chinese economists of eight centuries ago were fully aware then of a law of economics that many political leaders have not learned to this day.

5. Ancient India

A renowned Indian political philosopher known as Kautilya and sometimes as Vishnugupta was an influential king-maker who put the great Maurya Chandragupta on the throne in 321 B.C. He wrote the *Arthasastra*, the most famous of the ancient Indian "handbooks for Princes" as a guide to Chandragupta and other rulers; this collection of essays on the art of statesmanship contains much wise and perceptive advice. [20] However, like most government officials of his time and since, Kautilya could not forbear the practice of trying to regulate the economy on the lines he thought best.

In a chapter entitled "Protection Against Merchants", Kautilya outlined in some detail how the grain trade should be regulated and the levels of prices that merchants would be allowed to charge.

> . . ."authorised persons alone," he wrote, "shall collect grains and other merchandise. Collections of such things without

> permission shall be confiscated by the superintendent of commerce.
> Hence shall merchants be favourably disposed towards the people in selling grains and other commodities.
> The superintendent of commerce shall fix a profit of five per cent over and above the fixed price of local commodities, and ten per cent on foreign produce. Merchants who enhance the price or realise profit even to the extent of half a pana more than the above in the sale or purchase of commodities shall be punished with a fine of from five panas in case of realising 100 panas up to 200 panas.
> Fines for greater enhancement shall be proportionally increased." [21]

In a chapter entitled "Protection Against Artisans" Kautilya explains the "just" wages for a number of occupations, ranging from musicians to scavengers and concludes by saying "Wages for the works of other kinds of artisans shall be similarly determined." [22]

Kautilya also recommends the appointment of government superintendents for a wide variety of economic activities, such as slaughter-houses, liquor supplies, agriculture and even ladies of the evening. For instance, there is a provision which states that "The Superintendent shall determine the earnings . . . expenditure, and future earnings of every prostitute". There is a footnote for guidance which states very clearly that "Beauty and accomplishments must be the sole consideration in the selection of a prostitute." [23]

It is not known exactly how these price and wage regulations worked out in practice, but it would not be unreasonable to suppose that the end results were similar to what happened in Egypt, Babylon, Sumeria, China, Greece and other nations.

6. Greek earnings

Moving across another continent, we find that the Greeks behaved in just the same way. Xenophon[24] tells us that in Athens, a knowledge of the grain business was considered one of the qualities of a statesman. As a populous city-state with a small hinterland, Athens was constantly short of grain, at least half of which had to be imported from over-

seas. There was, needless to say, a natural tendency for the price of grain to rise when it was in short supply and to fall when there was an abundance. An army of grain inspectors, who were called *Sitophylakes*, was appointed for the purpose of setting the price of grain at a level the Athenian government thought to be just. It was a Golden Age consumer protection agency (of unusually large size for the period) whose duties were defined by Aristotle as "to see to it first that the grain was sold in the market at a just price, than that the millers sold meal in proportion to the price of barley, that the bakers sold bread in proportion to the price of wheat, that the bread had the weight they had fixed." [25]

The Professor of Ancient History at the University of Cambridge, M. I. Finley, comments in his recent study, The Ancient Economy, that,

> "Just price was a medieval concept, not an ancient one, and this interference by the state, altogether exceptional in its permanence, is a sufficient measure of the urgency of the food problem. And when this and all the other legislative measures I have mentioned on other occasions failed, the state, as a last recourse, appointed officials called *sitonai*, corn-buyers, who sought supplies wherever they could find them, raised public subscriptions for the necessary funds, introduced price reductions and rationing." [26]

The result was as might be expected: failure. Despite the penalty of death, which the harassed government did not hesitate to inflict, the laws controlling the grain trade were almost impossible to enforce. We have a surviving oration from at least one of the frustrated Athenian politicians who implored a jury to put the offending merchants to death. "But it is necessary, gentlemen of the Jury," he urged, "to chastise them not only for the sake of the past, but also as an example for the future; for as things now are, they will hardly be endurable in the future. And consider that in consequence of this vocation, very many have already stood trial for their lives; and so great are the emoluments which they are able to derive from it that they prefer to risk their life every day, rather than cease to draw from you, the public, their improper profits . . . If then, you shall condemn them, you shall act justly and you will buy grain cheaper; otherwise, the price will be much more. [27]

But Lysias was not the first and he was hardly the last politician to court popularity by promising the people lower prices in times of scarcity if only they would put an occasional merchant to the sword. The Athenian government, in fact, went so far as to execute their own inspectors when their price-enforcing zeal flagged. Despite the high mortality rates for merchants and bureaucrats alike, the price of grain continued to rise when supplies were short, and continued to fall when supply was plentiful.

Regulatory agencies have had the same problems from time immemorial. T. F. Carney, in his informative book *The Economics of Antiquity*, has described the rise and the economic effect of ancient regulatory agencies in the following terms:

> "If a government and its key bureaucratic institutions can create a favourable environment for business, by the same token they can also do the reverse. Historically, economic development has been associated with public instrumentalities . . .
> . . . Bureaucrats (in the ancient world) were officials, with a punishment orientation towards their subject populations. . . . The government bureaucracy was regulative and extractive, not developmental. Originating in a tribal culture, it always tended to favour a mandarinate of literary generalists. There were no forces to countervail against it. Neither corporations, legislatures, nor political parties were yet in existence. In most cases, most of any society's tiny elite went into the apparatus of government. This government served an autocrat whose word was law. So there could be no constitutional safeguards for businessmen or against that apparatus . . ." [28]

And there is another way in which such ancient regulatory efforts show great parallels with contemporary ones. The *sitonai* were originally intended to be temporary, but as shortages arose from time to time (in no way abated by their work) there was a growing desire to keep them as permanent officials. If all else failed, Athenian colonial policy made it convenient enough to get rid of surplus citizens whom the regulated economy could not sustain. Some might ask why some present-day economists have not thought of this solution to the comodity scarcities which inevitably follow upon price controls.[29]

III ROME: REPUBLIC AND EMPIRE

As might be expected, the Roman Republic was not to be spared a good many ventures into control of the economy by the government. One of the most famous of the Republican statutes was the Law of the Twelve Tables (449 BC) which among other things, fixed the maximum rate of interest at one uncia per libra (approximately 8%) but it is not known whether this was for a month or for a year. At various times after this basic law was passed, however, politicians found it popular to generously forgive debtors their agreed upon interest payments. A Licinian law of 367 BC, for instance, declared that interest already paid could be deducted from the principal owed, in effect setting a maximum price of zero on interest. The lex Genucia (342 BC) had a similar provision and we are told that violations of this "maximum" were "severely repressed under the lex Marcia." Levy concludes that "Aside from the Law of the Twelve Tables, these ad hoc or demagogic measures soon went out of use." [30]

The laws on grain were to have a more enduring effect on the history of Rome. From at least the time of the fourth century BC, the Roman government bought supplies of corn or wheat in times of shortage and re-sold them to the people at a low fixed price. Under the tribune Caius Gracchus the Lex Sempronia Frumentaria was adopted which allowed every Roman citizen the right to buy a certain amount of wheat at an official price much lower than the market price. In 58 BC this law was "improved" to allow every citizen free wheat. The result, of course, came as a surprise to the government. Most of the farmers remaining in the countryside simply left to live in Rome without working. [31]

Slaves were freed by their masters so that they, as Roman citizens, could be supported by the state. In 45 BC Julius Caesar discovered that almost one citizen in three was receiving his wheat at government expense. He managed to reduce this number by about half, but it soon rose again; through-out the centuries of the empire, Rome was to be perpetually plagued with this problem of artificially low prices for grain, which caused economic dislocation of all sorts.

In order to attempt to deal with their increasing economic problems, the emperors gradually began to devalue the currency. Nero (AD 54-68) began with small devaluations and matters became worse under Marcus Aurelius (AD161-80) when the weights of coins were reduced. "These manipulations were the probable cause of a rise in price," according to Levy. The emperor Commodus (AD 180-92) turned once again to price controls and decreed a series of maximum prices but matters only became worse and the rise in prices became "headlong" under the emperor Caracalla (AD 211-17). [32]

Egypt was the province of the empire most affected but her experience was reflected in lesser degrees throughout the Roman world. During the fourth century, the value of the gold solidus changed from 4000 to 180 million Egyptian drachmai. Levy again attributes the phenomenal rise in prices which followed to the large increase of the amount of money in circulation. The price of the same measure of wheat rose in Egypt from 6 drachmai in the first century to 200 in the third century; in AD 314, the price rose to 9000 drachmai and to 78,000 in AD 334; by shortly after the year AD 344 the price shot up to more than 2 million drachmai. As noted, other provinces went through a similar, if not quite as spectacular, inflation.

> "In monetary affairs," Levy writes, "ineffectual regulations were decreed to combat Gresham's Law (bad money drives out good) and domestic speculation in the different kinds of money. It was forbidden to buy or sell coins; they had to be used for payment only. It was even forbidden to hoard them! It was forbidden to melt them down (to extract the small amount of silver alloyed with the bronze). The punishment for all these offences was death. Controls were set up along roads and at ports, where the police searched traders and travellers. Of course, all these efforts were to no purpose." [33]

The most famous and the most extensive attempt to control prices and wages occurred in the reign of the Emperor Diocletian who, to the considerable regret of his subjects, was not the most attentive student of Greek economic history. Since both the causes of the inflation that Diocletian attempted to control and the effects of his efforts are fairly

well documented it is an episode worth considering in some detail.

Shortly after his assumption of the throne in AD 284, "prices of commodities of all sorts and the wages of laborers reached unprecedented heights." [34] Historical records for determining the causes of this remarkable inflation are limited. One of the few surviving contemporary sources, the seventh chapter of the *De Moribus Persecutorum*, lays almost all the blame squarely at the feet of Diocletian. Since, however, the author is known to have been a Christian and since Diocletian, among other things, persecuted the Christians, we have to take this report *cum grano salis*. In this attack on the emperor we are told that most of the economic troubles of the empire were due to Diocletian's vast increase in the armed forces (there were several invasions by barbarian tribes during this period), to his huge building program (he re-built much of his chosen capital in Asia Minor, Nicomedia), to his consequent raising of taxes and the employment of more and more government officials and finally, to his use of forced labor to accomplish much of his public works program.[35] Diocletian himself, in his Edict (as we shall see) attributed the inflation entirely to the "avarice" of merchants and speculators.

A recent classical historian, Roland Kent, writing in the University of Pennsylvania Law Review, [36] concludes from the available evidence that there were several major causes of the sharp rise in prices and wages. In the half century before Diocletian there had been a succession of short-reigned, incompetent rulers elevated by the military; this era of weak government resulted in civil wars, riots, general uncertainty and, of course, economic instability. There certainly was a steep rise in taxes, some of it justifiable for the defense of the empire but some of it spent on grandiose public works of questionable value. As taxes rose, however, the tax base shrank and it became increasingly difficult to collect taxes, resulting in a vicious circle.

It would seem clear that the major single cause of the inflation was the drastic increase in the money supply owing to the devaluing or debasing of the coinage. In the late republic and early empire, the standard Roman coin was the

silver denarius: the value of that coin had gradually been reduced until in the years before Diocletian emperors were issuing tin-plated copper coins which were still called by the name "denarius". Gresham's Law, of course, became operative, silver and gold coins were naturally hoarded and were no longer found in circulation.

During the fifty year interval ending with the rule of Claudius Victorinus in AD268 the silver content of the Roman coin fell to one five-thousandth of its original level. With the monetary system in total disarray, the trade which had been a hallmark of the Empire was reduced to barter and economic activity was stymied. "The middle class was almost obliterated and the proletariat was quickly sinking to the level of serfdom. Intellectually the world had fallen into an apathy from which nothing would rouse it." [37] To this intellectual and moral morass came the Emperor Diocletian and he set about the task of reorganization with great vigour. Unfortunately, his zeal exceeded his understanding of the economic forces at work in the Empire.

In an attempt to overcome the paralysis associated with centralized bureaucracy, he decentralized the administration of the Empire and created three new centres of power under three "associate emperors." Since money was completely worthless, he devised a system of taxes based on payments in kind. This system had the effect, via the *ascripti glebae*, of totally destroying the freedom of the lower classes – they became serfs and were bound to the soil to ensure that the taxes would be forthcoming.

The 'reforms' that are of most interest, however, are those relating to the currency and prices and wages. The currency reform came first and was followed, after it had become clear that this reform was a failure, by the Edict on prices and wages. Diocletian had attempted to instil public confidence in the currency by putting a stop to the production of debased gold and silver coins.

According to Kent, "Diocletian took the bull by the horns and issued a new denarius which was frankly of copper and made no pretence of being anything else; in doing this he established a new standard of value. The effect of this on prices needs no explanation; there was a readjust-

ment upward, and very much upward." [38] The new coinage gave some stability to prices for a time, but unfortunately, the price level was still too high in Diocletian's judgment and he soon realized that he was faced with a new dilemma. The principal reason for the official overvaluation of the currency, of course, was to provide the wherewithal to support the large army and massive bureaucracy – the equivalent of modern government. Diocletian's choices were to continue to mint the increasingly worthless denarius or to cut 'government expenditures' and thereby reduce the requirement for minting them. In modern terminology, he could either continue to 'inflate' or he could begin the process of 'deflating' the economy.

Diocletian decided that deflation, reducing the costs of civil and military government, was impossible. On the other hand:

> "To inflate would be equally disastrous in the long run. It was inflation that had brought the Empire to the verge of complete collapse. The reform of the currency had been aimed at checking the evil, and it was becoming painfully evident that it could not succeed in its task." [39]

It was in this seemingly desperate circumstance that Diocletian determined to continue to inflate, but to do so in a way that would, he thought, prevent the inflation from occurring. He sought to do this by simultaneously fixing the prices of goods and services and suspending the freedom of people to decide what the official currency was worth. The famous Edict of AD301 was designed to accomplish this end. Its framers were very much aware of the fact that unless they could enforce a universal value for the denarius in terms of goods and services – a value that was wholly out of keeping with its actual value – the system that they had devised would collapse. Thus, the Edict was all pervasive in its coverage and the penalties prescribed, severe.

The Edict was duly proclaimed in AD301 and, according to Kent, "the preamble is of some length, and is couched in language which is as difficult, obscure, and verbose as anything composed in Latin.[40] Diocletian clearly was on the defensive in announcing such a sweeping law which affected every person in the empire every day of the week;

he uses considerable rhetoric to justify his actions . . . rhetoric which was used before him and which, with variations, has been used in most times and places since."

He began by listing his many titles and then goes on to announce that "The national honor and dignity and majesty of Rome demand that the fortune of our State . . . be also faithfully administered . . . To be sure, if any spirit of self-restraint were holding in check those practices by which the raging and boundless avarice is inflamed . . . peradventure there would seem to be room left for shutting our eyes and holding our peace, since the united endurance of men's minds would ameliorate this detestable enormity and pitiable condition (but since it is unlikely that this greed will restrain itself) . . . it suits us, who are the watchful parents of the whole human race, (the term "parents" refers to his associate Augustus and two Caesars) that justice step in as an arbiter in the case, in order that the long-hoped-for result, which humanity could not achieve by itself, may by the remedies which our forethought suggests, be contributed toward the general alleviation of all." [41]

In *The Common People of Ancient Rome,* Frank Abbot summarizes the essence of the Edict in the following words "In his effort to bring prices down to what he considered a normal level, Diocletian did not content himself with half measures as we are trying in our attempts to suppress combinations in restraint of trade, but he boldly fixed the maximum prices at which beef, grain, eggs, clothing and other articles could be sold (and also the wages that all sorts of workers could receive) and prescribed the penalty of death for anyone who disposed of his wares at a higher figure." [42]

Diocletian was not a stupid man (in fact, from all accounts, he seems to have been more intelligent than all but a few of the emperors): he was therefore aware that one of the first results of his edict would be a great increase in hoarding. That is, if farmers, merchants and craftsmen could not expect to receive what they considered to be a fair price for their goods they would not put them on the market at all, but would await a change in the law (or in the dynasty).

He therefore provided that "From such guilt also he

too shall not be considered free, who, having goods necessary for food or usage, shall after this regulation have thought that they might be withdrawn from the market; since the penalty (namely, death) ought to be even heavier for him who causes need than for him who makes use of it contrary to the statutes." [43]

There was another clause prescribing the usual penalty for anyone who purchased a good at a higher price than the law allowed; again, Diocletian was well aware of the normal consequences of such attempts at economic regulation. On the other hand, in at least one respect the Edict was more enlightened (from an economic point of view) than many regulations of recent years. "In those places where goods shall manifestly abound," it declared, "the happy condition of cheap prices shall not thereby be hampered* —and ample provision is made for cheapness, if avarice is limited and curbed." [44]

Parts of the price-lists have been discovered in about 30 different places, mostly in the Greek-speaking portions of the empire. There were at least 32 schedules, covering well over a thousand individual prices or wages. A selection of some of the more interesting items were translated by Roland Kent into U.S. equivalents as of 1920, (based upon the price of a pound of refined gold set at 50,000 denarii). The price of a bushel of barley, for instance, was set at no higher than 87c. A quart of beer was meant to be especially cheap, only 3c a quart (obviously a demogogic provision). A farm labourer was to be paid no more than $0.108 a day (most workers received their meals from their employers). Masons or carpenters, however, could receive $0.217 a day.

Teachers of reading and writing could receive $0.217 per pupil monthly, teachers of Greek and Latin, $0.808 per pupil monthly. Teachers of public speaking (which prepared the way for governmental careers) were the highest paid, up to $1.08 per pupil monthly. Raw silk was almost astronomically expensive, set at $72.18 per pound – it had to be transported by land, of course, from China.[45]

* Those modern nations who have had to endure "Retail Price Maintenance", "Fair Trade Laws" and the various price-fixing agencies such as the International Air Transportation Association could well learn a useful lesson from Diocletian, who at least made it always legal to lower a price.

The results were not surprising and from the wording of the Edict, as we have seen, not unexpected by the emperor himself. According to a contemporary account ". . . then he set himself to regulate the prices of all vendible things. There was much blood shed upon very slight and trifling accounts; and the people bought provisions no more to markets, since they could not get a reasonable price for them and this increased the dearth so much, that at last after many had died by it, the law itself was set aside." [46]

It is not certain how much of the blood shed alluded to in this passage was caused directly by the government through the promised executions and how much was caused indirectly. An historian of this period, Roland Kent, believes that much of the harm was indirect. "In other words," he concludes, "the price limits set in the Edict were not observed by the traders, in spite of the death penalty provided in the statute for its violation; would-be purchasers, finding that the prices were above the legal limit, formed mobs and wrecked the offending traders' establishments, incidentally killing the traders, though the goods were after all of but trifling value; hoarded their goods against the day when the restrictions should be removed, and the resulting scarcity of wares actually offered for sale caused an even greater increase in prices, so that what trading went on was at illegal prices, and therefore performed clandestinely."[47]

It is not known exactly how long the Edict remained in force; it is known, however, that Diocletian, citing the strain and cares of government, resulting in his poor health, abdicated four years after the statute on wages and prices was promulgated. It certainly became a dead letter after the abdication of its author.

Less than four years after the currency reform associated with the Edict, the price of gold in terms of the denarius had risen 250 per cent. Diocletian had failed to fool the people and had failed to suppress the ability of people to buy and sell as they saw fit. The failure of the Edict and the currency 'reform' led to a return to more conventional fiscal irresponsibility and by AD305 the process of currency debasement had begun again.

By the turn of the century this process had produced

a two thousand per cent increase in the price of gold in terms of denarii:

> "These are impossible figures and simply mean that any attempt at preserving a market, let alone a mint ratio, between the bronze denarius and the pound of gold was lost. The astronomical figures of the French "assignats", the German mark after the First World War, and of the Hungarian pengo after the Second, were not unprecedented phenomena.[48] . . . . Copper coins could very easily be manufactured. Numismatists testify that the coins of the fourth century often bear signs of hasty and careless minting; they were thrust out into circulation in many cases without having been properly trimmed or made tolerably respectable. This hasty manipulation of the mints was just as effective as our modern printing presses, with their floods of worthless, or nearly worthless, paper money." [49]

M. Rostovtzeff, a leading Roman historian summed up this unhappy experience in these words:

> "The same expedient had often been tried before him and was often tried after him. As a tempory measure in a critical time, it might be of some use. As a general measure intended to last, it was certain to do great harm and to cause terrible bloodshed, without bringing any relief. Diocletian shared the pernicious belief of the ancient world in the omnipotence of the state, a belief which many modern theorists continue to share with him and with it." [50]

Although Diocletian's attempt to control the economy ended in complete failure and he was forced to abdicate, it was only sixty years later that his successor. Julian the Apostate, was back at the same old stand. Edward Gibbon, the brillian historian of the period, ironically noted that

> ". . . the emperor ventured on a very dangerous and doubtful step, of fixing by legal authority, the value of corn (grain). He enacted that, in a time of scarcity, it should be sold at a price which had seldom been known in the most plentiful years; and that his own example might strengthen his laws (he sent into the market a large quantity of his own grain at the fixed price). The consequences might have been foreseen and were soon felt. The imperial wheat was purchased by the rich merchants; the proprietors of land, or of corn (grain) witheld from that city the accustomed supply, and the small quantities that appeared in the market were secretly sold at an advanced and illegal price." [51]

As a desperate measure, succeeding emperors tried to tie workers to the land or to their father's occupation in order to prevent workers from changing jobs as a means of evading the low wages prescribed for certain professions. This, of course, was the ultimate consequence of the attempt to control wages by law.

The only legal escape for many workers was to find a willing replacement and then to give up all their goods to him. The emperor Aurelian had previously compared a man who left his profession to a soldier who deserted on the field of battle. [52]

The historian Levy concludes his survey of the economy of the empire by declaring that

> "State intervention and a crushing fiscal policy made the whole empire groan under the yoke; more than once, both poor men and rich prayed that the barbarians would deliver them from it. In AD378, the Balkan miners went over en masse to the Visigoth invaders, and just prior to AD 500 the priest Salvian expressed the universal resignation to barbarian domination." [53]

IV. THE 12TH – 18TH CENTURIES

During the Middle Ages, not only the national governments but also guilds and municipalities engaged in price-fixing as a normal activity. In the thirteenth century officials in England "felt themselves bound to regulate every sort of economic transaction in which individual self-interest seemed to lead to injustice." [54]

In the year 1199 the government in London attempted to control the wholesale and retail price of wine. The law was difficult to enforce and eventually failed. In 1330 the passion for price-fixing stirred again and a new law was adopted requiring merchants to sell at a 'reasonable' price – this figure to be based upon importation costs plus other expenses. In a few years, due to changing economic conditions, the price of wine rose far above the 1330 price and the government finally had to accept defeat once again. [55]

The many efforts to regulate the prices of wheat and bread in England came to a similar conclusion. The first attempt was apparently made in 1202; the leading law in

this case was 51 Henry III which fixed precise prices for varying weights of bread. The economic historian Simon Litman notes that "the law was enforced locally on sundry occasions, but fell gradually into disuse." [56]

"During the fourteenth and fifteenth centuries," the historian W. J. Ashley tells us, "parliament and the executive left the matter (of regulation of prices, place of sale, etc.) almost entirely in the hands of the local authorities . . . The municipal authorities frequently went beyond victuals, and regulated the prices of other articles of prime importance to the poorer classes, such as wood and coal, tallow and candles." [57]

During the reign of the Tudor dynasty (after 1485), Parliament "was not content with passing acts against practices which enhanced prices. It endeavoured to fix directly a fair price not only for victuals but also for other commodities." [58] Most of these regulations received little public support and gradually faded away.

Antwerp

In the sixteenth century misplaced economic controls were decisive in determining the fate of the most important city in what is now Belgium. From 1584 to 1585 Antwerp was besieged by Spanish forces led by the Duke of Parma who was intent on maintaining the rule of the Hapsburg Empire in the Lowlands. Naturally, during a siege, food quickly becomes a scarce commodity and prices accordingly rise. The City Fathers of Antwerp reacted as many others in their position have done before and since; they passed a law fixing a maximum price for each item of food. Severe penalties were prescribed for anyone who attempted to charge the market price. According to the historian John Fiske, the consequences of this policy were twofold:

> "It was a long time before the Duke of Parma, who was besieging the city, succeeded in so blockading the Scheldt as to prevent ships laden with eatables from coming in below. Corn and preserved meats might have been hurried into the beleaguered city by thousands of tons. But no merchant would run the risk of having his ships sunk by the Duke's batteries merely for the sake of finding a market no better than many others which

> could be reached at no risk at all . . . If provisions had brought a high price in Antwerp they would have been carried thither. As it was, the city by its own stupidity blockaded itself far more effectually than the Duke of Parma could have done."
>
> "In the second place," Fiske concludes, "the enforced lowness of prices prevented any general retrenchment on the part of the citizens. Nobody felt it necessary to economize. So the city lived in high spirits until all at once provisions gave out . . ."[59]

In 1585 the city of Antwerp surrendered and was occupied by the forces of Spain.

Bengal

An even worse disaster, made more costly still by government bungling, occurred in the Indian province of Bengal in the eighteenth century. The rice crop in 1770 failed completely and fully a third of the population died. A number of scholars attribute this disaster primarily to the rigid policy of the government which was determined to keep the price of grains down rather than allowing it to rise to its natural level. A price rise, of course, would have been a natural rationing system permitting the available food to be stretched out until the next harvest. Without this rationing system the reserve supplies were quickly consumed and millions died of hunger as a direct result.

For once in human history, however, government did learn by experience. Ninety-six years later the province of Bengal was again on the verge of famine. This time the procedure was completely different, as William Hunter relates:

> "Far from trying to check speculation, as in 1770, the Government did all in its power to stimulate it . . . A government which, in a season of high prices, does anything to check speculation acts about as sagely as the skipper of a wrecked vessel who should refuse to put his crew upon half rations . . . In the earlier famine one could hardly engage in the grain trade without becoming amenable to the law. In 1866 respectable men in vast numbers went into the trade; for the Government, by publishing weekly returns of the rates in every district, rendered the traffic both easy and safe. Everyone knew where to buy grain cheapest and where to sell it dearest and food was accordingly bought from the districts which could best spare it and carried to those which most urgently needed it." [60]

The experience of Bengal, which had two failed harvests of major proportions within a century, provided a laboratory for testing the two policies. In the earlier case, price-fixing was enforced and a third of the people perished; in the latter case, the free market was allowed to function and the shortage was kept under control.

V. NORTH AMERICA AND FRANCE – THE 18th CENTURY

1. The early Canadians

The history of attempts to control wages and prices in the early days of Canadian settlement has not yet been well researched. Accordingly, the episodes reported here may represent only a sample out of a broad but unrecovered experience with controls. Most of the persons in authority in the early days of Canadian settlement were agents of some European government and it would be reasonable to suppose that these functionaries carried with them their homeland's propensities for economic controls.

Quebec

It is certain from some of the records that have been preserved that the internal trade of Quebec was minutely regulated. Of particular concern in the late 17th century were the comings and goings of itinerant merchants. In general they were forbidden to enter into retail transactions of any sort and were subject to no less than ten general prohibitions. [61] These regulations had the effect of a retail price maintenance law since they expressly forbade the competition of 'outsider' merchants. These itinerant merchants were excluded specifically because they would have reduced the price of goods and taken business from resident merchants. There is some indication in the subsequent record that the regulation was not an unqualified success. In 1727 the local (Quebec) merchants found it necessary to write to the king requesting that he suspend the operation of the itinerant merchants. [62] There is no evidence that this attempted interference was successful either. In fact, a memoir from the king dated April 19, 1729 contains a paragraph indicating

the king's general support for the activities of the itinerant merchants. [63]

In 1689, the Superior Council of Quebec, following the long-established European practice, gave explicit permission to municipalities to regulate the price of bread. Although the exact effect of this regulation is not known it can be supposed that all was not well and that a change in the baker's costs would have meant a shortage of bread. Perhaps it was a situation of this sort that led to price controls on wheat in the fall of 1700 – certainly, it was clearly indicated in the regulation of that year that the bakers would have, as a result of the order, to work for the city and were constrained from working in any other way. [64]

Louisbourg

During 1750 rules were made as to the price that must be charged for fresh cod fish. It was, by this order, explicitly forbidden for fishermen to refuse to sell their fish at the posted price provided only that the buyer was solvent. To appreciate the serious nature of this law, it is necessary to remember that the bulk of New France's wealth was derived from the cod fishery. Of course, from time to time this regulation led to desperate circumstances for the fishermen and there is some reason to believe that it was responsible for the decline in the fishery in that area of New France [65]

Canada's first economist?

The most interesting commentary on inflation that this early period in Canadian history yields is by a person or persons unknown writing in Quebec 19th April 1759. The passage, which is worth reprinting in its entirety, was written as a commentary appended to an exposition of the price of commodities in Canada. Having shown the rate of increase in the cost of most important commodities the writer went on to say:

> "The excessive expense which this picture presents is such that one has perhaps never seen before an example of it. And it comes less from real scarcity than from the enormous expenditures of the government which have multiplied paper money without any consideration for the stock of commodities nor for the

> number of consumers . . . The price of commodities has been rising step by step because of a similar step by step increase in the expenditures of the government. These expenditures, which one can estimate by the sum of bills of exchange drawn on the royal treasury, have mounted as follows:
> – in 1754 to 7 or 800 thousand livres
> – in 1755 to 4,000 thousand livres
> – in 1756 to 7 or 8,000 thousand livres
> – in 1757 to 13 or 14,000 thousand livres
> – in 1758 to 20 or 25,000 thousand livres
>
> Perhaps in this year of 1759 they will go up to 50 millions and more from whence it is easy to forsee what will be the price of commodities before January 1760. One estimates that in France there are 18 million people and 1,400 millions of circulating money which makes a sum of 75 livres per capita. In Canada one can only estimate about 80 thousand people and the circulation in the month of August was more than 30 millions which makes almost 400 livres per capita. Thus, the stock of commodities in Canada being in proportion with those of France, their price ought to be 6 times over and above that of France, since the representative signs (money) exceed by 6 times the things to be represented (goods). Now these notes being held in profusion by those who have a share in the business (government) they do not perceive the expensiveness of it all." [66]

There are several amazing things about this paragraph. The first is that the writer showed such insight into the economic problems of the country at that juncture. The second is the remarkable extent to which current circumstances are a repetition of the follies of that earlier time. It appears that we learn very little from experience.

2. The early Americans

The early New England colonists were convinced that government ought to extend its powers into the regulation of all aspects of society, from the religious to the political to the economic. "This was a defect of the age," the economic historian William Weeden tells us (though hardly a defect unique to seventeenth century Massachusetts) "but the Puritan legislator fondly believed that, once freed from the

malignant influence of the ungodly, that once based upon the Bible, he could legislate prosperity and well-being for everyone, rich or poor." [67]

In 1630 the General Court made a fruitless attempt to fix wage rates. Carpenters, joiners, bricklayers, lawyers and thatchers were to receive no more than two shillings a day. A fine of ten shillings was to be levied against anyone who paid or received more. [68] In addition, "no commodity should be sold at above four pence in the shilling (33 per cent) more than it cost for ready money in England; oil, wine, etc., and cheese, in regard to the hazard of bringing, etc., (excepted)." [69]

Weeden comments dryly that "these regulations lasted about six months and were repealed." [70]

There was an attempt at about the same time to regulate trade with the Indians . . . with the same result. The price of beaverskins (an important article of trade at the time) was set at no more than 6 shillings a skin with a "fair" profit of 30 per cent plus cost of transportation. A shortage of corn, however, drove the price of that commodity up to 10 shillings "the strike", and sales of this dwindling supply to the Indians were prohibited. "Under this pressure, beaver advanced to 10 shillings and 20 shillings per pound; 'no corn, no beaver,' said the native. The court was obliged to remove the fixed rate, and the price ruled at 20 shillings." [71]

The offshoot of the Massachusetts Bay Colony in Connecticut experienced the same artificial efforts to control prices and to divert trade from its natural courses. One nineteenth century historian has briefly summed up these attempts. "The New Haven colony," he wrote, "was made notorious by its minute inquisition into the details of buying and selling, of eating and dressing and of domestic difficulties. Then the people were mostly of one mind about the wisdom of such meddling, the community was small and homogeneous in population and religious sentiments. If such legislative interference could have been beneficent, here was a favourable opportunity. It failed utterly. The people were wise enough to see that it was a failure." [72]

The effects of controls on prices and wages were by no means confined to the English-speaking colonies in North

America. In the territory that is now the State of Illinois, French settlers were faced with similar harassments from a far away government. In a history of that part of French North America, Clarence Alvord notes: "The imposition of minute regulations issued from Versailles had been a burden upon the beaver trade. Fixed prices for beavers of every quality that had to be bought, whatever the quantity, by the farmers at the Canadian ports, had made impossible a free development and had reduced the farmers one after another to the verge of bankruptcy . . . an order was issued on May 26, 1696, recalling all traders and prohibiting them from going thereafter into the wilderness . . . (though) complete enforcement of the decree was impossible." [73]

The sporadic attempts during the seventeenth and early eighteenth centuries to control the economic life of the American colonies increased in frequency with the approach of the War of Independence.

Not worth a Continental

One of the first actions of the Continental Congress in 1775 was to authorize the printing of paper money . . . the famous 'Continentals'. Pelatiah Webster, who was America's first economist, argued very cogently in a pamphlet published in 1776 that the new Continental currency would rapidly decline in value unless the issuance of paper notes was curbed. His advice went unheeded and, with more and more paper in circulation, consumers naturally began to bid up prices for a stock of goods that did not increase as fast as the money supply. By November, 1777, commodity prices had risen 480 per cent above the pre-war average. [74]

The Congress, however, at least when addressing the public, professed not to believe that their paper money was close to valueless but that prices had risen mainly because of unpatriotic speculators who were enemies of the government. "The real causes of advancing prices," one historian notes, "were as completely overlooked by that body as they were by Lysias when prosecuting the corn-factors of Greece. As the Greek orator wholly attributed the dearness of corn to a combination among the factors, so did Congress ascribe the enormous advance in the price of things to

the action of those having commodities for sale." [75]

On November 19, 1776, the General Assembly of Connecticut felt impelled to pass a series of regulations providing for maximum prices for many of the necessaries of life. It also declared that "all other necessary articles not enumerated be in reasonable accustomed proportion to the above mentioned articles." [76] Another similar act was passed in May, 1777. By August 13, 1777, however, the unforeseen results of these acts became clear to the legislators and on that date both acts were repealed." [77]

In February 1778, however, the pro-regulation forces were again in the ascendancy and Connecticut adopted a new tariff of wages and prices. Retail prices were not to exceed wholesale prices by more than 25 per cent plus the cost of transportation. [78] In a few months it became evident once again that these controls would work no better than the former attempts and in June 1778, the Governor of Connecticut wrote to the President of the Continental Congress that these laws too, "had been ineffectual." [79]

The Connecticut experience, of course, was by no means unique. Massachusetts, among other states, went through almost exactly the same on-again, off-again syndrome with its own version of wage and price controls. In January 1777, a law was passed imposing "maximum prices for almost all the ordinary necessaries of life: food, fuel and wearing apparel, as well as for day labor . . . so far as its immediate aim was concerned," an historian concludes, "the measure was a failure." [80] In June 1777, a second law was passed (a Phase II), † on the ground that the prices fixed by the first law were "not adequate to the expense which will hereafter probably be incurred in procuring such articles."[81] A few months later, in September, The General Court of Massachusetts, convinced that the price-fixing measures "have been very far from answering the salutary purposes for which they were intended" completely repealed both laws.[82]

†Editor's Note: "Phase II" refers to the second stage of President Nixon's multi-staged wage and price control program.

Washington at Valley Forge

In Pennsylvania, where the main force of Washington's army was quartered in 1777, the situation was even worse. The legislature of that commonwealth decided to try a period of price control limited to those commodities needed for the use of the army. The theory was that this policy would reduce the expense of supplying the army and lighten the burden of the war upon the population. The result might have been anticipated by those with some knowledge of the trials and tribulations of other states. The prices of uncontrolled goods, mostly imported, rose to record heights. Most farmers kept back their produce, refusing to sell at what they regarded as an unfair price. Some who had large families to take care of even secretly sold their food to the British who paid in gold.

After the disastrous winter at Valley Forge when Washington's army nearly starved to death (thanks largely to these well-intentioned but misdirected laws) the ill-fated experiment in price controls was finally ended. The Continental Congress on June 4, 1778, adopted the following resolution:

> "Whereas . . . it hath been found by experience that limitations upon the prices of commodities are not only ineffectual for the purposes proposed, but likewise productive of very evil consequences to the great detriment of the public service and grievous oppression of individuals . . . resolved, that it be recommended to the several states to repeal or suspend all laws or resolutions within the said states respectively limiting, regulating or restraining the Price of any Article, Manufacture or Commodity."[83]

One historian of the period tells us that after this date commissary agents were instructed "to give the current price . . . let it be what it may, rather than that the army should suffer, which you have to supply and the intended expedition be retarded for want of it." By the Fall of 1778 the army was fairly well-provided for as a direct result of this change in policy. The same historian goes on to say that "the flexibility in offering prices and successful purchasing in the country in 1778 procured needed winter supplies wanting in the previous year."[84]

The American economist, Pelatiah Webster, writing

toward the end of the War of Independence in January, 1780, evaluated in a few succinct words the sporadic record of price and wage controls in the new United States. "As experiment is the surest proof of the natural effects of all speculations of this kind," he wrote " . . . it is strange, it is marvellous to me, that any person of common discernment, who has been acquainted with all the above mentioned trials and effects, should entertain any idea of the expediency of trying any such methods again . . . Trade, if let alone, will ever make its own way best, and like an irresistible river, will ever run safest, do least mischief and do most good, suffered to run without obstruction in its own natural channel." [85]

3. The French revolution

During the twenty months between May 1793 and December 1794, the Revolutionary Government of the new French Republic tried almost every experiment in wage and price controls which has been attempted before or since.

At the beginning of 1793, France found itself besieged by all the powers of Europe and blockaded by the British fleet. On the home front, her currency was rapidly falling in value and inflation was rampant. On the other hand, France was the richest agricultural country in Europe and the harvest of 1793 was to be particularly abundant. [86]

Her food problem in that year was not one of production but rather of distribution. [87] A constant series of decrees and regulations, each one designed to remedy the defects of the last, had the effect of leading the bread basket of Europe to the brink of starvation.

The Law of the Maximum

The first of these laws aimed at keeping prices down was passed by the Committee of Public Safety on May 3, 1793, together with a progressive tax on the rich and forced loans. [88] This first Law of the Maximum, as it was called, provided that the price of grain and flour in each district of France should be the average of local market prices which were in effect from January to May 1793. In addition, farm-

ers were required to accept in payment the paper *assignats* at their face value, just as if they were coin.

Naturally many farmers kept their produce away from the markets since they were not allowed to ask a fair price for their goods in a time of rising inflation. Popular uprisings took place in several departments and by August of that year the May Law was generally regarded as a dead letter.

On September 11, 1973 a new plan, which might be called Phase II, was adopted by the National Convention: a uniform price for a long list of goods was set for the whole country, with allowances made for the cost of transportation. This plan too was soon discarded and the Law of September 29 was proclaimed (Phase III). The new system provided that prices should be fixed at the local rates of 1790 plus one-third.

In a little over a month, this plan too was clearly shown to be a failure and the Law of November 1 (Phase IV) was enacted. This latest attempt at regulating prices was more complicated than the previous phases. Prices were to be based upon those of 1790 at the place of production plus one-third plus a rate per league for transportation plus 5 per cent for the wholesaler and 10 per cent for the retailer. Local governments were given the right to compel farmers to bring their grain to markets and to sell it at the fixed price. By the use of the army and police, enough farmers were physically transported (with their grain) to market places to enable the French people to survive the last months of 1793 and the first months of 1794.[89]

The revised system of price control was, of course, no more successful than previous attempts. One scholar has succinctly explained why:

> "This scheme, judged from the point of view of modern experience, had two bad features. The first was the failure to guarantee the farmer a reasonable profit, and so encourage him to put more acres under cultivation and raise larger crops. Should his labors slacken and his crops become small, no amount of energy in insisting upon a fair distribution of the product would keep the people from going hungry. The scheme not only failed to encourage the farmer, it threatened him with ruin. His expenses for tools, draft animals and wages were steadily rising, but

> his profits were cut down, with the prospect of further losses every succeeding month."
> "The second blunder was the obverse of this; it was the assumption that force could be used successfully with the largest body of producing workmen the country had. The agents utilized to apply the force, when the last links in the chain of authority were reached, would be the farmers themselves, for the communal officers were either farmers or men dependent upon them." [90]

A large black market grew up all over France in response to the government's repeated attempts to control the prices of foodstuffs. Butter, eggs and meat in particular, were sold in small quantities door-to-door, mainly to the rich. [91] It was impossible to control this contraband trade and the net effect was to insure that the wealthy had more than enough food while the poor were left to go hungry. In other words, the actual results of the Law of the Maximum were precisely the opposite of what was intended.

An Englishwoman living in Amiens wrote that "detachments of dragoons are obliged to scour the country to preserve us from famine." By the summer of 1794, demands were coming from all over the country for the immediate repeal of the Law. In some towns in the South the people were so badly fed that they were collapsing in the streets from lack of nourishment. The department of the Nord complained bitterly that their shortages all began just after the passage of the by now hated Law of the Maximum. "Before that time," they wrote to the Convention in Paris, "our markets were supplied, but as soon as we fixed the price of wheat and rye we saw no more of those grains. The other kinds not subject to the maximum were the only ones brought in. The deputies of the Convention ordered us to fix a maximum for all grains. We obeyed and henceforth grain of every sort disappeared from the markets. What is the inference? This, that the establishment of a maximum brings famine in the midst of abundance. What is the remedy? Abolish the maximum."[92]

The attempts of the French Republic to control the prices of food were clearly doomed; many areas of France did not wait for the national government to act but repealed

the hated law by popular vote. Finally, in December 1794, the extremists in the Convention were defeated and the price control law was officially repealed. When Robespierre and his colleagues were being carried through the streets of Paris on their way to their executions, the mob jeered their last insult: "There goes the dirty Maximum."[93]

VI THE TWO WORLD WARS – AND AFTER . . . .

1. The First World War

With the outbreak of the First World War in 1914 the most wide-spread and extensive system of economic controls in history began to go into effect. Before the war was over all the major industrialized nations had enacted regulations governing production, distribution, profits, prices and in many cases, wages.

The U.K.

In Great Britain, the sudden and dramatic upsurge of government demands for supplies combined with almost immediate shortages caused by the German submarine fleet, drove prices far above pre-war levels. There were insistent demands, of course, for the government to 'do something.'

The new government regulations, however, led to a whole series of difficulties and produced many new problems. *The Spectator* pointed out that the dangers of government controls were double in character; they were both political and economic. Politically, too much power is concentrated in the hands of the government and the people become accustomed to relying upon government to accomplish goals which can best be done by the workings of individual initiative and the free market.[94] As prices are artificially kept down in times of increasing demand and diminishing supply, the only results are inconveniences and disappointments. People go to the shops expecting to find food available at the legal prices and go away disappointed.[95] Many people are also made to believe that high prices are caused by unseen manipulations which could be corrected by government manipulations.[96] They then ask for still stricter controls and yet more state interference.

Economically speaking, *The Spectator* and other journals pointed out, in times of increasing demands and decreas-

ing supplies, high prices are necessary. They act as a rationing system, checking consumption and channelling goods into areas where they can be most productively used. Besides reducing waste, high prices act as a stimulant to production and importation. A free price system, in short, works to end a period of shortages and tends to solve economic problems. Government controls or rationing only act to prolong the shortages. [97] *The Fortnightly* warned that by restricting prices the government is "encouraging consumption, discouraging production and preparing disaster." [98] *The Nation* noted that without such conscription, a necessary corollary of government-fixed maximum prices set below the market rates, "a period of acute shortage, even of starvation, for the poor can be easily brought about." [100]

As *The Edinburgh Review* underscored, government regulation of the economy cannot be done without tying up the entire trade of a nation in official rules and red tape. Numerous boards and commissions must be appointed, countless clerks and supervisors employed, innumerable orders, rules and regulations must be issued. Perhaps worst of all it also "involves endless frauds, including the wholesale forgery of food tickets, together with a general lowering of the moral standards of the community."[101] *The Fortnightly Review* remarked dryly that a process which began with the promulgating of a few orders holding down prices ended by reaching a stage "when practically everything is controlled, and the greater the control the more complete the confusion and the greater the economic loss." [102]

After the war, one of the most respected journals in the world, *The Economist* of London, summed up succinctly the legacy of controls in Great Britain. "Why not let it alone? (It was) repeatedly said, in response to the shortsighted demand for control of prices, that price was less important than supply, and that if the State prevented prices from rising by artificial interference, it might cut off the supplies that high prices would attract . . . The State (nonetheless) interfered in every possible direction . . . The country now can view the results. On every side failure is visible and palpable. No single branch of trade which the government has touched shows a success." [103]

No controls in the U.S.?

The experience of the United States of America with economic regulation during the war was not very much different from that of Great Britain or indeed of other industrialized nations. The economic historian, Simon Litman, noted that "government price fixing during the war was guided little by economic principles. It was not uniform either in its objects or in its methods feeling its way from case to case. It might be termed opportunist." [104]

Oddly enough, no statute authorizing over-all fixing of prices was enacted by the United States Government during the war. The War Industries Board derived such power as it had to set prices from the power granted to the President to place compulsory purchase orders with any manufacturer and the related power to set priorities. In 1917 the Food and Fuel Administration was given very wide powers over the prices of food and fuel products and later the War Industries Board set up a Price Fixing Committee to establish prices for goods other than food and fuels. Generally, it fixed prices at rather high levels permitting the low-cost producers in an industry to make huge profits. [105]

In theory, the Price Fixing Committee set prices by agreement with the industry concerned. Bernard Baruch, in his 1921 report to the President on the experience of government war-time economic controls, noted that "the bases in law for different regulations were varied, and in some cases doubtful." Mr. Baruch himself later pointed out that in fact most of the so-called 'voluntary agreements' were in fact imposed on industries under the threat of commandering.[106]

Dr. Simon Litman summed up his study of the effects of price control in the United States in 1917-18 by concluding that "the fixing of a 'reasonable' price, when the supply of a commodity is not sufficient to meet the usual demand, cannot prevent hardships and dissatisfaction. Price-fixing alone does not solve the problem of keeping the poor provided with commodities; in fact, 'reasonable' prices may aggravate the situation by giving people of means an incentive and an opportunity to acquire ahead of their actual needs, thus leaving the less fortunate ones without any supply." [107]

Not a liberal policy

It would be fair to conclude that most American economists regarded the experiment with price controls in the First World War as having, at best, mixed results. Almost all students of the subject opposed their continuance in peacetime. *The American Economic Review*, in a special supplement published in March 1919, included an analysis of the possibilities of price-fixing in time of peace. "A general policy of price-fixing, however democratic the government that adopts it, is an illiberal rather than a liberal policy . . ." the author asserted. "If we adopt a general, undiscriminating policy of price-fixing as a part of a permanent peace program, we shall be going backward rather than forward; we shall be returning to a regime of authority and compulsion rather than going forward toward a regime of voluntary agreement among free citizens." [108]

Czechoslovakia

Price controls were attempted by one of the new democracies to emerge from World War I in the first years of peace with results similar to those predicted by British, American and other economists. A study of the Carnegie Endowment For International Peace on the economic and social history of the World War reported that "not only did the attempt of the Government (of Czechoslovakia) to reduce prices by official order fail – it was bound to fail according to the laws of political economy – but it had the effect of constantly driving prices and costs of production upwards." [109] In December of 1920, "the control of meat and fats was discontinued altogether and that of corn and flour restricted." [110] The author of this study concluded: "All this the people felt to be servitude rather than beneficent rule, so that even the most strenuous champions of economic control were compelled at length to capitulate." [111]

Russia

Although price controls seemed to have been something less than efficacious in democracies it might be expected that they would work better in a dictatorship. The case of Russia at this period provides an almost perfect laboratory. Prior to 1917, that vast country was ruled by a semifeudal despot and after November of that year it fell into the hands of the Bolsheviks. Under the Imperial Government, the bureaucracy issued contradictory and confusing regulations which only succeeded in bringing the economy to the brink of chaos. The enforcement of a consistent policy on prices was not possible mainly because the government itself violated its own rules. "The authorized agents of the Ministry of War" we are told, "bought up supplies for the army at prices much higher than those officially fixed. [112]

When the Bolsheviks seized power from the Social Democrats in November, they "abolished all freedom of trade and inaugurated a severe policy of fixed prices on all necessary articles of consumption. The peasants retaliated by refusing to sell their produce, whereupon the Soviet Government began its systematic campaign against the villages, which continued for about two years and ended with the complete defeat of the Bolsheviks." [113] An observer who visited Moscow in 1919 reported that "controlled prices do not, in fact, exist. They are merely issued as decrees to which no one pays the slightest attention." [114]

It might be thought that price-fixing in the two kinds of dictatorship in Russia was still not given a fair trial because both the Czar and the Communists presided over an essentially weak government ravaged by long years of war and hampered by the inherent problems of a backward nation. For a genuine test of what can be done by a firm dictatorship in a modern, industrialized nation one should examine events in Germany.

Germany

"The most comprehensive experiment in Europe in direct price-fixing," according to one scholar, "was that carried out by the German government subsequent to the outbreak of

war in August, 1914." After discussing all of the many regulations designed to lower prices, he concludes that the Imperial Government was simply not effective in preventing a large increase in the cost of food. [115]

An English economist, writing in 1916, concluded that "the lesson from the German experiment in the State control of food prices is not that maximum prices must inevitably fail in all circumstances. All that can be definitely asserted is that in this outstanding instance, Germany, the organized State *par excellence*, showed itself unable to make maximum prices work to any sort of national advantage." [116]

Summary

The record of government attempts to control the economies of the industralized participants in the First World War, democracies and dictatorships, Allies and Central Powers, seems inescapable. A prominent Canadian economist having no control system at home to observe, examined the systems of price-fixing in Great Britain, France, Germany, the United States and Australia during this period. He came to the conclusion that, "the policy of fixing maximum prices . . . fails to accomplish the objects sought and it has a multitude of unforseen consequences which are frequently worse than the original evils." [117]

2. The Second World War

A naive observer might have expected that at least one nation would have learned from the experience of 5,000 years when the Second World War broke out in 1939. None did, however, and all the major nations proceeded to set up machinery for government controls over a wide range of economic activities.

Due to the inherent nature of their social and political systems, some nations began the process earlier than others. Fascist Italy, for instance, moved toward government control over the economy as soon as Benito Mussolini was installed as Prime Minister and "Duce" in 1922.

Italy

On April 3, 1926, the Rocco Law of Corporations was promulgated under which 22 "Corporazione" were established, presided over by Mussolini. The Labor Charter of April 21, 1927, included a section (Article IX) which specifically allowed the government to intervene in all economic affairs. "State intervention in economic production," it declared, "takes place only when private initiative is lacking or insufficient, or when the state's political interests are at stake. Such intervention may take the form of controls, encouragement or direct management." [118]

The provisions of this law were soon put into effect in an attempt to stem the tide of the world-wide depression. Despite rigid price-fixing backed by a totalitarian regime, Italian prices and wages steadily declined and many businesses collapsed as the unemployment rolls swelled. Although the economy still floundered, government controls did have at least one major result; they gave Mussolini almost absolute control over the labor movement and slightly less control over industry and businesses.

Germany

In Nazi Germany, events took a similar course, except that economic controls were administered with far more ruthlessness. In May, 1933, shortly after the Nazis came to power, trade unions were suppressed and merged into a German labor front. The Law Regulating National Labor was enacted on January 20, 1934. Wages were determined by labor trustees, appointed by the Nazi-controlled Labor Front. Hitler was quite clear about his plans to keep wages low. "It has been the iron principle of National Socialist leadership," he announced, ". . . not to permit any rise in the hourly wage rates but to raise income solely by increase in performance." [119] In September, 1938, the four-year plan was launched under the direction of Hermann Goering. The purpose was to make Germany economically independent and ready for war. "Imports were reduced to a bare minimum and severe price and wage controls were introduced." [120]

An authoritative critique of the Third Reich's economic policy was given by Reichsmarschall Hermann Goering, (who was responsible, among other things, for economic planning) while a prisoner of war in 1946. He told the war correspondent Henry J. Taylor that "Your America is doing many things in the economic field which we found out caused us so much trouble. You are trying to control people's wages and prices – people's work. If you do that you must control people's lives. And no country can do that part way. I tried it and failed. Nor can any country do it all the way either. I tried that too and it failed. You are no better planners than we. I should think your economists would read what happened here . . . "

"Will it be," he asked, "as it always has been, that countries will not learn from the mistakes of others and will continue to make the mistakes of others all over again and again?" [121]

Canada

The Canadian war-time control system was the most comprehensive attempt at price freezing that any country, up to that time, had ever been subjected to:

> "It was a novel experiment, never before attempted in any democratic country; even the German 'price stop' of 1936 had been much less far-reaching . . ." [122]

The *Maximum Prices Regulations* of December 1, 1941 provided that no good or service could be sold at a price above that charged during the historical period September 15 to October 11, 1941. The price regulations were part of an overall economic mobilization program that included wage and salary controls, income and excess profits taxation, savings campaigns and a massive conservation program encouraging people to "eat it up", "wear it out", "make it do". Setting of production priorities, production directives, raw material allocation, distribution controls and selective service regulations were also part of the overall mobilization effort. In recognition of the fact that the price of imported goods could not be controlled, the government established a system of subsidies to enable it to freeze domestic price of

imported goods. (A similar stance was taken during 1974-1975 by the Government of Canada with respect to the price of oil.)

The system of economy-wide controls that the government installed for the purpose of prosecuting the war effort was consciously designed to remove any semblance of market forces from the process of resource allocation. Canada actively encouraged inter-allied economic planning and the communal use of the raw materials available. In short, there was a total commitment to the war and virtually total sacrifice of personal economic freedoms.

> "The government, with the overwhelming support of the people, was committed to an all-out war effort . . .
>
> Reliance on a free price system would have required the government to keep continuously outbidding its citizens. The consequent rapid and accelerating rise in prices would have entailed acute hardship." [123]

There is an element of self-contradiction in these two remarks. Surely, the very best test of the first of these statements would have been the government's reliance on people's free choice in the market place rather than on coercion as a means of carrying on the war. The second statement contradicts the first and clearly indicates that, by and large, the population would not have supported the war effort to the extent that it did, without the coercive measures adopted by government. Nevertheless, there was certainly wide-ranging support for the program and people were, it seems, willing to give up their economic freedoms in the short-run for the sake of freedom in the long-run.

As we have seen, mankind has a terrible tendency to forget and hence repeat historical experiences. Human beings also have a tendence to 'color' past experiences – the 'good old days' phenomenon being a good example of this sort of behaviour. In looking back on the war years there seems to be an assumption that wage and price controls 'worked' – that they accomplished something that would not have occurred in their absence. It is certainly true that production controls 'worked' in the sense that large volumes of resources were devoted to the production of war *materiel*. It is not clear, however, that this redirect-

ion of resources was accomplished without the inflation that would have occurred had there been no controls.

An interesting test of the idea that controls reduced the inflation associated with the Second World War is provided by a comparison of that inflation with the inflation during the period of the First World War. The impression given by the cost of living indices reproduced in Table 1 and Chart 1 is that, overall, the control program adopted during the Second World War had the effect of preventing the surge in prices that was associated with the First World War. Notably, the controls did not keep prices from ultimately rising by about the same amount. There is reason to believe, however, that there was much more inflation during the Second World War than is suggested by the price index.

> "No matter how rigidly prices were held in check, costs tended to creep up . . . The major attack on this problem was along the lines of simplification and standardization in both production and distribution . . . reducing the number of varieties or models, cutting out frills, minimizing the use of scarce materials . . . every class of industry was affected." [124]

In other words there was a conscious effort to reduce the quality of every commodity that Canadians bought, to prevent the quoted prices from 'creeping up', Since it is clear that quality degradation was used to cut costs, what are we to make of the 'reported' price index?

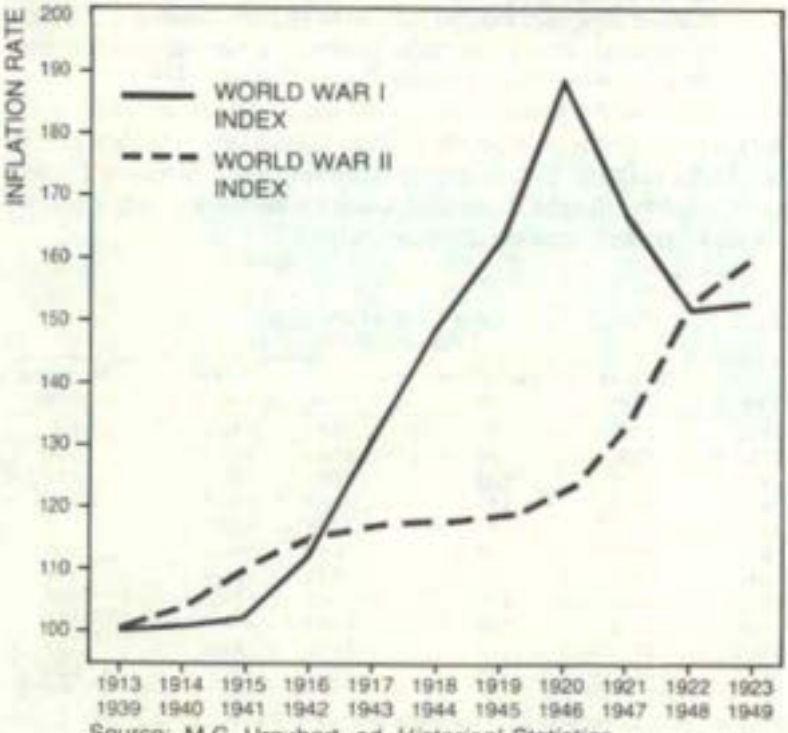
Table 1 — Cost of Living
1935-1939=100

Year	Cost of Living	World War I Index	Year	Cost of Living	World War II Index
1913	79.5	100	1939	101.5	100
1914	80.0	101	1940	105.6	104
1915	81.4	102	1941	111.7	110
1916	88.1	111	1942	117.2	115
1917	104.3	131	1943	119.2	117
1918	118.1	149	1944	119.8	118
1919	129.8	163	1945	120.4	119
1920	150.4	189	1946	124.5	123
1921	132.3	166	1947	136.3	134
1922	121.1	152	1948	155.7	153
1923	121.5	153	1949	161.6	159

Source: M.C. Urquhart ed., *Historical Statistics of Canada*, 1965, p. 304 Series J139-140.

> "It would be impossible to give any quantitative expression to the savings in man-power, materials or money which these orders achieved, but they were very considerable and undoubtedly were of major importance in enabling the Board . . . to 'hold the line' effectively." 125

Accordingly, all that we can say for sure is that the official statistics for the rate of inflation during the Second World War represent a 'considerable' underestimate of the true inflation situation. Accordingly, the straight-forward comparison of the official statistics is not a totally meaningful exercise. In spite of this, the statistics indicate that after the 'smoke had cleared', prices had risen by about the same amount over both war periods. We must therefore, seriously question whether the controls did indeed have much effect. In any event, it cannot simply be accepted that, even under those stringent war-time conditions, controls were successful." 126



Source: M.C. Urquhart, ed., *Historical Statistics of Canada*, 1965, p. 304. Series J139-146.

U.S.

When the United States entered World War II, the Roosevelt Administration delayed imposing price and wage controls for almost two years. This reluctance may well have been stimulated by the example of Germany and Italy; restrictions on personal freedom were not altogether welcome in the midst of an all-out war in defense of freedom. From January 1941, until October 1942, the government attempted to restrain the inevitable rise in both prices and wages by 'voluntary' controls and moral persuasion. During that period, wholesale prices rose almost 24 per cent and consumer prices over 18 per cent. With the establishment of the Office of Price Administration and the imposition of strict controls, however, consumer prices rose 8.7 per cent from October 1942 to August 1945. Price and wage controls were relatively effective during the Second World War largely because of the strong patriotic feeling which supported any government action that seemed to bring the end of the war nearer. Even so, hourly wage rates in manufacturing rose 14.7 per cent in that same 35 month period. [127] The rise in prices was not as steep because some manufacturers lowered the quality of goods while not raising the official selling price and many persons engaged in the black market, paying very high prices to get what they wanted when they wanted it.

After the war was over, however, the pent-up inflation burst and the controls broke down completely. From August 1945 to November 1946 wholesale prices rose over 32 per cent and consumer prices almost 18 per cent. [128] It is entirely possible, therefore, that the end result would have been almost the same by the year 1946 if controls had never been introduced in the first place.

Much the same series of events occurred when the United States next imposed price and wage controls during the Korean War. In June 1950, when the war began, the Consumer Price Index stood at 177.8. Half a year later, when controls went into effect the Index was at the level of 184.7. In September of 1952 when that freeze ended, the Consumer Price Index had reached 191.1. It would seem clear from the experience of Korean War controls

that price and wage restraints, in the long run, have little effect in controlling inflation. The effects, of course, are largely negative. Thousands of bureaucrats spend hundreds of thousands of man-hours doing essentially non-productive work. In addition, the economy is distorted in numerous ways as workers, businessmen, and consumers devote their energies to getting around controls.

And the U.K. too. . .

Finally, to end this brief survey of 5,000 years of experience with wage and price controls, mention must be made of the U.K.'s controls during the Second World War. On September 3, 1939, when Prime Minister Neville Chamberlain broadcast the news that Britain was at war with Germany he commented: "It is evil things we shall be fighting against, brute force, bad faith, injustice, oppression and persecution." [129]

Inevitably, the mobilization and organization of the British people to enable Winston Churchill's war-time Coalition Government to pursue the war aim to the bitter end involved the central government taking upon itself almost limitless powers. According to the authors of the Civil History of Britain during the Second World War: "The year 1941 was certainly a watershed in the conduct of the war, producing firm policies of taxation, of free and forced saving, of price control, of rationing and control of civilian supplies, together with exhaustive discussions of wages policy." [130]

As the war neared its conclusion, so the debate continued on the best way for the smooth and orderly demobilization of the war-time economy, and the future of controls over labour, raw materials, finished products, prices and consumption. Following the election of Clement Attlee's Labour Government, his Chancellor of the Exchequer, Sir Stafford Cripps, instituted a policy of wage and dividend restraint, which, as Professor Parkin notes in the fifth chapter "was based on persuasion and voluntary compliance." "It must be borne in mind, however," Parkin comments, "that throughout this period an elaborate system of points rationing, licencing and other war-time controls remained

in force. These controls, in effect, temporarily replaced the resource allocating function normally performed by changes in prices and wages."

In 1952, the then Chairman of Lloyds Bank in England put the results of controls over the British economy in clear perspective. "There cannot really be any dispute," he wrote, "about the superior *efficiency* of a properly working price system . . . Rationing and controls are merely methods of *organizing* scarcity; the price system automatically works toward *overcoming scarcity*. If a commodity is in short supply, a rise in its price does not merely reduce demand but will also stimulate an increase in its supply. In this, the price system stands in direct contrast with rationing and controls, which tend to make it less profitable or less attractive in other ways, to engage in essential production than to produce the inessentials which are left uncontrolled." [131]

As Professor Parkin concludes in his study, the existence of controls has certainly contributed to "Britain's last twenty-five years of slide into economic and social chaos." One should add, this has happened largely, if not entirely, because of the continuation of the policies of planning, control and growing government intervention in the economy; policies which were widely endorsed and probably inevitable in the crucible of war-time conditions, but which have become obviously more and more disastrously redundant in peace-time society in Britain. Hence, the utter irony of the saying, "Great Britain won the war but lost the peace."

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CHAPTER 2.

A Second Look at Three Episodes

(i) & (ii) Samuel Brittan and Peter Lilley
(iii) Horst Mendershausen

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Horst Mendershausen served with the U.S. Military Government of Germany in the capacity of Assistant Chief of Price Control.

A Second Look at Three Episodes.

(i) 1351 — and the first English incomes policy*

Samuel Brittan and Peter Lilley

To the modern student, by far the most interesting attempt at control was the wage regulation imposed in England after the Black Death of 1348-9 had wiped out between a third and a half of the population. The result was an upsurge in wages, both money and real. The 1351 Statute of Labourers of Edward III was not the first attempt to impose maximum wages, but it was the most notable. The older view was that the motivation came from feudal lords trying to put the clock back and reimpose labour services – endeavours which eventually provoked the Peasants' Revolt of 1381, so celebrated by trendy schoolteachers and radical television playwrights. The more up-to-date view is that the pressures came from smaller farmers.

Throughout the middle ages there was plenty of uncultivated land available for anyone with the energy to bring it into cultivation. Consequently all those who wished to farm on their own behalf did so and there was a chronic scarcity of landless labourers available at harvest and other busy seasons. There are a number of recorded statements of the resentment felt by small farmers at the substantial

*from: Samuel Brittan and Peter Lilley, *The Delusion of Incomes Policy*, Maurice Temple Smith, London 1977, pp. 78-82.

wages they were obliged to pay landless labourers. Their indignation sounds astonishingly similar to that of a twentieth-century bourgeois declaiming at the cost of getting a plumber.

Maximum wages were fixed, first at pre-1349 rates and then according to the current price of wheat. Wage rates were also laid down for industrial craftsmen. The mobility of labourers was restricted. From 1388 anyone who had served in husbandry up to the age of twelve, had to continue to do so. In 1376 the export of Cotswold yarns was forbidden partly to prevent the spinning industry from drawing labour from the fields. A little later labourers and smallholders were forbidden to apprentice their sons to a craft. The guild statutes in many parts of Europe forbade one member to poach labour from another with offers of higher wages.

Wherever the pressure came from, it proved markedly ineffective. Some landlords did probably try to compel their villeins, not to resume labour services, but to take up vacant holdings. But in Professor Postan's words, 'Flight, competition among landlords anxious to attract settlers and the downright refusal of villeins to obey, defeated both the compulsory regulation of wages and the compulsory resettlement of vacant lands. In the end economic forces asserted themselves and the lords and employers found that the most effective way of retaining labour was to pay higher wages just as the most effective way of retaining tenants was to lower rents and release servile obligations.'

The data of the period are naturally sparse; but to whatever source one goes, the story remains the same. Chart 1 shows money wages in certain ecclesiastical manors of Winchester and Westminster. It demonstrates very clearly the pronounced rise in money wages after the Black Death, but no effect at all from the wage regulation statutes. A similar picture emerges from the Phelps Brown-Hopkins charts of the wages of building craftsmen and labourers reproduced in Chart 2.

The result is the more remarkable because of the evidence that prices of 'consumables' were, after a temporary rise after the Black Death, on a gradually falling trend for

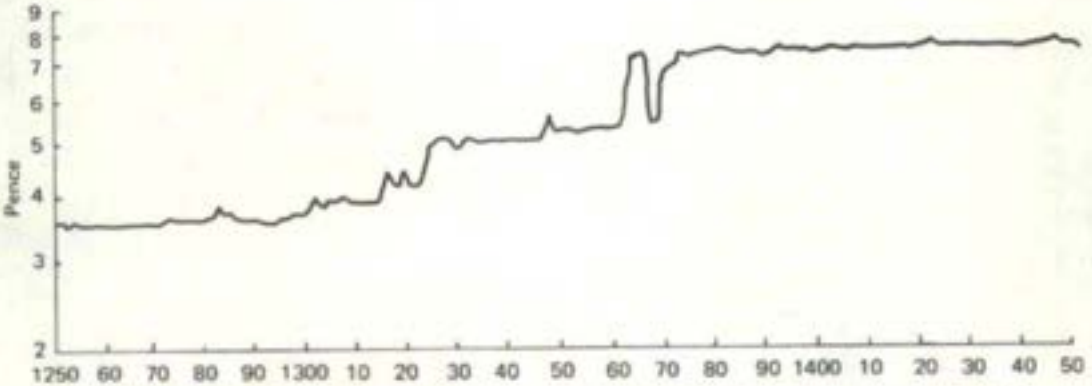

CHART 1: MEAN COST OF THRESHING AND WINNOWING one raised qr each on some manors of the Bishops of Winchester and the Abbots of Westminster (7 years moving averages). Price data of the British Committee on Price History

Source: M.M. Postan, *The Medieval Economy and Society*, Weidenfeld, 1972

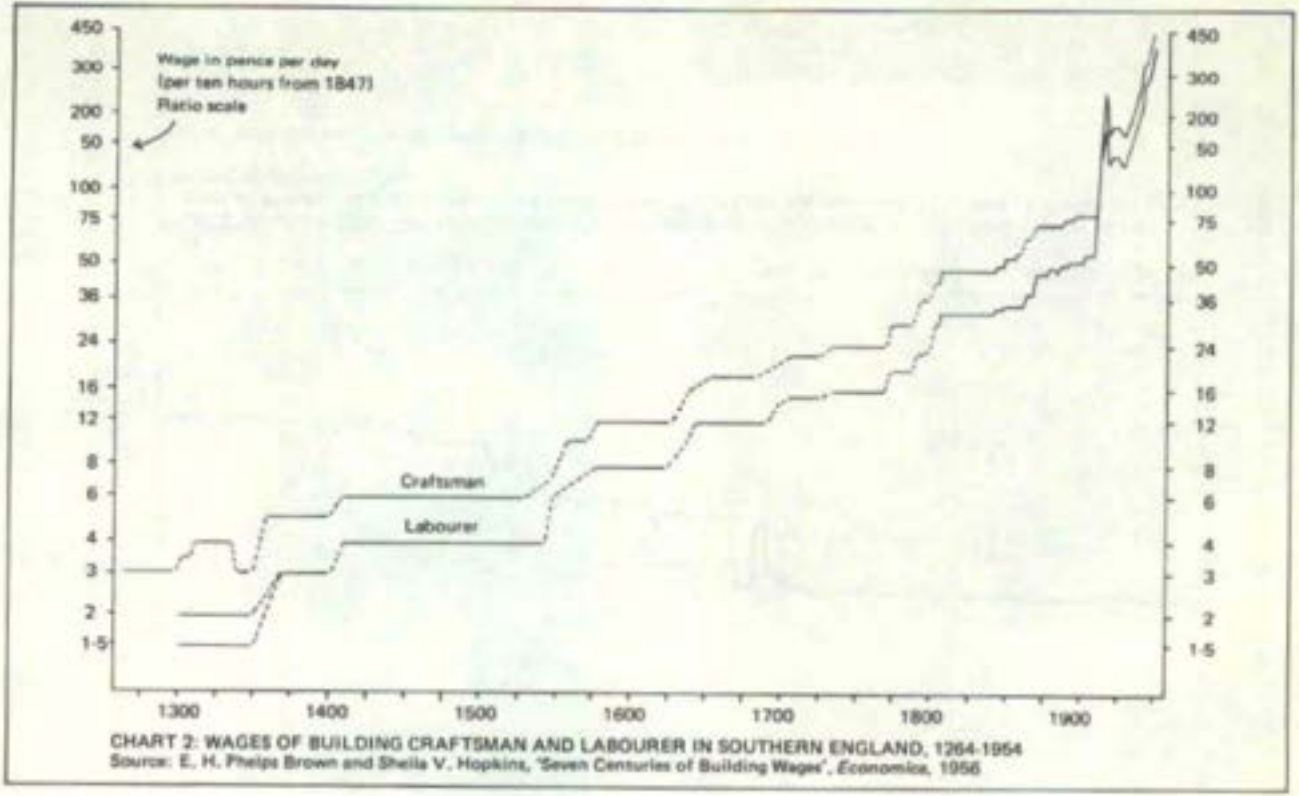

CHART 2: WAGES OF BUILDING CRAFTSMAN AND LABOURER IN SOUTHERN ENGLAND, 1264-1954
Source: E. H. Phelps Brown and Sheila V. Hopkins, 'Seven Centuries of Building Wages', *Economica*, 1956

well over a century. Indeed the Phelps Brown-Hopkins index of real wages (not adjusted for hours of work) suggests that building craftsmen attained a living standard towards the middle and end of the fifteenth century which they were afterwards to lose and not regain until the second half of the nineteenth century. With whatever pinch of salt we want regard these exact figures, the boom in working-class living standards at the end of the Middle Ages, and the subsequent setback, are attested to in nearly all contemporary records and literature.

(ii) The 16th Century: Elizabethan direction of labour*

Samuel Brittan and Peter Lilley

There were many English attempts at wage and price control during the Price Revolution of the sixteenth century. These controls certainly had an impact on daily life; but they do not figure in the historical literature on the course or the extent of the inflation. As far as we know no scholar has suggested that Elizabeth refrained from debasing the coinage because the Statute of Apprentices kept wages in check – though perhaps this remark will stimulate some historically minded wage-push devotee to advance the suggestion!

The fourteenth-century wage regulations had never been abolished, but the task of fixing wage scales had been transferred to the JPs and town councils. The tendency had been to ratify market rates; and with the coming of the Price Revolution official scales were increasingly disregarded.

*from; Samuel Brittan and Peter Lilley, *The Delusion of Incomes Policy*, Maurice Temple Smith, London 1977, pp. 85-88.

The original wage-control statute of Edward III was continually being re-enacted and modified with ineffective results. Richard II, Henry IV, Henry V, Henry VI, Henry VII, Henry VIII and Edward IV all enacted laws of this kind. Sir Charles Oman, in his magisterial book *The Coinage of England*, mentions that Henry VIII had 'been simple enough (or shameless enough) after his earlier mild debasement to issue a Proclamation in 1526 forbidding any person to raise the price of any wares or merchandise under the colour of the money being changed.' The most serious attempt to tighten up was, however, Elizabeth's Statute of Artificers and Apprentices of 1563. The Act has normally been ascribed to Cecil; but a revisionist view attributes it to Bacon (presumably as a little light relief before going on to write Shakespeare's plays). A yearly wage assessment was to be made by JPs of maximum wage rates, graded for different occupations and based on the cost of living. The Statute was for the most part a summary restatement and reinforcement of the original legislation of Edward III. There were similar measures in France, Germany, Italy, Spain and the Netherlands.

The legislators were well aware that wages or prices at below market levels were liable to create shortages; and the 1563 Statute set up a complicated system of direction of labour. Professor Bindoff calls the Statute the 'National Service Act of the sixteenth century'. There was a system of priorities, with agriculture coming first, simple trades such as cloth making next, and merchants and lawyers lowest in order of priorities, as they used to in Sir Harold Wilson's speeches. Entry into most crafts was restricted to those who had served a seven-year apprenticeship, and no employee was to be engaged for less than a minimum period, usually a year. Trades such as clothier, merchant or goldsmith were to be confined to the wealthier families. Everyone seeking employment had to a produce a certificate from his last master. Qualified craftsmen might be compelled to work at their crafts; other men might be compelled to work in agriculture, and women in domestic service.

All artificers and labourers might be compelled to work in the field at harvest time. All unmarried people, and the

unemployed poor, might be compelled to work for a farmer. The Act also attempted to lay down minimum working hours, including a twelve-hour day for labourers in summer. But these provisions, together with compulsory harvest service, soon became a dead letter. Indeed most of the agrarian side of the legislation was superfluous, as the growing pressure of population kept enough labour on the land to rob it of scarcity value. Some of the absurd urban restrictions were also relaxed after a while. In the year 1600, for instance, the courts ruled that a costermonger need not have served an apprenticeship 'because his art was in the selling of apples, which required no skill'.

According to the preamble of the 1563 Act, JPs were supposed to adjust wages to the cost of living ('the plenty and scarcity of the time') after consulting 'grave and discreet persons'. Professor R.H. Tawney demonstrated in an essay forming part of W. E. Minchinton's *Wage Regulation in Pre-Industrial England* that in the late sixteenth and seventeenth centuries wheat prices rose much faster than wages. But after the Civil War 'the scarcity of labour forced wages up' and JPs' assessments followed the market upwards. Tawney was no lover of the market system, but he was a conscientious historian and he stated that, on the meagre available evidence, 'the legal rate fixed under the Statute of Artificers often differed considerably from the market rate and usually fell short of it.' In Buckinghamshire building workers at the end of the sixteenth century were being 'paid more than double than what had been allotted under the 1567 assessment. Although the legal scale was raised in the seventeenth century, it was still exceeded by the actual rates paid.' Eighteenth-century court rulings allowed what we should call today merit awards at the employers' discretion over and above the legal scales. In short, capitalist competition secured an increase in working-class living standards despite the attempt of capitalists to use the law to keep labour cheap.

The precise working of wage regulation is still far from clear. The degree of enforcement, and the divergence between legal and market wages, varied from county to county and time to time; but enforcement was far more active in

the late sixteenth and early seventeenth centuries than in the subsequent hundred years, and by the mid-eighteenth century the system was moribund, although prices were far more stable. A modern survey by Minchinton accepts Tawney's general presumption that market forces were more important than assessments in determining wage rates. But the wage provisions of the 1563 Statute were not finally repealed until 1813.

Despite the continuing rediscovery of county wage assessments, they were clearly not frequent enough and rigorous enough to please the Privy Council which often had to remind JPs of their responsibilities in the early part of the period. In many cases the same wage schedule was automatically reissued over decades or even half centuries. Where assessment was taken seriously, the three main influences were the desire to keep down real wages, cost of living adjustment and the state of the labour market. The last factor became more important as the seventeenth century proceeded. An instance was in Shrewsbury where the JPs increased all wages in 1640 even though prices had been falling.

The evidence then is clear that the periods of greatest legislative activity coincided with the fourteenth-century wage increases and the sixteenth-century wage and price rises. During the long period of price stability in the seventeenth and eighteenth centuries the system of wage setting by JPs withered away. The simplest explanation is that periods of inflation provoke legislative intervention which has little effect one way or the other on general wage or price levels, but which may nevertheless interfere with individual freedom in a throughly uncomfortable manner.

(iii) Germany 1945-48: evasion saves the day*

Horst Mendershausen

In the summer of 1948, the economy of Western Germany underwent a radical change. The change was brought about by a variety of factors. The monetary reform of the 20th of June and the subsequent abandonment of a large part of price and rationing controls reestablished money as an effective devices of allocation. An abnormally good harvest and increased external aid led to a significant rise of food rations and improved supplies of industrial raw materials. But, above all, there came into existence an economy with legal and functioning markets.

The effect of the monetary and economic measures was impressive. If the Rentenmark of 1923 performed a miracle, the Deutsche Mark of 1948 may be said to have wrought a revolution. Beyond the immediate change in the availability of goods, a significant change in economic relations took place. It was as if money and markets had been invented afresh as reliable media of the division of labor.

During the preceding years there had occurred a genuine regression of economic civilization. Foreign trade had practically ceased and come to be replaced largely by the intake of foreign relief and the outgo of foreign levies. Internal trade had become a most ineffectual system of redistribution by government agencies, overlaid with forms of primeval long-distance trade and local barter, both illegal. Far from having been a "market economy" during the 1930's and the war years, the German economy in terms of its legal institutions came close to being an "economy without markets." This regression was as extraordinary to the economic observer

*from Horst Mendershausen, "Price Controls in Postwar Germany, 1945-1948", in Colin D. Campbell, ed, *Wage-Price Controls in World War II, United States and Germany*, American Enterprise Institute, Washington, DC 1971, pp. 55-62.

as it was painful and bewildering to the people involved in it.

The severe effects of Germany's repressed or stagnant inflation on incentives and production had been widely realized. The index of industrial production in the bizonal area did not reach 50 per cent of 1936 before March, 1948—it was at 51 per cent in the month of currency reform, June, 1948—while the published indexes of other countries, except Japan, reached levels of at least 66 per cent of prewar, generally better than 75 per cent, in 1947. But it is far from certain that an earlier imposition of currency reform and an earlier decontrol of prices and commodity flows alone would have caused an earlier and better recovery. In view of the protracted disorganization of government, social life, and foreign supplies, it may be said that economic recovery was hardly within reach before 1948, and that a policy of rigidly suppressed inflation was not more unsatisfactory than any other policy available during that time. Nor would it be proper to limit one's view to the effects of stagnant inflation on production. The listlessness of the economy was accompanied by a dulling of organized social conflict. Market, government, and social conflict had simultaneously and temporarily fallen into disorganization. When decisions were taken to reorganize the economy and the government, the stage was set for progress and for more acute social conflicts.

The economic experience of Germany in the three years since V-E Day contains interesting lessons in the reaction of a modern Western nation to severe economic disorganization. Features of general significance are of course inextricably inter-woven with the peculiar facts of post-Hitler Germany. It would be very difficult to separate these components of the situation.

1. **1945: The Allies maintain Hitler's price and wages control.** Price control and rationing survived the collapse of the Hitler Reich. In November, 1945, the four-power Allied Control Authority resolved to continue the German price laws and regulations and the local and regional agencies for price control, thus reaffirming earlier actions taken by the

various zone commanders. On February 7, 1946, the Coordinating Committee of ACA agreed on a statement of price principles applicable in the four zones of occupied Germany and Berlin. This was to remain the basic price policy document for more than two years.

This statement provided for the rigid maintenance of the price stop: "As a rule, on the majority of commodities, prices are to be maintained, for the time being, at the level before occupation. Price increases over the level prevailing on the 9th of May 1945 shall only be permitted as an exception . . ." The need for such exceptions was to be proven by actual losses, after exhaustion of all methods to eliminate cost increases. The possibilities of price relief were further limited by the stipulation that only "average direct cost of production of the aggregate of products of the firm" should be covered, that not more than "the smallest margin for overhead and profits" should be allowed, and by the consideration that "the cumulative effect of all price increases permitted . . . on the cost of living shall not be so great as to necessitate any adjustment in the present general level of wages. . . ."

With the formation of bipartite Anglo-American economic policy bodies in late 1946, the principle of the price stop was reaffirmed. In a statement on price, wage, and subsidy policy of November 2, 1946, the Bipartite Board declared that "full expression in prices should not be given to the many temporary and abnormal elements in the present cost structure, especially in the basic commodities, and a limited program of temporary subsidies and stringent control generally is recommended for this purpose." The German price authorities, at the bottom of the hierarchy, reflected the combined influence of Allied policy and German popular opinion. Applications for price increases usually faced long delay and much red tape.

The "price stop with exceptions" was maintained in the face of a tremendous imbalance of spendable money and available goods. In 1947, currency in circulation in the four zones of Germany and Berlin was estimated at about 10 times the amount that circulated in the Reich in 1936—when Hitler imposed the price stop—total currency and

deposits at five times the amount of 1936, while the real national income was put at roughly one-half of that of the Reich of 1936 . . .

2. The failures and successes of price control.

Price control during the first three years of occupation was surprisingly effective. There was a great deal of evasion; but the bulk of the goods changed hands at legal or nearly legal prices. Legal prices were charged for rationed foodstuffs– which made up more than three-quarters of the "normal" consumers' intake of food–and for the few manufactured consumers' goods that could be obtained on rations or purchase permits; for allocated raw materials and equipment and, as will be seen below, even for producers' goods obtained outside the allocation system. Legal prices governed the sale of all imported agricultural products as well as the bulk of the deliveries of domestic grain and other products. Legal prices were paid for export goods. In addition, legal wages prevailed throughout the economy. Even the fees of artisans and professions remained relatively stable, although to a lesser degree than wages and although extra services usually had to be rendered in return.

It is of course true that the legal prices and rates did not represent the essence of the bargain in many of these transactions. Much more important than the return in money was the preservation of goodwill or at least tolerance on the part of government authorities, customers or employers, suppliers or workers in a social situation that was full of dangers to liberty and property. Compliance with price control was a form of insurance premium, and there were ways for many businesses and individuals to make the premium relatively inexpensive.

Most of the violations discovered by the price supervision offices were relatively minor. During 1947, the price authorities of the bizonal area confiscated excess proceeds of 32 million marks in the prosecution of 200,000 cases of price violations. Price increase applications were submitted to the price formation offices in a regular fashion. Usually more than half of the applications submitted in the U.S. zone got

some measure of price relief; more than three-quarters, in the British zone.

Thus, in the midst of currency, supply and demand conditions that would certainly have produced price inflation in a market economy, there remained a fairly high degree of price discipline and stability under price control. But the economic incongruity of the situation produced changes in the methods of distribution, a limited black market and a widespread system of reciprocal exchanges of goods and services. These changes took the substance out of the price system and tended to make it a hollow shell.

The black market was one of the balance wheels of postwar Germany's disequilibrium system. Its existence could hardly surprise; but its limitation and its stability did. There is no evidence of its spreading during the three years' period, nor is there evidence of general cumulative price movements. The German black market before currency reform may be empirically defined as the purchases and sales for money (or for such money substitutes as cigarettes or coffee) at prices many times as high as the legal level. It comprised a certain section of economic transactions, probably less than 10 per cent of the total by volume. It had its special agents and links to the remaining bulk of economic exchanges.

It is impossible to measure the quantitative importance of black market transactions with any degree of exactitude; but "informed guesses" of Military Government officials allowed to them not more than 5 per cent of imported grains, industrial materials or Army supplies; not more than 10 per cent of German industrial and agricultural production; up to 20 per cent of the imported goods coming into the hands of Allied personnel as their private property (after private importation of cigarettes had been banned); probably 90 per cent of the turnover of existing luxury goods (jewelry, cameras, china, rugs, furniture).

Black market operations consisted primarily of transactions in finished products. They usually involved traders and final consumers, to a lesser extent original producers. The products came partly out of German production (typically bread, potatoes, fats, meat, soap, textiles), partly from Allied sources (typically gasoline, tobacco goods,

chocolate, certain foods), partly out of personal and household possessions of the German population. They were handled by black market traders, recruited from the ranks of the displaced persons and Germany's unstable and dislocated population.

The contacts between this class and the rest of the population were manifold. People who knew where to buy or sell "black" goods could be found in nearly every house, especially in the larger cities. Every family was involved, at more or less frequent intervals, in the black market sale of some possessions and the purchase of some "black" foods, stimulants, clothing, etc. Characteristically, the excess of expenditures over income in a sample of 81 Bavarian workers' and white collar households (September, 1947), amounting to about one-third of income was almost entirely balanced by money receipts from the sale of personal property.

Likewise, all business enterprises would at one time or another make a black market purchase or sale to obtain critical materials or parts and to cover costs and tax bills that could not be met out of legal income. But the great majority of house-holds and businesses considered their involvement in black market transactions as shameful, and the agents of the black market as immoral and asocial individuals.

The prices of the black market varied from place to place and fluctuated in time. Owing to bad transportation and communications and to its illegality it was of course an imperfect market, in which some transactions and some places, especially Berlin, would show much higher prices than others. Information collected by the price supervision offices and the police indicated that in May, 1947 black market prices in the main cities of the U.S. zone were about 100 times or more the legal prices for sugar, butter, coffee, saccharine, flour, ladies' stockings, soap, flints; about 75 times the legal prices of oleomargarine, eggs, liquor; about 50 times the legal prices of potatoes, beef, Leica cameras; about 25 times the legal prices of coal, suits and dresses, electric bulbs, automobile tires and gasoline; and about 10 times the legal prices of typewriters, and electric wire. The

most important black market foodstuffs sold at prices in the range of 50 to 150 times the legal level. As a rule, industrial goods had a smaller black market agio, with the notable exception of ladies' stockings, soap and flints. The average of black market prices may be estimated at 50 to 75 times the legal prices.

At that price level, even a small turnover of goods would absorb a large volume of purchasing power. Assuming that only 8 per cent of the total volume of transactions were carried out at that level, while the remaining 92 per cent were carried out at legal prices, the volume of money engaged in the black market transactions would be about five times as great as that engaged in transactions at legal prices. Allowance for the use of money substitutes might lower this figure somewhat; but the order of magnitude would probably remain similar.

In this fashion, the black market absorbed a considerable part of the excess supply of money in postwar Germany. The remainder of the excess was neutralized by the considerable decline in the velocity of money circulation, compared with prewar, that resulted from a variety of factors: the decline of financial transactions, the regression to cash payment and official sterilization policies. Moreover, the excess did not increase; it possibly even declined with time. The slow advance of production and of legal prices probably exceeded any net infusion of money that may have come from the Soviet zone. The fiscal policies followed in the bizonal area whittled away some of the excess purchasing power after 1945. These factors explain in large part the stability or slightly downward tendency in the black market price level during the three years' period.

The black market was limited to commodity and property transactions. Black market wages commensurate with black market prices were practically unknown. Employees working in establishments with obvious black market incomes as a rule preferred compensation in extra goods to extra money, and the same rule usually applied to irregular employment and odd jobs.

3. Widespread evasion through barter.

While Germany's postwar inflation remained stagnant in a setting of rigid price control and a stable black market, the distribution of goods and services underwent an important institutional change. Bilateral exchange assumed major proportions. In a large sector of the economy, goods and services could not be obtained for money alone, nor even for money plus ration coupons or allocation certificates. They could only be obtained on the condition of delivery of other goods and services.

To most people, money did not lose value by way of depreciation but it lost significance through an increasing limitation of its usefulness. Food rations could be bought at legal prices, but it was the ration card, not the money, that controlled the access to the scanty and irregular distribution of foodstuffs. The amount of money that could actually be spent on the food rations was not hard to find. Pegged wages and an occasional black market sale would put that amount into everybody's hands, even without the benefit of former savings. This held true *a fortiori* for other consumer goods. The quantities of clothing and metal goods available after allotments to refugees, and in the latter part of the period, to miners and other workers' groups, were so small that the opportunities to obtain them for money and permits were negligible. The black market, finally, was narrow and an unreliable source of supply for the commodities of daily living, entirely insufficient to obtain the ingredients of production. A mark might be worth half a cent or half a dollar in relative purchasing power; but in either case there was not much of a point in relying on that purchasing power and in laboring to get hold of the mark.

For reliable supplies, businesses, farmers and workers increasingly turned to bilateral exchange via "compensation trade," "distributions to works," and regular barter. These practices were illegal under the sweeping prohibitions of Nazi wartime legislation, in particular the War Economy Ordinance which were kept in force under the occupation. But the German and occupation authorities found these breaches

of economic controls almost irrepressible. In September, 1947 U.S. Military Government experts believed that from one-third to one-half of all business transactions in the bizonal area proceeded in the form of "compensation trade." "At least 50 per cent," was the guess of German government officials in the Ruhr area. This was an all-pervading feature of the economy.

Apart from the limited usefulness of money, two factors helped to establish bilateralism on a broad scale. First, the occupation authorities led the way. In the early days of occupation, local military commanders obtained essential goods for their district by loading up some trucks with the district's products and taking them to the outside suppliers for straight barter. Throughout the period, the occupation authorities offered a ration-free noon-day meal at the legal price to all of their German employees, from top-level expert to street cleaner. This arrangement was the major and indispensable material attraction of service in occupation establishments. Likewise, the occupation authorities introduced "incentives in kind" to boost the economic activities judged most important; coal mining and export production. They thereby acknowledged that in order to buy something you have to sell something to the seller.

Second, in the eyes of most people bilateral exchange was far less immoral than black-marketing. It was usually considered an unfortunate necessity. "How can I keep my workers without putting tires on their bicycles? They will take them, anyway," said the rubber manufacturer. "Everybody knows that to get cement you must offer coal," said the city fathers of Stuttgart, and they bought liquor brewed in the surrounding countryside, shipped it to the French zone in exchange for cigarettes, shipped the cigarettes to a Ruhr mine and swapped them for coal, brought the coal back to a cement plant in Wuerttemberg, and thus got the cement for reconstruction work. The monitored correspondence between two businessmen showed the negotiations preceding certain compensation deals. Their illegality was understood. But when one of the parties demanded an unusually large counter-shipment in return for his products, the second party indignantly charged him with "illegal black-marketing."

Money did enter into "compensation" trade, both as an accounting standard and as a means of payment. Typically, the equivalent quantities of goods in these reciprocal transactions were computed with the help of legal or near-legal prices, the common formula being "peace-time value for peace-time value". From the point of view of price control, many of these transactions were inoffensive. But there also were characteristic changes in equivalencies that reflected the incorrectness of the frozen price structure. For instance, the going rate for the widespread bilateral exchange of cement for coal was one ton of coal for one ton of cement. At legal prices, one ton of coal was the equivalent of one-half ton of cement. The balance due the cement producer at legal prices would usually be settled in money. That was for bookkeeping purposes chiefly.

"Compensation trade" was the typical form of bilateral exchange among industrial producers and wholesale traders. A considerable part of their effort was spent on locating partners to a deal and in arranging for the expeditions needed to carry goods from one place to another safely. The system was costly and cumbersome, and most businessmen disliked it intensely. But it provided a market mechanism, even to the point of developing some clandestine "bourses", and it helped avoid a complete breakdown of industrial activity under the weight of scarcities and trade prohibitions. It is noteworthy that in the more elaborately planned and policed Soviet zone, compensation trade was not only rampant but even formalized occasionally. A big chemical plant, appropriated by a Soviet Corporation, was known to have a detailed list showing the exchange equivalences of a hundredweight of fertilizer in terms of coal, flour, potatoes and other goods, for the benefit of its customers.

Bilateralism in the employer-employee relationship took the form of factory meals more substantial than the turned-in ration coupons of the workers warranted, the sale of consumers' goods to the workers at legal prices but without permits, and the granting of facilities and materials to "work shops" in the plant, where the workers could make some articles for their own use on company time or after hours. Naturally favored were the employers producing goods

of general usefulness to consumers. But where the production was not suitable, or could not be made so by the addition of special lines, goods for distribution to workers were obtained from other producers through "compensation trade", or the workers were given factory products that could be taken out to the peasants and bartered for food. In this way, even a steel mill could satisfy its workers by giving them Thomas fertilizer and steel bands for the wheels of peasant carts.

The pre-commercial system of *Deputate* (payment in kind) that had lived on in German coal mining and on large agricultural estates thus spread throughout the entire industrial economy, chiefly in the form of the provision of facilities to buy at legal prices what was otherwise unobtainable. The 20th century institution of the works' councils, representatives elected by all the workers of a plant, was frequently made the vehicle of the *Deputat* system. The works councils allotted the goods to workers according to some standard of need and they frequently also participated in the procurement of food for the works kitchens.

Finally, there was the direct barter between city dwellers and peasants. The city people hiked to the villages with an assortment of hardware, textiles, tobacco and personal possessions and bartered them for food. In this trading, money played almost no role at all. City people also worked as farm helpers for the food and whatever living quarters were available in the crowded villages.

The bilateral exchange economy was the chief means of survival for businesses and individuals in Germany before currency reform. It developed in the domestic economy to cope with the same basic problem that bilateralism seeks to meet on an international plane, *i.e.*, unreliability of a complex division of labor. Its German variety represents the extreme stage of a development that could be observed in milder forms in the war and postwar economies of Great Britain and the United States. Where neither trading for money nor redistribution of goods by political authority, alone or in combination, can ensure a reliable division of labor, bilateral exchange seems to be the safest line of economic retreat . . .

PART B

MODERN WAGE AND PRICE CONTROLS

CHAPTER 3

Price and Income Policies: Can They Work?

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Price and Income Policies: Can They Work?

Malcolm Fisher

1. Incomes inflation – Keynes and the Keynesians.

The difficulty of diagnosis

We all know that medical diagnosis can prove difficult. We also know that even with a correct diagnosis the correctives ascribed, though appropriate, may have unfortunate side effects. We also know that where diagnosis is unreliable the 'correctives', so-called, may prove detrimental directly as well as through side effects.

Incomes and prices policies are presented as correctives for a certain type of inflation, traditionally known as cost-push. It is often unclear that the patient, the economy, suffers from this disease, and hence the prescription policy may be called into question. Whether or not it is clear that that *is* the disease, it is known that incomes and prices policies have important adverse side effects. Hence accurate diagnosis of the disease is all the more important before such a 'corrective' is prescribed. There is even much uncertainty as to the homogeneity of the corrective, the incomes and prices policy itself.

Theoretical explanations of "cost-push"

In economics we know that theories are virtually never displaced, merely pushed aside for a while and then qualified. 'It takes a theory to kill a theory', is a good precept for which there is little sign of support in the social sciences. And theories of inflation prove no exception.

In modern economic thought it would seem that the process, cost-push inflation, derives directly from Keynes' work – not the *General Theory*, but his immediately preceding work, *A Treatise on Money* [1] There we find a section in Volume I where Keynes talks of the possibility of spontaneous changes in earnings. This spontaneity he attributes to "the character of the Wages System (including in this e.g., the powers and activities of trade unions)" [2]. It is also clear that Keynes regards this as Income or Earnings inflation, in contradistinction to Profits inflation. He says that the former might come about under a system of competitive individualism by an act of collective foresight on the part of entrepreneurs in anticipation of impending monetary changes, or by a *coup de main* on the part of trade unions.

"In existing circumstances, however, the most usual and important occasion of change will be the action of the entrepreneurs, under the influence of the actual enjoyment of positive or negative profits, in increasing or diminishing the volume of employment which they offer at the existing rates of remuneration of the factors of production, and so bringing about a raising or lowering of these rates[3]."

This would seem to suggest that in 1930 Keynes accorded primacy to profits over earnings inflation and there does not seem to be anything in the *General Theory* that alters that [4] ranking. Indeed his *How to Pay for the War*[5] seems to be presented with just such a similar priority in mind.

Where spontaneous changes in earnings arise the outcome in employment terms depends crucially upon whether the Currency Authority is supportive, or not supportive, in a closed economy. In the absence of support, unemployment will mount in step with money wage rises even if, in the new equilibrium, product prices were somewhat higher. But unemployment will not emerge if the Currency Author-

ity is fully and simultaneously supportive in a closed economy.

As argued, this appears to be a discussion of a one-shot effect of spontaneity on the part of unions; as inflation, by definition, relates to persistent price rises, clearly we have to refer to repeated acts of worker spontaneity, fully and simultaneously endorsed by the Currency Authority. Thus these acts of spontaneity must be regularly repeated – evidently there is no learning from experience. This of itself suggests that some must have gained from money illusion, else why reactivate the process? Presumably there must be enough "noise" in the economic system to mislead enough people sufficiently as to the payoff from the process.

Alternatively, (as Keynes also allowed for), when we recognise that we live in an open economy, spontaneous rises in earnings transmitted to prices imply transfer of foreign purchases from domestic markets – which must spell unemployment unless the exchange rate moves down in step, and the re-adjustments in domestic demands through lowered imports are speedily executed. Of course the domestic spontaneity can be accommodated in the international economy if other countries' demands move precisely in step.

The modern Keynesian interpretation

As Sir John Hicks puts it, ". . . the causes of 'wage-push', on this view are exogeneous, even non-economic. They are matters of trade union organisation, of politics, or of public opinion. So if we dislike the effects of the wage-push, we must deal with it directly – by negotiation between Government and unions, by political pressure or by legal freezes . . . The Keynesian independence between wage policy and other economic policy is by this school still maintained."[6]

To this we might add that the spontaneities must be repeated spontaneities, and in an international trading world produce rather similar movements *across* countries, if the effects of such domestic spontaneity are not to prove nugatory.

This view of incomes inflation seems to accord with that long maintained by Lord Kahn, Keynes' closest disciple,

who in his writings [7] right up to the present time, has maintained this, virtually to the exclusion of the profits inflation to which Keynes' himself tended to accord primacy. Essentially these same views are held within the Cambridge School.

The thesis analysed

If one accepts the Keynesian thesis that, up to the full employment range, wage rates are exogeneously determined, clearly, within that range, spontaneous changes in earnings can alter the base level of money wage rates, and such spontaneity can be attributed to non-economic influences. But we must enquire as to whether the analytic sufficiency of the basic Keynesian model is assured, for it is on this that such spontaneous rises are super-imposed. Granted that it is, we must secondly enquire as to the empirical significance to be attached to it.

On the analytics there has been much argument especially appertaining to the behaviourist implication of Keynes' thesis that workers bargain for money wage rates, not for real wage rates, for this implies a degree of money illusion. It should be noted that, in this context, it is not enough to point to sustained wage and price rises as a denial of money illusion, for the theorem only requires that movements in prices should be recognised by workers after a lag, and that this lag persists over a series of spontaneous rises in wage rates demanded. But one is entitled to ask why this lag does not eventually disappear – a question that demands more attention than it has so far received.

But more attention must also be paid to the full employment zone. The presence of various types of labour, the mix of other factors, the existence of separated goods markets in the complex of industries, means that wage rates are likely to start to rise over a range within the vicinity of full employment. Moreover, such spontaneity in the actions of labour can easily give rise to these effects at successively lower rates of capital and labour utilisation when repeated through time. Indeed, it is probably only in this way that workers are able to delay the adverse effects of learning from experience from becoming dominant. In any

event, such acts of repeated spontaneity might induce one to ask whether the presumed exogeneity of the effects should not be accorded a more substantial intellectual base.

The monetarist analysis

Yet it must be admitted that those who would ascribe inflation to demand forces could face a similar conceptual difficulty insofar as the explanators of inflation are here also regarded as autonomous. For certain groups of years, not least the late sixties and early seventies, the American financing of the Vietnam War would seem eminently capable of carrying much of the weight of explanation required without the need to strain credulity with resort to a set of ad hoc influences. Moreover it has the merit of aiding explanation of fairly closely aligned movements noted across a wide range of trading countries when each is adhering to a stable exchange rate policy and permitting the inflow of US dollars to expand the monetary base.

2. Modern inflation – the empirical reality

But we are already running over into our second question of empirical relevance. These bursts of spontaneity are especially difficult to account for, when repeated with some regularity, the more so when we try and account for them in an international context. The forces that would engender reasonable parallel movements in wages and prices in a range of major trading countries are not at all obvious. The Trade Union movement is comparatively weak in the USA, at least when judged by European standards. Yet even in Europe, inflationary effects have varied greatly in intensity, as witness France and Italy on the one hand and Federal Germany on the other. Of course we are really making a comment upon the exogeneous wage pressures when generated, *in combination with* the attitude of the currency authorities, and it may be that in some of these countries the authorities have a sufficient degree of political support to stifle such pressures at birth. Or it may be that for some countries sustained gains in real incomes per capita, in the absence of money illusion, have served to ensure that worker tensions and frustrations are kept sufficiently in check.

Are Hicksian remedies relevant?

The uncertain strength and relevance of this 'Incomes inflation' view in a closed economy, let alone in an international context, raise questions as to the relevance of the proposed remedies. For, say we stick to Hicks' selected three, negotiations between Government and Unions, political pressure, and legal freezes. Each of these is capable of being interpreted in more than one way and it is quite clear that Hicks views them as differing one from another. Moreover, it is self-evident that each of them is capable of considerable *economic* influence – yet they are brought forward to cope with a *non*-economic originating cause!

Hence it is abundantly clear that the listed remedies are at best gross correctives for the 'Incomes inflation' disease. Each of them has considerable side-effects. They are in no sense symmetric with the incomes inflation that induced the authorities to consider their use. We must hence be wary that their side-effects are not more detrimental than their direct effects.

The UK experience

The three Hicksian remedies have each been deployed several times over in the United Kingdom in the last fifteen years. Political pressure on the decision-makers in nationalised industries has been used to hold down the prices of public utility products and the wages and salaries of bargaining groups 'with clout' in the public sector, doubtless in the belief that good examples established here would induce more co-operative behaviour in the private sector. It proved easier to hold prices of products than costs and eventually substantial losses produced such an addition to the national budgetary deficit that the scheme had to be abandoned – but only after many, especially the elderly, had been induced to invest in such items as electrical appliances. The inequities they suffered really hurt.

Negotiations between Governments and powerful interest groups such as the Confederation of British Industry and the leaders of the Trade Union Congress have become a regular feature under successive Governments. Sometimes Governments have tried to induce concerted support for

both prices and incomes controls, intensified to explicit instructions where insufficient support was forthcoming. At other times they have leaned on the representatives of one side of Industry hoping that indirectly this would also bring the other to heel. Government pressure has been great when inflation has been great, sometimes resulting in a comprehensive system of controls, beginning with a freeze, and then being modified to formulae for adjustment, to cope with the problem of containment in circumstances where the underlying rates of inflation would not permit adherence to a freeze for long. At other times essentially the same results have been sought in more informal arrangements, such as the recent 'social contract'.

3. Controls: The long run effects

Nearly always the initiative has come from Government and it has had to pay a price to secure cooperation, a price in arm-twisting that has tended to increase with time. In a sense, Governments get caught in their own trap. They introduce such controls in order both to expose, and put brakes on, the behaviour of specific interest groups. Such controls distort market allocation and when the controls fail to fulfil their objectives Governments become afraid to contemplate their relaxation because the deviation between their regulated rates of wage and price levels and the current expected market rates are becoming large. The second round of controls which serves to broaden the disparity has to be bought at a high price from the interest groups because they are becoming more conscious of the costs imposed. These concessions by Government to secure continuance of the controls have taken the form of protective job legislation, the offer of more extensive participation in firm decision-taking, specifically favourable patterns of taxation. These deals entered into rather surreptitiously, and ostensibly without immediate cost, can build up tremendous *longer* run costs in an economy through the impediments they introduce to flexibility and change in the economy over time. These are integral elements in the maintenance of long run employment patterns.

But in the meantime considerable uncertainty attaches to the short-run success of the policies. Unless directional contractionary fiscal and monetary measures are working in harmony, the mere damming up of price elements of the income flows is not likely to do more than distort the patterns of those flows. Even when such directional flows have proceeded in harmony the fact that the income and prices policies were introduced at an arbitrary date and with scant attention to the price and wage structure pertaining across industries and occupations at that date, means that there will be an accumulation of pressures for realignment of wage-price structures as soon as that becomes practicable. This is the so-called *re-entry problem*. This problem will be all the greater if the combination of deflationary measures have not worked, for, short of the introduction of comprehensive controls, there is a limit to the period of tolerance of any interest group with interference in the pattern of its wage and price setting policy in anything less than a completely centralised economy.

Government's responsibility

Unanticipated inflation is politically unpopular: hence Governments are eager to disclaim responsibility by attacking any interest group whose pricing indicators currently give the appearance of being out of line. It is a moot question whether any interest group can engender inflation without at least the tacit support of Government. Often Government has itself directly set inflationary forces in train. Where interest groups appear to have instigated inflation the explanation probably lies in the presumed political inability of the Government and currency authority to withstand the pressures generated. This would seem to be a direct commentary on the ineptness of the democratically elected Government in the country in question. Such ineptness can arise by accident; sometimes it is a failure to learn from experience; at other times, given the electoral cycle, it is probably wilfully contrived.

Price and incomes policies have tended to produce an appeal of their own to Governments, even where underlying circumstances are not wage-push originating. For ex-

ample, one would be hard-pressed to describe the inflationary expansion of 1972 in Britain as union power in action but this did not deter the Prime Minister from resorting to an elaborate set of price and wage controls as the major anti-inflationary weapon.

False stability

More often than not such measures are not introduced as a sole counter-inflationary device and the empirical task of ascribing success to one influence or another becomes onerous. Not surprisingly empirical studies have proved indecisive. What they have shown is that incomes policies tend to distort the movement of wages and prices across time – causing moderation in rises currently with the introduction of controls and marked acceleration in wages and prices two or three years later. There has even been the suggestion that the ultimate price and wage rise is higher than it would have been without the controls.

If such controls were to break the pattern of inflationary expectations, market interference to promote stability might more than offset the damage to resource allocation for society at large. Failure to achieve this means that any credit points on stability grounds are likely to be easily outweighed by the negative effects on resource allocation and on growth. It cannot be gainsaid that society uses a mixture of competitive price and wage indicators coupled with movements in stocks of factors and products as guides to the sensible deployment of resources across time. By definition, the introduction of an incomes and prices policy necessarily means a different alignment of these from that which market forces would themselves generate. This must be true even when a substantial range of decisions affect bodies within the public sector directly. Otherwise such policy measures could have been aligned already. The question then becomes one of how much short-term dislocation in market patterns should be endured for stability reasons when long-run effects of such controls are negative.

The answer turns on the range of influences we have already enumerated. In general, we doubt the significance of wage-push inflation, and we doubt the cleanness of the

counterattacks that incomes and prices policies can provide. Hence, apart from a short sharp freeze to break accumulating inflationary expectations, we find the case for such policies extremely weak, and of doubtful merit even in a freeze context. On the accumulated evidence [8] we would need a lot of convincing that the resource allocation role of markets – the key to the long-run prosperity of our country – should be tampered with in this way.

Fortunately, it would seem that considered opinion is moving in our direction, as the report to the OECD known as the McCracken Report signifies [9] But on this we must not remain sanguine. The need to disburse blame for undesired economic effects is going to make incomes and prices policies attractive to democratic Governments for a long time to come, for whatever else they produce their smokescreening properties are politically attractive.

Notes

1. J.M. Keynes, *A Treatise on Money*, Vols. I & II, London, 1930.
2. *op. cit.*, p. 168.
3. *op. cit.*, p. 157.
4. J.M. Keynes, *The General Theory of Employment, Interest and Money*, London, 1936, pp. 301-3.
5. J.M. Keynes, *How to Pay for the War*, London, 1940.
6. Sir John Hicks, *The Current Crisis in Keynesian Economics*, Oxford, 1974, p. 62.
   see also
   M.R. Fisher, *Professor Hicks and the Keynesians*, Economica, August 1976.
7. R.F. Kahn, *Selected Essays in Employment and Growth*, Cambridge, 1972. Mr. Eltis and the Keynesians, Lloyds Bank Review, April 1977.
8. See in this context the informative article by G.P. Shultz and K.W. Dam, 'Reflections on Wage and Price Controls', *Industrial and Labor Relations Review*, Vol. 30 No. 2, January 1977.
9. OECD, *Towards Full Employment and Price Stability* (McCracken Report), Paris 1977, esp. paras. 374-393.

CHAPTER 4

Europe 1951—76: Persistence Unrewarded

Editorial Summaries

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Europe, 1951–76
Persistance Unrewarded*

Editorial Summaries

I. INTRODUCTION

In this chapter, I shall attempt to summarise the various price and incomes policies pursued by six West European governments over the last 25-odd years. Four out of these six governments have had an incomes policy of one kind or another in operation since at least the early 1950's and in some cases, even earlier. Towards the end of the 1960's, they added price policies.

One government, that of France, has never succeeded in imposing an incomes policy. Instead, it has had a comprehensive prices policy since the early 1960's. Only West Germany has not had price and income controls, whether official or unofficial.

As we shall see, a wide variety of incomes policies were tried out. The institutional settings are equally varied, ranging from a fairly tightly knit employer-union framework, as in Austria, to the much looser system found, for instance, in Denmark. The extent to which the central trade union

*based on Eric Schiff, *Incomes Policies Abroad*. American Enterprise Institute, Washington DC 1971, and on further material.

and employers' organisations control their individual member unions and associations also varies from the fairly effective control exercised in Austria and Sweden, to the relatively greater autonomy to be had in Denmark and the Netherlands. With the exception of France, all the countries considered here have some method, formal or informal, of bringing unions and employers together, and frequently governments as well, into a central consultative council. In some countries, this council has the authority to impose specific decisions or issue guidelines, with respect to money-wage increases, in other countries it remains merely a deliberative body.

Some union federations, e.g., in Austria and Sweden, have displayed considerable awareness of their possible role in maintaining overall economic stability. Other union organisations have not expressed any official opinions in this regard. Some union federations have co-operated with official incomes policies; others have co-operated intermittently; some (in France) have simply refused to deal with the government.

Price policies have been less varied than incomes policies. Attempts to control prices have usually taken the form of price freezes, either general or for some commodities or services. Such attempts have been supplemented by attempts to slow down price increases, or to link price increases to increases in costs or to ensure that companies absorbed cost increases. Employers' associations and individual firms have generally co-operated with governments in operating price controls.

In the following sections, I shall summarise each country's experience individually.

II. AUSTRIA

The institutional setting

All workers and employers, in agriculture and in industry, are obliged to join some branch of an appropriate trade union or employers' organisation. These branches are organised on a regional or a federal basis.

At the federal level, the **Joint Commission**, (also known as the Parity Commission), consists of representatives from

employers' organisations, trade unions and the government. The federation of employers' organisations, the federation of agricultural organisations and the two major trade union federations have two members each. The government is represented by four senior ministers, including the Federal Chancellor.

Price and wage policies are implemented via the price and wage sub-committees of the Joint Commission. The price sub-committee has representatives of employers' organisations and trade unions, together with two ministerial members. The wages sub-committee consists of employer and trade union representatives only.

An Economic and Social Advisory Council was set up in 1963. As economic growth slowed down, while wages and prices rose, it appeared desirable to place wage and price policy within a wider context, by closer co-ordination with investment, budgetary, foreign trade and social policy. The Council is made up of technical experts from the main employers' and workers' organisations. Its recommendations, based on consideration of broad policy issues, are submitted to the federal government via the Parity Commission, rather than to the various organisations involved in the Commission. In these recommendations, the Council is required to aim simultaneously at achieving price stability, economic growth and full employment.

Price Policy

Under the Anti-Profiteering Act and the Price Control Act (of 1957), about 20% of the prices entering into the Consumer Price Index are fixed by government, including the prices of such "necessities" as bread, flour, sugar, cigarettes, etc. Bus, railway and tram fares are also government-regulated. Government attempts to raise these prices in a contra-cyclical manner resulted in sudden sharp rises at the end of prolonged booms.

A further 20% of the prices entering the consumer index come under the review of the Joint Commission's price sub-committee. The sub-committee does not scrutinise the prices charged by private bodies (such as private schools)

that are not affiliated to any employers' organisation or trade union. Prices in retail trade and in service industries are also left unsupervised, where profit margins are not affected.

Applications for price increases are submitted by the firm (or industry) to the sub-committee, via the federal employers' organisation. In general, price increases are permitted only where costs have risen, without offsetting increases in productivity. The sub-committee is required to render a decision within six weeks. In the absence of any decision, the price increase automatically passes through. If the sub-committee does decide to consider the application, it may approve or reject the entire increase or a part of the increase; or it may refer the application to the full Commission. Up to 1966, in practice, price increases of up to 3% were passed virtually automatically – i.e., the sub-committee made no recommendations within the six weeks stipulated.

Until 1962, the price review system was entirely voluntary, i.e., the employers' federation was able to ensure compliance without further government backing. In that year, the government took additional statutory powers to set prices for a maximum of six months, where the price increase was unauthorised or exceeded the approved limit. Two more Acts, one in September, 1972 and the other in January, 1973, extended government authority in this field. The Price Determination Act (September, 1972) obliged firms to deduct certain taxes and to pass on reductions in customs duties when computing final prices to consumers.

Comprehensive computerised surveys were undertaken by the appropriate ministry with the assistance of employers' organisations, trade unions, local authorities, etc. Actual prices are checked against ceiling prices to facilitate enforcement of the sub-committee's decisions.

Wage Policy

Wage claims go from the union concerned via the trade union federation of which it is a member, to the Joint Commiss-

ion's sub-committee on wages. The sub-committee takes into account both productivity increases and changes in the cost of living in making its recommendationss. It may approve the claim, ask for more information, recommend a postponement, or refer the claim to the full Commission. It is obliged to make such a reference where the wage increase in question is likely to lead to price increases, or is held to be of national significance.

Influences on the Austrian price index

(a) International influences: Austria is a small country, heavily dependent on both exports and imports, and on income from tourism and other international transactions. Austrian prices are thus, generally, quite sensitive to international influences, and particularly to developments in the West German economy.

(b) Structural changes: The 1960's saw a significant shift of labour out of manufacturing and industry into services. "Productivity" here is difficult to assess, but incomes rise just as rapidly as in other sectors.

Price and Wage Developments

In the early 1960's, Austrian prices and labour costs – after allowing for productivity increases – more or less kept pace with costs and prices in the E.E.C. and the E.F.T.A. countries, Austria's major trading partners. However, towards the middle and the end of the 1960's, Austrian labour costs began rising more rapidly. From 1970 onwards, it appeared that domestic cost influences became more pronounced than international ones. At the regional level and that of the individual firm, actual earnings rose more rapidly than nationally-settled money-wage rates.

By 1972, Austrian price increases began to exceed the average for all other European O.E.C.D. countries (although the Austrian index fell behind the average for all the O.E.C.D. countries). At the same time, investment rose quite strikingly, a building boom appeared, and the demand for labour rose rapidly in relation to supply. Productivity increases were reduced, and could no longer offset increases in labour costs.

1973 saw a six-month wage and price freeze, together with the passage or implementation of the two Acts mentioned earlier. Nevertheless, a cumulative wave of unauthorised price increases swept through the economy. The Price Determination Act was extended to the end of December, 1974.

The wage-drift accelerated through 1974 (Table 1) and the "voluntary" co-operation of trade unions and employers' organisations became more and more strained. The government postponed increases in many controlled prices, but since only a minor part of the consumer price index was covered, this did not mitigate increases in other prices. An attempt to extend the 1957 Price Control Act to other goods and services failed; but the government was empowered to impose a six-month price freeze on services and on goods other than those mentioned in the 1957 Act.

In 1975, wage-drift began to slow down (Table 1), as foreign demand slackened off and Austrian labour costs began to decline relative to the O.E.C.D. average.

TABLE 1: WAGE-DRIFT IN AUSTRIA, 1969-1975
(% Change Over Previous Year)

	1969	1970	1971	1972	1973	1974	1975
Standard wage-rates, overall	7.1	6.1	9.4	9.3	11.3	13.2	12.9
Total compensation of employees	8.8	9.3	15.1	13.3	16.9	15.5	12.9

Source: O.E.C.D., Economic Survey of Austria, 1975, p. 13.

Conclusions

For historical reasons, and because of Austria's peculiar international position, there is an unusual degree of consensus between Austrian employers' organisations and trade union federations. Officials and members frequently meet, even on an informal basis. But a strong sense of national

unity, of social co-partnership, failed to prevent wage and price acceleration in the late 1960's and the 1970's. Despite the close personal contacts between the members of the various union federations, employers' associations and economic commissions, despite a national spirit of compromise, wages and prices followed much the same pattern of accelerated increases as in other countries.

III. DENMARK

Introduction

Denmark has no formal "tripartite" machinery of the kind found in some other Western European countries where government, employers' associations and unions are all formally and continuously involved in wage negotiations. Instead, intervention by the Danish government in labour markets has been more sporadic. Such intervention, however, has often involved far more drastic measures than in many other European countries. As all Danish wage contracts have a cost-of-living clause, the government sought mainly to influence the unindexed component of money-wage increases. But it was impelled, in due course, to intervene on the cost-of-living side of wage agreements as well.

Wage-drift, price and income policies

In the late 1950's, Denmark experienced considerable inflation. Hence, incomes policies were added to the pre-existing fiscal and monetary policies (in 1962), to better control this inflation. An Economic Council was set up, with representatives from unions, employers' associations, the civil service, the handicraft sector, and agriculture. The National Bank and the ministries of finance and economic affairs also had representatives on the council. Danish wage and price policy have thus proceeded generally in tandem.

In 1963, existing wage agreements, all of which had cost-of-living clauses, were officially extended for two years. Prices, profit margins, dividends, directors' fees, and agricultural subsidies were all temporarily frozen.

1964 saw the wage-price spiral start up again. The

Economic Council recommended that wages should increase by a maximum of 3% per annum. This recommendation was accepted by the employers' federations and the federations of trade unions. But wage drift pushed earnings well above this limit. Between 1965 and 1971, hourly earnings in manufacturing and construction rose by an average of 11.5% per annum, or 3.8 times higher than the 3% guidepost.

In 1967, the Economic Council issued new guidelines, now covering wage-drift as well. The maximum increase was set at 6% per annum (a rate which implied that price stability had been abandoned as an aim of policy). Of this 6%, 1.5% was meant to cover increases in the cost-of-living. Wage-drift was supposed to be held to a maximum of 2.5%. Bargaining could increase money wages in particular sectors by 2%. However, as we saw above, wage-drift pushed the rate of increase in earnings to nearly twice the recommended maximum.

Following the 1967 devaluation, the government recommended that cost-of-living adjustments be suspended for a year. During 1968, a partial price and profit freeze was imposed. In an attempt to stop money wages from rising, the government offered a virtual ultimatum to the leading Danish trade union federation – either adopt a stringent line on wage increases or else submit to higher taxation. Trade union leaders preferred the latter alternative.

The Danish government now tried to influence the volume of money wages by more indirect methods – via the cost-of-living index. In an attempt to stave off increases in retail prices, the government began to compensate firms (in September, 1976) for the cost-of-living adjustments they were obliged to make in their wage bills. This subsidy was ended in February, 1971. Since then, the Danish authorities have reverted to using a variety of price and profit freezes, for the same purpose.

1973 saw an acceleration of wage-drift; it accounted for almost half the total money wage increases in that year. Attempts to restore differentials were partly responsible (wage negotiations had generally proceeded on the egalitarian principle of narrowing differentials). 1973 also saw a further two-month price freeze, followed by new price

control legislation. Wage-drift began slackening somewhat, as the demand for labour fell off.

Wages, however, continued to rise through 1973 and 1974. The combined effect of cost-of-living compensation and wage-drift brought wage increases to an annual average rate of 20-25%. Firms were once again granted subsidies to cover the cost-of-living increases they had to pay, but these subsidies now equalled only half of such increases.

The behaviour of wages and prices

If the increases in average hourly earnings over the four years 1966-70 are analysed, we find that wage-drift tended to reflect variations in the demand for labour. Thus, the rate of increase in earnings declined when unemployment rose (and vice versa). Centrally-negotiated wage rates tended to narrow skill differentials, but wage-drift offset this trend; the money earnings of skilled workers rose at higher rates than did the earnings of unskilled workers.

If wage patterns over the 23-year period from 1950 to 1973 are examined, it becomes evident that wage-drift became more important as time went on. It contributed a growing share to total money wage increases. At the beginning of this period, during the years 1950-55, wage-drift accounted for 37% of the rise in money wages, in the case of skilled men; 21% of the total increase for unskilled men; and the same percentage for women. By the end of the period, in the years 1969-73, these percentages had risen to 66%, 55% and 44% respectively.

During the decade 1961-71, the Danish consumer price index rose twice as fast as the average for all the O.E.C.D. countries. Between May, 1972 and December, 1974, the Danish price index continued to exceed the O.E.C.D. average, but by a far smaller margin.

Recent developments

Early in 1975, wage negotiations broke down. Hence, the government extended existing wage agreements for another two years by legislation. Only very small wage rises were permitted. Ceilings were imposed on profit margins, and on

dividend and bonus payments, in the manufacturing, handicraft, transport and service sectors of the economy. Firms continued to receive cost-of-living subsidies.

In August, 1976, the Danish parliament adopted a series of income guidelines. These guidelines were to cover the two years from March, 1977 to March, 1979. Rents, prices and incomes were frozen to the start of this new wage agreement.

Under these guidelines, wages and salaries could rise by a maximum of only 6%. Indexation would take up 3½-4% of this maximum, leaving only 2-2½% for plant – or firm – level bargaining. Indexation payments would not rise beyond 6% no matter what happened to consumer price index. Price and profit regulations were tightened. The cost-of-living subsidy to firms was abolished.

Conclusions

Denmark's openess and smallness, its loose institutional structure, and the close link between Danish money wages and the cost-of-living index, all meant that the Danish money wage explosion was the more explosive when it came. But for the same reasons, this explosion was open and not diverted into other channels. The Danish government was no more successful than other governments have been so far in containing wage and price increases whether by direct or indirect measures.

IV. FRANCE

Introduction

France is unique in having a fairly comprehensive system of price controls, with very little official control over incomes, though not for want of trying on the government's part. In the first place, there are practical obstacles to incomes control – the percentage of the labour force unionised in France is the lowest of any Western industrial nation. Only some 20-30% of workers in manufacturing belong to unions. Secondly, any form of central wages policy is strongly opposed by both unions and employers. The main trade union in France is Communist-dominated; other unions are

controlled by various socialist groups. In either case, union leaders are little inclined to co-operate with any official wage policy.

Incomes policy by exhortation and guidelines

Nevertheless, between 1959-1963, the government attempted to control wages by exhortation. Its recommendations had little influence on wage negotiations. Money wages rose well ahead of increases in productivity. In October, 1963, recognising the failure of exhortative incomes policy, the French government convened an Incomes Conference. A large number of unions and employers' associations participated, but the Conference failed to provide any basis for an official incomes policy. The unions feared that only wages would be controlled; they argued that tax allowances and tax evasion together resulted in an understatement of net profit. Business organisations on the other hand stressed the importance of profits in financing investments. After this fundamental disagreement, the government was obliged to continue with an incomes policy which remained merely "indicative".

The Five Year Plan, published in 1965, offered a set of quantitive guidelines for increases in money incomes in various occupations. Three years later, a money wage explosion followed by a price spiral relegated these guide-lines to history. Despite massive increases in money wages, real incomes failed to rise above trend.

Thus, the French government failed to obtain an incomes policy which could be enforced. It had to remain content with appeals to employers and to trade unions to show a sense of responsibility.

Prices policy

French policy has concentrated perforce on price controls, of which a large variety have been imposed. The 1960's saw the spread of so-called "price planning contracts", or agreements, between the government and particular firms. These contracts include the following features – permitted price increases are linked both to overall national productivity and to the productivity of the individual firms concerned.

Large productivity gains must be passed on, but where productivity increases are low, prices may be increased to a greater extent. Limits are placed on the extent to which cost increases may be passed on. In the case of certain non-wage cost increases, larger price increases are permitted than for rises in other costs. Profit margins are regulated, especially in the distributive trades. In return for price moderation on the part of companies, the government undertakes to hold down public sector prices and the rates of indirect taxation. Within the limits of these planning agreements, firms may raise prices without giving prior notice to the government. If a firm raises its prices beyond the limits agreed upon, these prices are then frozen.

Those companies that do not sign price planning agreements are subject to price surveillance. They are required to give notice of proposed price increases and to deposit their list prices and sale conditions with the Prices Directorate, which may object to the proposed increases, and freeze existing prices. Firms in highly competitive sectors, those producing luxury goods, and small firms, are all exempted from the operation of any price controls. By the end of the 1960's, some 80-90% of French industry was either covered by price planning agreements or subject to price surveillance.

The terms of these agreements are varied from time to time and prices in certain sectors may be temporarily frozen. In June, 1971, prices in the service industries and profit margins in retail food distribution were all frozen. During 1972, the service industries were directed to consult the government before raising their prices. Indirect tax rates were reduced and firms were told to pass on these reductions. As the year progressed, prices were refrozen in the service sector, and in firms without an official price planning agreement.

The following year, agreements were varied, permitting firms to pass on increases in raw material costs, on condition that they absorbed increases in other costs. Larger price increases on some products were required to be offset by lower price increases on other products. Profit margins could be raised in proportion to costs. Firms without official price agreements had their profit margins frozen. Some

firms subject to vigorous international competitors were nonetheless subjected to domestic price controls on the grounds that the import of international cost increases must be prevented. Service firms were allowed to increase their prices to cover higher non-wage costs only.

In 1974, an excess profits levy was introduced. If profits exceeded pre-determined margins, they were to be taxed. The levy was refunded if price increases, on average, remained within certain overall limits. To prevent dynamic firms from being penalised, allowances were made for an increase in employment directly connected with production; for higher exports; and for productivity gains, all on the assumption that the price target was reached.

So far as costs were concerned, only increases in the costs of raw materials, fuel and intermediate goods could be passed on in full. All other cost increases had to be partly absorbed. Service industries were allowed to pass on wage increases only if these were limited and productivity was increased. Firms were made liable both to fines and to imprisonment, for breaking price planning agreements.

In 1975, the excess profits levy was repealed when it led to serious cash flow difficulties for some firms. Detailed maximum prices were set for oil products, among a number of other items. During the following year, some food prices and the prices of certain consumer goods were frozen. Other prices were gradually freed from some of the stringent controls imposed on them in the previous years.

Conclusions

To summarise, it has not been possible to do much by way of an incomes policy in France. Even public sector wages policy has met with little success owing to trade union intransigence. Price planning agreements with firms have attempted to limit price increases by:–

1. linking these increases to productivity;
2. limiting the extent to which cost increases could be passed on legally;
3. regulating profit margins.

These agreements are reinforced by a comprehensive

system of price surveillance and by various other sanctions, chiefly price freezes.

Despite this highly organised, elaborate system of price controls, price rises in France have not been held back to any significant degree. Between 1959 and 1972, the French consumer price index rose by an annual average of 4.2% – slightly more than the O.E.C.D. average of 3.5%. From December, 1972 and up to January, 1976, the average annual increases in the French price index just about equalled the O.E.C.D. average – 11.3% as against 11.1%. Between 1968 and 1972, the French economy experienced substantial gains in productivity. But apparently, neither an extensive system of price controls nor large increases in productivity could bring the rate of price increase in France below the average for all other developed countries.

V. THE NETHERLANDS

Introduction

The Netherlands have covered the spectrum from relatively free collective bargaining to a fairly tightly controlled system. In doing this, they have tried out a rich variety of incomes policies and price controls. These attempts were based on the faith, evinced by even the trade unions, in the officially-made short-term economic forecasts. (This faith waned in due course as we shall see). These forecasts were used to derive wage guidelines.

Immediately following the Second World War, the main task facing economic policy was to rebuild the devastated Dutch economy. Wage policy was formulated and implemented via a powerful Board of Government Mediators, who had the authority to fix wages and set the terms of collective agreements. It was required to consult a tripartite body – the "Foundation of Labour" – which included employer and employee representatives and independent experts. From 1945 to 1948, wages were fixed at "socially tolerable minimum levels" with some allowances for regional cost of living and skill differentials. General price controls remained in force to 1948, when they were abolished. From

1948 to 1950, wages were linked more closely to the cost of living index.

Wage guidelines – their rise and fall

The system of wage guidelines which now came into operation eventually come under increasing strain by the late 1950's and early 1960's. The emergence of full employment and more especially the development of labour shortages in many areas led to grave difficulties with this system of wage fixing.

Up to 1959, wage guidelines were based on the comprehensive macroeconomic forecasts made by official government agencies. These guidelines sometimes included limits on the extent to which wage increases could be passed on as higher prices. The use of economic forecasts meant that there were systematic attempts to found wage policy on a well worked out analytical basis.

The years from 1959 to 1963 witnessed an interesting case study in the use of productivity criteria for wage increases. A rise in wages in any particular industry or sector was made dependent on productivity increases in that sector or industry. The Dutch experience, however, confirmed the theoretical objections to the use of **physical** productivity as an **economic** criterion; the physically most productive industries were not necessarily those that it was economically most desirable to expand; nor were they necessarily those to which more labour should have been attracted. Two fundamental practical difficulties recurred – firstly, that of actually measuring productivity at the plant or enterprise level. Secondly, there was the problem of checking up on these reported productivity increases. The Board of Government Mediators and the other government agencies concerned found themselves involved in endless disputes and discussions. Productivity figures were manipulated (or alleged to be); "productivity" was offered as the occasion for wage increases that had been previously agreed upon, on some other basis; and so on.

The "objective" criterion of productivity turned out to be highly subjective in practice and to increase rather than reduce government intervention in labour markets.

In 1963, wage fixing was placed on a new basis. The productivity-linked system was abandoned and predetermined wage guidelines were introduced. These guidelines continued to be derived from official macroeconomic forecasts. The Central Planning Bureau and the Social and Economic Council made a comprehensive and extensive examination of the state and prospects of the Dutch economy. These two bodies then indicated the possibilities for wage increases.

Although employers and unions were given somewhat more freedom than previously to reach collective agreements, the Dutch government retained its extensive powers – to disallow agreements, to impose a wage freeze and to issue other directives on wages. The permitted wage maxima were made binding and violators were prosecuted. But these maxima in turn were obtained after an extremely complex series of consultations with unions and employers, down to the individual plant level.

The wage explosion and more intervention

This system of wage fixing ran almost immediately into a large number of practical difficulties. As labour markets became tighter – in 1963, there were four notified vacancies for every person registered as unemployed – wage-drift and the phenomenon of "black wages" appeared. "Black wages" made up an estimated 6-7% of the total wages bill for 1968. In due course, labour shortages made both employers and unions restive. They became less and less willing to accept the prescribed maximas, and ever more willing to violate the guidelines.

A wages explosion set in after 1963. In 1964, wages rose by some 15% as against the official guidelines of 6%. Moreover, in both 1964 and 1965, the Dutch economy performed better than forecast. Union leaders suspected the government of undue pessimism in these forecasts in order to be able to hand down conservative wage guidelines. In 1965, wage increases once again exceeded the official maximum – 11% as against 7%. Between 1963 and 1965, money wages rose overall by some 38% while the official limit was less than half that figure. Government guidelines were based

on the long term growth of productivity – but the short term tightness of Dutch labour markets pushed money wages well above this standard.

Active wage and price controls

1966 saw a sharp increase in government intervention in the field of prices and incomes. The government laid down a limit of 7% for wage rises, but several agreements exceeded 10%. The government-set maximum was disregarded for very understandable reasons. Employers offered more than 7% and union members saw no reason for refusing; thus, union leaders saw their rank and file slipping away. The government, however, now imposed both wage and price controls. Wages were frozen at first, and then the government insisted that no agreement should exceed 7%. With respect to prices, firms were forbidden to pass on wage increases. Only increases in "external" costs (raw materials, freight, etc.) could be passed on while cost declines had to be reflected in lower prices. All price rises had to be reported to the Ministry of Economic Affairs; any such increases could not be used to raise profit margins.

Wage controls were continued through 1967. The limits were reduced to 4% and then to 1½%. Employers' associations voluntarily maintained stable prices. In December, the unions, employers and government reached a tripartite agreement which was to last for another 2 years.

Beginning in January, 1968, collective wage agreements were permitted to be settled outside the guidelines. The government, however, reserved the right to veto agreements that "threatened the economy's equilibrium". The Board of Government Mediators and the Foundation of Labour were converted into advisory bodies. The Central Planning Bureau continued to turn out projections for "acceptable" wage increases. Although these limits were no longer binding on employers and unions, the government used them as the basis for its intervention in labour markets.

A wage freeze was staved off in 1969 only by strong parliamentary opposition. Throughout that year and the next, the government sought to reduce the level of wage settlements, in an attempt to stave off a further wages

explosion. The tripartite Social and Economic Council recommended that wage increases be held to 5%.

In February, 1970, the Dutch parliament finally passed the wage regulation bill first introduced by the government in September, 1968. The government's "standby" veto powers over wage agreements were formally enacted into statute. This so angered union leaders, however, that two major trade union federations refused to co-operate in tripartite agreements.

Price controls were continued on the same basis as previously. But as wages rose, prices rose by more than the increase in "external" costs. As attempts to keep price increases within the official guidelines failed, prices were frozen in April, 1969. Six months later, the freeze was partly lifted, to permit higher "external" costs to be passed on. Firms were required to give 30 days' notice of any price increase.

Thus, wages and prices rose inexorably beyond the limits set by government, both when these limits were legally binding and when they were not.

Detailed price and wage regulation

In 1972, the government moved from price control by notification, to a price freeze. Then regulations were introduced, allowing non-wage cost increases to be passed on, but forbidding unit profits to rise. Wage increases could not be passed on if productivity had also risen.

In December, 1972, a tripartite agreement was concluded among unions, employers and the government. Wage rises for 1973 were to be limited by productivity increases and by increases in the cost-of-living. Price increases were also to be limited – price controls were tightened to reduce the quantum of cost increases that could be passed on, and also to ensure that cost reductions led to lower prices. Government, in turn, made certain concessions in tax and investment policy.

Union wage policy now turned to narrowing differentials, but this simply exacerbated wage drift. Wage increases in 1973, at 13-14%, significantly exceeded productivity gains (5-5½%), partly as a result of cost-of-living adjustments. Price regulations were eased somewhat, to

permit the maintenance of profit margins.

A Special Powers Act was passed in January, 1974, allowing the government to control prices and wages without first obtaining parliamentary approval. Wages were frozen for the first quarter. Then, as the employers' organisations and trade unions failed to reach an agreement for the year, the wage freeze was extended. Finally, a maximum increase of 1% was permitted. Price controls were also extended. The passing-on of cost increases was further delayed. Professional fees, rents and public sector prices were either frozen or rises were limited.

Later in the year, the wage limits were raised slightly and the price regulations were eased somewhat to raise profit margins and to permit some part of the wage increases for the year to be passed on.

But money wage increases in 1974 exceeded those in the previous year. The government's price regulations were intended to ensure that wage rises covered by productivity increases were not passed on as higher prices. As productivity declined, these regulations had to be eased. The price-index rose more rapidly than expected – earlier price controls had delayed, not prevented, price increases. At the end of the year, wage negotiations broke down for the second year in succession.

During 1975, wage regulations actually accelerated the growth in earnings; wage rates were fully indexed, and cost-of-living adjustments actually pushed up wages faster than the consumer price index. In July and again at the end of the year, wages were raised by a flat amount, rather than by reference to the cost-of-living. But then the consumer price index rose by more than expected, and wage payments were raised slightly to offset this increase. Wage differentials were thus narrowed over the year. Hours worked continued to fall throughout 1975, but wage incomes rose by a total of 16%.

Price regulations were eased in the course of the year to permit a slight widening of profit margins. The margin by which wage increases could be passed on was raised further; non-wage costs continued to be passed through. Detailed regulation of professional fees remained in force.

In December, 1975, wage negotiations broke down for the third year in succession. Leaders of the main trade union federations now demanded wage rises which combined a flat increase with cost-of-living adjustments. The Dutch government, however, froze all wage payments, and wage agreements, through to the middle of 1976. It also announced that full indexation would not be permitted for the second half of that year. Salaries in the civil service and professional earnings were now brought into the control system. With regard to price regulations, a larger proportion of wage increases could now be passed on in higher prices. In other respects, the regulations were tightened and prices could not be raised to reflect cost increases that had occurred before a set date.

Comparative price behaviour

During the years 1961 to 1972, the consumer price index in the Netherlands rose by an average annual rate of 5.1% – somewhat higher than the O.E.C.D. average of 3.8%. In the period from December, 1972 to January, 1976, this situation was reversed – the O.E.C.D. average (11.2%) exceeded that of the Netherlands (9.4%).

Price controls were not the only restraining influence during these latter years. Domestic demand was slack; the guilder was revalued; and the rise in Dutch import prices itself decelerated. Nevertheless, as Dutch earnings rose well above the rise in productivity, such increases were clearly regarded by the Dutch authorities as an acute policy problem. Although the Dutch consumer price index did not rise as rapidly as the average for all other O.E.C.D. countries, the Dutch government was still patently unhappy about this increase.

Conclusions

The Netherlands thus moved from a fairly well controlled but decentralised system of collective bargaining to a period of relatively free collective bargaining, and then to a system of government-determined wage and price regulations. None of these changes prevented the continued upward pressure on

wages and prices. The Dutch system was particularly noteworthy for its reliance on the apparently objective criteria obtained from widely accepted macroeconomic forecasts. But even such widespread economic awareness failed to prevent continued inflation.

VI SWEDEN

Introduction

The Swedes describe their wage policy as being "privately determined, yet nationally oriented", one in which "the government remains merely a watchful observer".

Swedish trade unions initially displayed a commendable awareness of the problems that wage demands could create for macroeconomic management. In two official publications in 1951, the Swedish trade union congress emphasised that fiscal, monetary **and** wage restraint were **all** necessary if wage and price stability was to be achieved. Under conditions of excess demand, wage restraint would fail to produce price stability. If some unions pressed for wage increases in excess of productivity gains, then the price level would rise even if other unions moderated their wage demands, and despite any fiscal or monetary restraints. Fiscal, monetary and wage policy all had to work together. The trade union congress even acknowledged that under extreme conditions, a wage freeze might be necessary.

Ten years later, however, an official report to the annual trade union congress placed macroeconomic stability on a somewhat lower plane. The report listed two main objectives for union wage policy. First came the creation of "rational wage structure", i.e. one in which incomes and differentials were determined by labour effort, rather than by variations in profitability among firms. The second main objective was to ensure that a reasonable share of the national income went to wage earners. Preventing macroeconomic disequilibrium, and supporting structural shifts in the economy, in the interests of general economic expansion, were listed as only secondary objectives.

On another occasion, while accepting that trade unions could not avoid part of the responsibility for ensuring price

stability, the trade union congress added that unions should not be made to bear the sole responsibility.

The institutional set-up

The Swedish Employers' Confederation negotiates wage agreements with the Swedish Trade Union Association, the largest and most powerful union organisation, covering blue-collar workers. Professional and salaried employees are members of two separate and smaller trade union bodies.

The Swedish system developed gradually. Up to 1948, the government relied on exhortation and direct controls to achieve wage restraint. Although wage increases remained moderate up to 1950, the following year saw a wage explosion. As official attempts at containment failed on this occasion, it was felt that the responsibility for obtaining moderation in wage increases must be placed on those negotiating directly with one another.

Since 1956, the Swedish Employers' Confederation and the Swedish Trade Union Association have negotiated so-called "framework agreements", covering wages and other conditions of employment. These agreements run for up to three years. The various unions and firms affiliated with the two central organisations negotiate separate agreements within these centrally negotiated guidelines. The two white-collar unions also follow these guidelines. As Sweden is one of the world's most highly unionised countries, and as both the employers' and the union federations are relatively powerful viz-a-viz their constituent union and company members, it has been possible to maintain some control over individual wage agreements.

For a number of years, the government confined itself to issuing macroeconomic forecasts and outlining possible future wage and price developments. These views have little influence on negotiations. Government, employers and unions are (or were) convinced that official guidelines and incomes policies would be far less effective than direct, bilateral negotiations conducted with a sense of national responsibility.

The results – wage-drift and labour shortages

The Swedish system is not, however, an unqualified success. While negotiated increases in wage rates have been moderate, it has not been possible to satisfy the demand for labour in many markets at these wage rates. Wage drift has been exceptionally high. Thus, over the ten years from 1957 to 1967, wage rate increases of between 2% and 5% per annum were negotiated in the mining and manufacturing sectors. In construction, agreed increases ranged between 0.1% and 4% per annum. In all three sectors, **actual** earnings rose by some 4-10% per annum. Between 46% and 92% of the increase in hourly earnings for these three sectors could be attributed to wage-drift. Negotiators were willing to restrain wage increases, but they could not control incomes.

Wage acceleration and price controls

The system came under mounting strain in the years after 1968. The leaders of the white collar unions became restive and broke away from the central federation to conclude settlements outside the guidelines. A general price freeze was imposed in October, 1971.

Wage drift continued through the 1970's adding 7% to earnings in 1970 and some 14% per annum over the period to 1973. The "framework agreement" concluded for that year provided not only for an increase in wage rates, but also a "wage-drift guarantee", i.e., certain other additional increases in earnings.

Total hourly wage costs accelerated over the 1970's from a rise of 11% in 1972 to 15% in 1974 and 22% a year later. Wage costs fell back somewhat in 1976, but the increase remained well above the level of the early 1970's. Wage drift and the total rise in wage incomes slackened somewhat through 1975 and 1976, but both remained higher than in the five years preceeding.

In the 10 years to 1972, the retail price index in Sweden rose at an average annual rate of 4.7%, slightly higher than the average for all the O.E.C.D. countries at 3.9%. Over the next four years to January, 1976, the rate of increase in the Swedish index doubled to an average of 9.6% per annum.

The average O.E.C.D. rate, however, rose somewhat faster to 11.3%.

Swedish price policy followed the familiar pattern. The price freeze imposed in October, 1971 was relaxed and then ended at the beginning of 1972. But in December of that year, food prices were frozen and remained so until July, 1974. Subsidies on food products and a tighter system of price surveillance helped to contain the rate of increase in the price index in that year. 1975 saw the passage of a price regulation act which was later extended.

December, 1976 saw yet another price freeze, now covering a wider range of products. This freeze was ended three months later, but it was replaced by a tighter system of price surveillance.

Conclusions

The Swedish trade union movement was well aware, long before unions and even economists in other countries were, of the dangers to price and economic stability of a lack of wage restraint. Union negotiators fully recognised the need for moderation and acknowledged that unions had a role to play in securing macroeconomic equilibrium. Yet, despite this awareness and despite their responsible attitudes, unions and employers alike were helpless to prevent wage and price increases through the 1960's and 1970's. The Swedish system ran into the same inflationary difficulties that faced other countries, and proved no more adept at meeting these problems.

VII. WEST GERMANY

Introduction

Of all the countries referred to in this chapter, West Germany alone has no official controls over prices and incomes. The government considers that such policies distract attention from the real problems. It prefers to rely on demand management, principally via stern monetary controls.

In the area of prices and incomes, West German arrangements are all unofficial and informal. The government confines itself strictly to furnishing information, to be considered by trade unions and employers' associations. This

information takes the form of "benchmarks" or tentative targets for the four main policy objectives: price stability, a high level of employment, balance of payments equilibrium, and a steady rate of economic growth. Initially, these targets were stated fairly specifically. Then they became zones of acceptability.

The other major source of such macroeconomic background information is the independent Council of Economic Advisers, which was set up in 1963. The Council issues an annual report containing its views as to how these four main policy aims might be reconciled and achieved simultaneously. Its views and suggestions have differed frequently from those of government and it has been often critical of policy. The Council argued against incomes policy on the grounds that German inflation is imported and not due to rising domestic costs. It drew attention repeatedly to the incompatibility between internal price stability, fixed exchange rates and free convertability. In the context of persistent large surpluses on the balance of payments, with a fixed exchange rate, to call for wage restraint (the Council argued) would raise false hopes with respect to the achievement of price stability. The Council saw price stability as dependent on achieving external balance.

"Concerted" action

In 1965, it was generally felt that some rather more systematic attempts should be made to provide "concerted" action between trade unions and employers' groups. Consequently, annual discussions are held within the framework of the four policy "benchmarks" set out by the government. Participation in these discussions is entirely voluntary and each union or employers' association decides for itself whether either discussion or "benchmarks" should influence its policy. No guidelines or recommendations are issued, no votes are taken, and there are no official "deliberations" of any sort. Nevertheless, up to the end of the 1960's wage claims tended to remain within the "benchmarks" issued by the government.

On the incomes front, a certain consensus prevailed throughout this period. Unions, employers' groups, the

government and the council of experts all agreed that money wages could not be reduced. The council of experts went on to suggest that money wage increases should take fringe benefits into account, and should be strictly linked to increases in productivity, except where the terms of trade were favourable and where unit capital costs had fallen. Union leaders generally accepted these principles, but felt that there should be some compensation for increases in the cost of living, and some attempt at redistributing income. Thus, despite the lack of any official incomes policy, there prevailed an informal yet effective consensus on the principles of income determination.

The record – price and wage behaviour

Between 1962 and 1972, the consumer price index in West Germany rose at an annual average rate of 3.2%, somewhat behind the O.E.C.D. average of 3.9%. Over the same period, money wages in West Germany rose at an annual average rate of 7.5%.

However, the West German economy, as part of the larger international economy, could not escape entirely from international inflationary influences. In 1973, the rate of increase in the consumer price index accelerated almost 2½ times to 7.9%. But the rate of increase slowed down in the next two years, falling to 5.3% per annum by the beginning of 1976. The O.E.C.D. observes that the German price index was unique in showing "no significant acceleration after the outbreak of the oil crisis". The rate of increase in money incomes also rose, but not steeply, to a peak of 10.9% per annum in 1974. Thereafter, it also fell back to an annual rate of 7.8% at the end of 1975. This rate was only slightly above the average for the 1960's.

Conclusions

Almost alone among the Western industrialised nations, West Germany has displayed a remarkable degree of price stability. Money incomes, too, have risen only moderately. The West German government is virtually alone, too, in relying on monetary and fiscal policies to promote macroeconomic stability, and in refusing to use an officially backed

wage and price policy. West German trade union leaders are undoubtedly moderate in their money-wage demands, and very well aware of the macroeconomic implications of these demands, but they are not unique in this respect. The success of the West German government in containing inflation clearly must be attributed to its economic policies.

VIII. CONCLUDING OBSERVATIONS

It would not be unfair to conclude that price and income policies have failed to control increases in prices and in money incomes in a wide variety of contexts and a wide range of institutional settings. It appears to have made little difference whether governments were actively involved in union-employer negotiations or whether they were content to remain – officially – on the sidelines; whether individual unions and employers' associations were tightly controlled by their central federations or had considerably autonomy; whether incomes policies were more or less ad hoc or based on productivity criteria, or derived from macroeconomic forecasts. In all instances, money incomes continued to rise inexorably. Equally, price freezes, price surveillance, advance warnings, limits on price increases – all were of no avail against the persistent rise in the consumer price indices of the five countries considered here.

The price and income policies outlined in this chapter have one common feature – they have tried to limit overall increases – in a price index or in total money incomes – by limiting increases in **particular** prices and incomes. In doing this, such policies have prevented those movements in relative prices and incomes necessitated by changing circumstances, i.e., changes in supply and demand conditions in individual product and labour markets. Consequently, the more "successful" these policies, the greater the associated difficulties – labour shortages and wages drift. Changes in prices and incomes perform vital **allocative** functions – they direct resources to particular uses, and away from others. These allocative functions need to be performed even in an inflationary context. Consequently, direct wage and price controls hit another target than the one aimed at: while seeking to control increases in a price index or in total

money incomes, they actually produce confusion in the allocation of resources.

Direct wage and price controls implicitly assume that a price index rises, or total money incomes rise, because of the particular increases in prices and incomes in particular markets. The failure of direct controls suggests that price and wage increases in particular markets are simply the channels for some more general economic influence. Both sets of phenomena, the rise in a price index, together with rises in money incomes, on the one hand, and particular money wage and price increases on the other hand, reflect this more general influence. This supposition is strengthened when we see the variety of institutions and policies under which money wage and price increases occurred.

Alone among the six countries considered here, West Germany succeeded in moderating increases in its consumer price index, and in aggregate money incomes. The West German government was also alone in relying on general macroeconomic measures – monetary and fiscal policies – far more than in many other West European countries. It is of course true that the governments of these countries have also used wider macroeconomic restrictions. But they have not been as ruthlessly persistent as the West German government has. An examination of the record as regards monetary and fiscal policies is beyond the scope of this chapter. Whatever the role these policies played (or could have played), it seems clear that direct controls added difficulties of their own without curing inflation.

CHAPTER 5

Britain, 1951–72: The Lessons Unlearned

Michael Parkin

THE AUTHOR

Michael Parkin was born in Yorkshire, England in 1939 and in 1963 was graduated from the University of Leicester. Until fall 1975, when he moved to Canada, he was Professor of Economics at the University of Manchester. Currently, he is Professor of Economics at the University of Western Ontario.

Professor Parkin's scholarly publications are numerous and include on the subject of inflation alone: *Incomes Policy and Inflation*, edited by M. Parkin and M. T. Sumner, University of Toronto Press, 1973: *Inflation in the World Economy*, University of Toronto Press, 1976: and "Inflation: A Survey" (with David Laidler), *Economic Journal*, December, 1975.

Britain 1951–72: The Lessons Unlearned*

Michael Parkin

I INTRODUCTION

It is an increasingly common view that the simultaneous pursuit of high and stable employment and stable prices via Keynesian-inspired economic policies is inconsistent with traditional free collective bargaining and market determination of prices. It is a popular view that 'new' prices and incomes policies must be adopted if the twin objectives of high and stable employment and stable prices are to be simultaneously achieved. In fact, nothing could be further from the truth. Rather, the so-called 'new' policies are the oldest[1] and crudest, best likened to medieval medicine, based on ignorance and misunderstanding of the fundamental processes at work and more likely to kill the patient than to cure him.

Understanding inflation

It was not until relatively recently in the long sweep of human history, in the seventeenth and eighteenth centuries[2] that the principles governing the determination of the general level of prices were made clear. The insights of Bodin and

*from Michael Parkin, "Wage and Price Controls – the Lessons From Britain", in Michael Walker, ed, (The Illusion *of Wage and Price Control, Fraser Institute, Vancouver 1976.*

Hume and the refinements which have followed through the work and writings of Irving Fisher, Wicksell, Keynes and modern monetary theorists such as Milton Friedman, are critical for understanding and influencing the fundamental monetary forces which determine the general level of prices, the rate of inflation and the general level of output and employment. In their way, these insights are as important as those of Newton and the subsequent refinements of his ideas for an undertstanding of gravity and the fundamental laws governing the behaviour of physical matter.

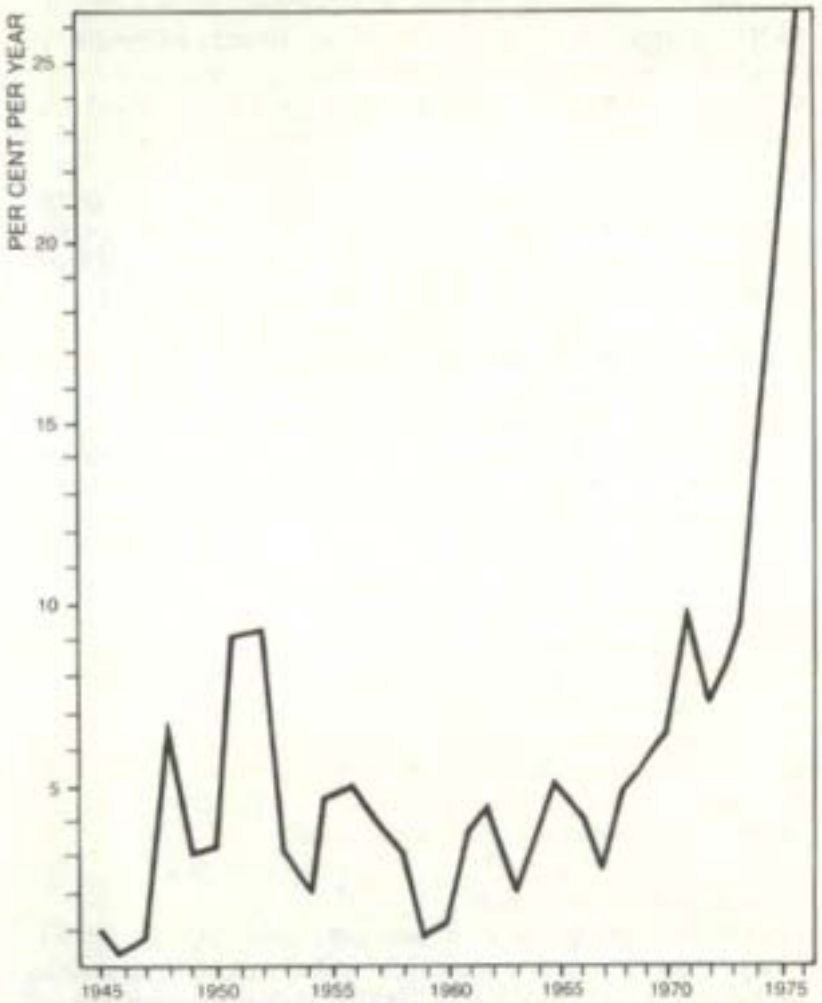
This study has the more negative, though vitally important task, of analyzing the effects of wage-price controls and of showing that, whatever their superficial attractiveness, they simply do not work. *They do not control inflation.* At best, they are evaded by the skilful use of legal and financial talent – talent which is scarce and could, more importantly should, be put to productive use. At worst, they destroy the allocation of scarce economic resources, they produce arbitrary and in general unjust redistributions of income, they generate a deterioration in industrial relations and they engender a disregard for the rule of law. These are strong claims and cannot simply be made by assertion. Nor can they be justified by *a priori* argument. They must be demonstrated by hard evidence.

This paper focuses solely on the United Kingdom's experience with wage-price controls since 1945. The study has three main sections. First, it examines Britain's post-war inflation record and describes the various episodes of controls. Second, it compares the performance of inflation in 'controls on' and 'controls off' periods and assesses the impact of controls on the pace of inflation. Third, it examines the side-effects of controls.

II INFLATION AND CONTROLS: THE BRITISH POST-WAR HISTORY

Britain's post-war inflation record has, on the average, been worse than that of most other major industrial countries and, in the years since 1970, has been especially severe. The full post-war record, as measured by the rate of inflation of retail (consumers') prices is set out in Chart 1. Three things

Chart 1 — United Kingdom Inflation, 1945-1975 (Retail Prices)



Source: U.K. Department of Employment Gazette.

stand out in this chart. First, with the exception of 1948, the Korean war years 1951-52 and the years since 1969, inflation has never been really severe and has uniformly been below 5 per cent per annum. Second, there has been, until recently, a pronounced and rather regular cycle with a dur-

ation of approximately four years. Third, there is no single discernible trend but rather two distinct sub-trends: the 1950's during which, measuring from trough to trough to avoid the distortion of the Korean War, the trend was clearly downwards, while in the 1960's and 1970's the price trend has been strongly upwards and explosively so in the final years.

Against this background of the ebbs and flows of the inflation tide, let us now briefly describe chronologically, the various episodes of 'prices and incomes policies'. Eleven distinct episodes can be identified, many of them consecutive.

Episode one – the Cripps-TUC co-op

The first ran from 1948 to 1950, and its chief feature was an impressive and widely-respected appeal by Sir Stafford Cripps (the then Chancellor of the Exchequer), to the Trades Union Congress (TUC) for wage restraint and to the Federation of British Industry for dividend restraint. The episode ended in October 1950 with a vote by the TUC to abandon wage restraint. There were no statutory agencies set up to implement Cripps' policy and no announced 'norms' or guidelines. The entire program was based on persuasion and voluntary compliance. It must be borne in mind, however, that throughout this period, an elaborate system of points rationing, licensing and other wartime controls remained in force. These controls, in effect, temporarily replaced the resource allocating function normally performed by changes in prices and wages.

Episode two – mild rebuff

The second episode covered one year only, 1956, and was milder than either its predecessor or successors. It amounted to repeated requests by the then Conservative government for wage restraint and repeated refusals by the unions to co-operate.

Episode three – the pay pause

Episode three was initiated at the height of a balance-of-payments crisis in the summer of 1961 and was a request by the Conservative Government for a temporary wage freeze (or

'pay pause' as it was called). Again there was no enforcing agency and compliance was voluntary.

Episode four – the guiding light
The next episode was a direct extension of the previous one and was an attempt to make the relaxation of the 1961 wage freeze as orderly as possible. It specified a set of 'guiding lights' for wage and price rises based on the assumption that productivity would grow at 2.5 per cent per annum. The 'guiding light' for wages was to be a rise of 2 to 2.5 per cent per annum and for prices nil. Again these 'norms' were voluntary but for the first time an agency (the National Incomes Commission) was established to monitor and encourage compliance. However, the unions adopted a position of non-cooperation with this agency. The 2.5 per cent (maximum) 'guiding light' for wages was adjusted to 3.5 per cent in 1963 and by the time of the 1964 General Election (October) the policy was abandoned.

Episode five – accord
That election saw the return of a Labour Government after thirteen years of Conservative rule and, in consequence, a revival of cooperation between government and organized labour. By the middle of 1965, the new government was able to sign with the Trade Unions and the employers' federation (the Confederation of British Industry) a *Joint Statement of Intent on Productivity, Prices and Incomes*, which set down a voluntary guideline of 3 to 3.5 per cent per annum for wage increases, rules for permissible price increases, and criteria for exceptions. It also established a National Board for Prices and Incomes. This episode of policy lasted until mid-1966.

Episode six – Labour – first forced freeze
The next episode was the first British attempt (and this by a Labour government) to impose *statutory* limits on wage and price increases with penalties (fines) for non-compliance and provision for 'roll-backs'. For the first six months, July to December 1966, there was a total wage freeze and to mid-1967 a further period of 'severe restraint'.

Episode seven – rule by exception
Episode seven was a mild relaxation of its predecessor. The force of the law still lay behind the guidelines, but more 'exceptional cases' were permitted to take pay increases above the 'norm'.

Episode eight – controls for a decade
The next episode was, in effect, the phasing out of the previous restraint. A White Paper published in April 1968, *Productivity, Prices and Incomes in 1968 and 1969*, reverted to a 3.5 per cent per annum norm for wage increases but made exceptions, both for 'lower paid' workers and in cases of 'productivity agreements'. These turned out to produce loopholes through which a blindfolded man could drive a bus and in effect were the method whereby the policy was gradually abandoned. The maximum permissible normal wage increase was raised from 3.5 to 4.5 per cent at the end of 1969 and the policy finally ended with the election of the new Conservative Government in June 1970. This also ended almost ten unbroken years of some form or other of wage and price controls.

Episode nine – Tory phased-freeze
Controls were reactivated by Edward Heath's Conservative Government in November 1972 in a three-stage statutory program. Stage I was a three month total freeze (similar to that imposed by President Nixon in 1971); Stage II a flat £1 per week plus 4 per cent to last six months; Stage III, a norm of 7 per cent plus partial indexation. Stage III was finally abandoned in a bitter conflict between the government and the coal miners which led to British industry being put on the three-day week and ended in the defeat of the Heath Government in February 1974.

Episode ten – Labour's social contract
The new Labour Government of Harold Wilson which emerged from the wreckage entered into a 'social contract' or voluntary incomes policy, with the unions, a contract described as 'not worth the paper on which it was not written' which pledged the government to deliver high employment

and more sustained *real* income in return for the unions delivering moderation in *money* wage claims.

Episode eleven – *Attack on Inflation*
The final episode started in July 1975 and is still in force (1976). This places statutory obligations on employers to limit pay increases to £6 per week (about 12 per cent of the average weekly wage) and to limit price rises to ensure that margins do not increase.

With all this vast variety and extent of experience, it should be possible to discover whether or not controls do have any effect on inflation and also to establish what side effects they have. We now turn to that task.

III THE EFFECTS OF CONTROLS ON THE PACE OF INFLATION

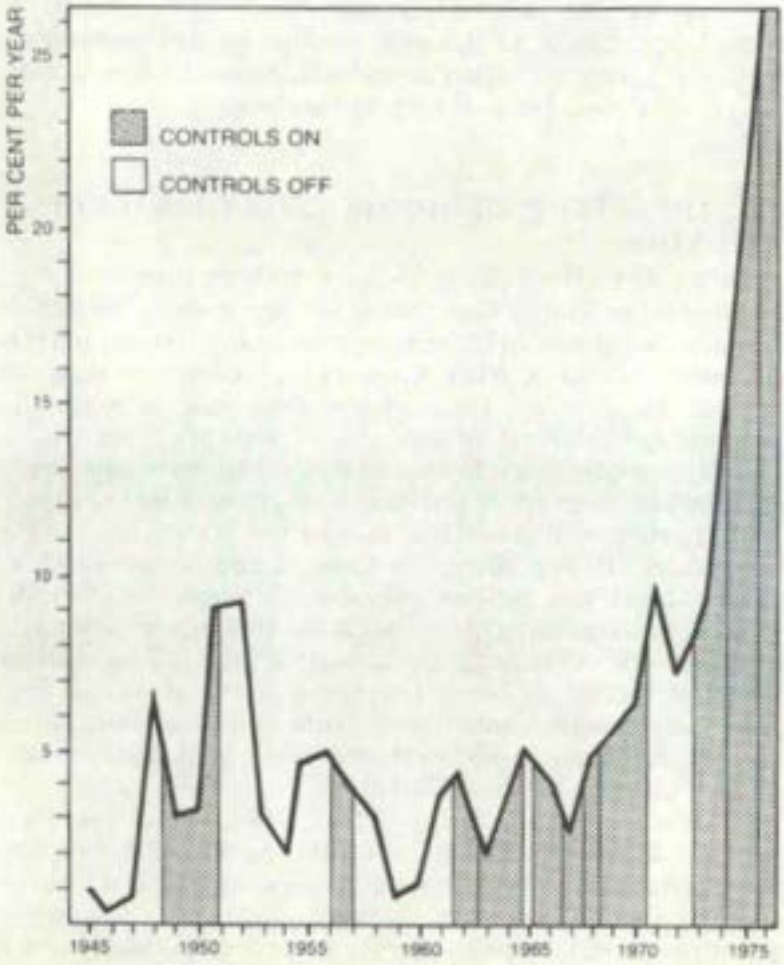
Isolating the effects controls have had on the pace of inflation in the United Kingdom is no easy matter. The rate of inflation is subject to influences from many sources and it is necessary to assess what these influences are in order to remove their effect from our analysis and establish the separate and independent influence of wage-price controls.

As a preliminary to that analysis it is instructive to see how Britain's record of inflation lines up with its experience with controls. This is done in Chart 2 which repeats the course of inflation shown in Chart 1 and superimposes as shaded areas the various episodes of wage-price controls. What is striking about this chart is the lack of any systematic tendency for controls to be associated with a reduction in inflation. Indeed, in broad terms, the reverse is true. As controls have become more severe (with statutory controls replacing voluntary guidelines) and more prolonged, so the pace of inflation has accelerated.

Of course, to a large extent, this reflects causation running from inflation to controls. As inflation becomes more serious so it brings in its wake an increasing clamour for the government to 'do something' and, in view of their primitive appeal, controls are the natural measures to create the impression of government action. Few would want to

deny that inflation leads to controls; but do controls lead to the moderation of inflation?

Chart 2 — Inflation and Controls, United Kingdom 1945-1975



Source: U.K. Department of Employment Gazette.

The answer from the facts portrayed in Chart 2 must be a qualified "no". It is true that in the *early phases* of episodes (1), (3) and (6) and throughout episodes (2) and (5), the rate of inflation did fall. However, it is also clear that in the *later phases* of episodes (1), (3) and (6) and in all other episodes of controls, the inflation rate continued to climb. It is noteworthy that, with the exception of 1956, the rate of U.K. inflation was *higher* at the end of each control episode than it had been at the beginning of the episode. However, we must qualify, with a caution, the conclusion that controls do not help to reduce inflation. Could it be that the forces making for inflation were on a strong upward trend, especially throughout the 1960's and that, bad though Britain's inflation record was over this period, in the absence of controls it would have been much worse? If we are to assess properly the contribution of the controls, we cannot dodge that question.

To answer this question it is necessary to establish what have been the main causes of inflation in postwar Britain and, in the light of these factors to predict the course that inflation would have taken in the absence of controls and then to measure the separate and independent effects of the controls.

What then have been the main sources of Britain's post-war inflation? This, of course, has been and continues to be a controversial question and one on which a great deal has been written – much by the present author.[3] It is also though a question on which a stronger consensus is beginning to emerge as the facts become clearer. The two broad opposing views on the question may be labelled: 'wage-push' and 'monetary-pull'.

1. Causes of Inflation

Wage-push inflation

The wage-push view takes as its starting point factors which directly determine the rate of wage inflation. The central precondition for the wage-push analysis of inflation is the notion that, in an economy which uses Keynesian aggregate demand management techniques to maintain full employ-

ment, the demand for labour in aggregate will be almost independent of the level of money wages since any wage level will be validated by the actions of the government and central bank. Trade unions, behaving in the absence of constraints on employment will set wages in order primarily to achieve what they regard as fair wages. Concern with justice in the distribution of wages will ensure that any badly out-of-line high wage settlement in a particular sector of the economy will quickly transmit itself to other sectors, thereby preserving the general structure of relative wages but raising their overall level. With wages determined in this manner and with productivity growth determined by longer-term factors, unit costs and hence prices will inflate in line with the initiating behaviour of wages. Monetary and fiscal policy will accommodate and validate the inflation in order to ensure that real output does not fall and too much unemployment emerge. Further, if the inflation gets too far out of line with inflation in other countries, then, from time to time, the exchange rate will have to be depreciated.

Monetary-pull inflation

The alternative 'monetary-pull' view takes as its starting point an analysis of the socio-political factors which lead to the printing of an excessive supply of money relative to the demand for it. The central ingredients in this analysis are that vote-seeking politicians believe (rightly apparently) that, by increasing government expenditure on social programs, subsidies and the like, and by holding down interest rates, especially in the housing sector, they can improve their electoral chances. The result of such behaviour is an excessive rate of money creation to pay for the programs.

Excessive money supply leads first (with a variable time lag but a lag of between one and two years) to an increase in the demand for goods and labour services. With a further (variable) time lag of up to a year, this excess demand leads to faster rises in wages and prices. Further, because the prices of some groups are the costs of others, an interactive spiral between wages and prices is set up. The more persistent is the inflationary money creation process,

the more will firms and unions come to expect its continuance and the faster will wages and prices rise simply in anticipation of what others are likely to do. If the resulting inflation is faster than in other countries, the exchange rate will eventually have to be depreciated. When this happens inflation will be given a further upward thrust, the magnitude of which will be determined by the country's dependence on imported goods.

What does cause inflation?

Having said what the two most popular views of inflationary forces are we must now decide which of them is correct. To do this we have to examine what actually happened in the United Kingdom and compare what actually happened to what these two theories would have predicted. First, let's consider what the theories would have predicted about the relationship between the rate of money creation and the rate of inflation.

According to the wage-push view the pressure for increases in wages produces, via cost increases, increases in prices. Increasing prices then produce pressure for increases in the money supply. Accordingly, if the wage-push theory is correct we expect to find that on average changes in wage growth and inflation precede, by a short interval, changes in monetary growth.

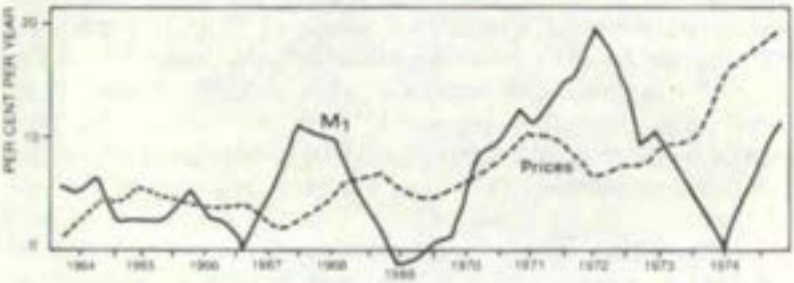
The monetary-pull view, on the other hand, maintains that a high rate of money creation is the cause of the inflation. Hence, if the monetary-pull view is correct we would expect to find that changes in the rate of inflation occur two or three years after a change in the rate of money creation.

The second relationship that we must analyze is that between changes in wages and the factors that are supposed to cause the changes.

From the point of view of the 'wage-push' theory, changes in wages represent a struggle for 'the income pie' and are only vaguely related to the demand for and supply of labour on the one hand and to inflation expectations on the other. If this view is correct, the rate of change in wages, on the whole, should be observed to adjust largely independently of labour market conditions and inflation ex-

pectations and respond, instead, to a whole variety of socio-psychological factors. If the 'monetary-pull' view is correct, wages should be seen to respond primarily to market forces – i.e. the supply of and demand for labour – and inflation expectations.

Chart 3 — Inflation Rate and Growth of Money Stock, United Kingdom 1964-1974



Source: Reproduced from "Where is Britain's Inflation Going?" *Lloyds Bank Review*, July 1975, No. 117.

We now have two predictions from each of the views of inflation. To determine which one of the theories is correct we must compare the predictions to what has actually happened. Let us look first at the relationship between money and inflation which Chart 3 illustrates. It shows the rate of inflation and the rate of growth of the money supply[4] on a quarterly frequency from the beginning of 1964[5]. Casual inspection of the chart does not reveal any strong correlation between money supply growth and inflation. However more careful inspection reveals there to be a strong correlation between the rate of monetary expansion and the rate of inflation some three years later. There is no similarly strong correlation in the opposite direction. That is, there is no strong tendency for the rate of growth of money to lag behind inflation as is predicted by the 'wage-push' theory.

In terms of the cycles, these regularities can be seen most clearly in the latter part of the period depicted in the

chart. The buildup of the money supply growth rate in 1967 and the U.K. devaluation of the pound of that year can be seen to have generated the inflation takeoff in 1969-70 and the even more dramatic buildup in the money supply growth rate from mid-1969 to mid-1972 as having brought the 1972 onwards inflation explosion. The reductions in the rate of inflation in 1969 and 1971-72 are equally clearly associated with earlier reductions in the rate of growth of the money supply in 1966 and 1968-69 respectively.

Thus, on the basis of this evidence, it appears that the 'monetary-pull' view is the correct explanation of Britain's inflation. It is also clear that the monetary forces making for faster inflation were in fact on the increase on the average through the later 1960's and 1970's. Hence, simply observing that inflation increased despite the presence of wage-price controls, does not lead to the inference that such controls were useless. We must examine whether, with controls in force, inflation was worse or better than it otherwise would have been. To do that within the framework of the relationship between money and inflation is not easy since that relationship is never exact and is subject to variable time lags. It turns out to be more fruitful to proceed by way of an analysis of the other relationship predicted by the 'monetary-pull' view and denied by the 'wage-push' view, that is the relationship between wages and the state of the supply of and demand for labour, together with inflation expectations. As a prelude to examining that relationship let us briefly consider the basic methods employed in the large and still growing literature which has attempted to isolate the separate effects of controls on the pace of wage inflation.[6]

2. Controls and Inflation

Inflation – with and without controls

The basic method adopted in all the studies which we shall consider is the same and can be described very simply. First, the periods in which controls were not in operation are studied and a quantitative model is developed which explains how wages (and prices) are affected by the state of

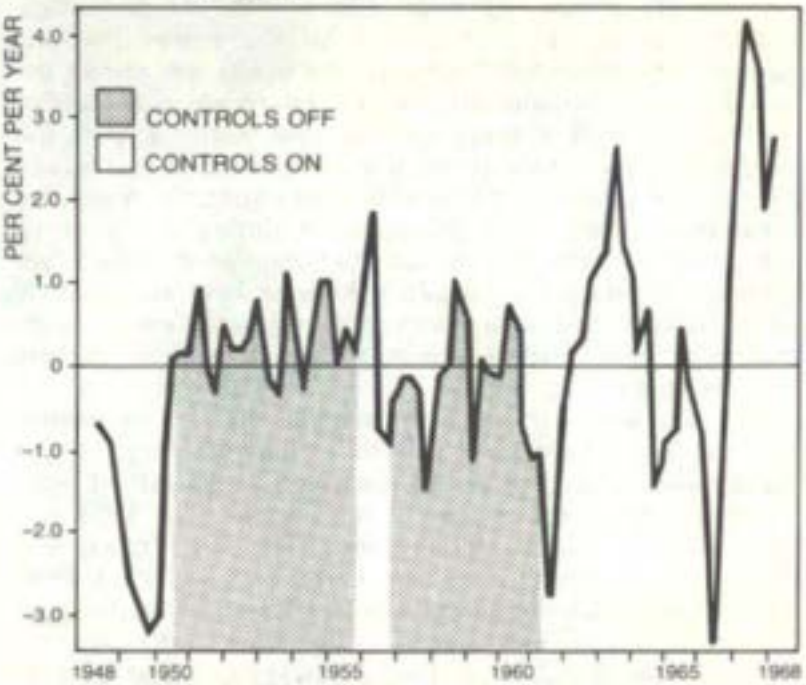
demand pressure, the state of inflation expectations and other (if any) relevant variables. The model is then used to predict the rate of wage and price change during a period in which controls are in operation. Any systematic differences between the actual behaviour and predicted behaviour of wages and prices is then attributed to the effects of controls. This procedure is not, of course, as reliable as a laboratory experiment in which everything is held constant except for the presence or absence of a controls program and the experiment then repeated a large number of times. It is, however, the nearest we can get to a laboratory experiment in a social science and, provided the statistical work is handled carefully, provides us with the most reliable information available.

The starting point for such studies has been a familiar and intuitively appealing model which describes inflation in the absence of controls and has two propositions. The first proposition is that wage change depends on the excess demand for labour, the expected rate of inflation (usually measured by a weighted average of recent actual rates of inflation) and such factors as the change in the fraction of the labour force unionized. The second proposition is that prices are a markup over unit costs, which in turn are determined by wages, output per head and import prices. Models based on these propositions explain the bulk of the variability of wages and prices in postwar Britain.[7]

Predicting the effect of controls

When such models are used to predict the rate of wage and price change during a period of wage-price controls they show that, on the average, with the exception of the Cripps episode, there is no significant downward adjustment of inflation attributable to the controls. The controls do, however, have a temporary effect but one which, in the subsequent development of inflation, is offset and negated. Although individual studies differ in their details, their broad findings agree and to illustrate the calculated effects of controls, we will look at the findings of a study done by Lipsey and Parkin.[8] Chart 4 summarizes their findings.

Chart 4 — Wage Inflation in the United Kingdom 1948-1968



PREDICTION ERRORS OF EQUATION FITTED TO "CONTROLS OFF" PERIODS AND PREDICTION ERRORS OF THAT EQUATION FOR "CONTROLS ON" PERIODS.

Source: Reproduced from Lipsey and Parkin, *op. cit.*, Figure 4.

The chart shows the difference between the actual rate of wage inflation and the rate of wage inflation predicted by the model that Lipsey and Parkin constructed. Because the model is only an approximation to reality there will always be a lack of precision in predicting the rate of wage increase at particular times. However, if the basic determinants of wage inflation stay the same then we should expect the precision of the model to stay the same through time. The shaded areas show the precision of the model during periods when controls were not in effect. As can be seen,

the model was usually successful in predicting the percentage change in wages to within one per cent of the actual change.

During periods of wage controls the normal wage-determining process is suspended to the extent that the controls are successful. Therefore, we would not expect the model, which contains only the normal variables, to predict well during such periods. In fact, we would expect the model to make errors during periods of control that would vary in size with the effectiveness of the controls. A positive error larger than about one per cent during the 'controls on' period indicates that the control period produced a larger increase in wages than would otherwise have occurred. A negative value less than about one per cent (negative) indicates that the controls were successful in reducing the rate of wage increase.

Using this criterion let us analyze the various control periods. The first control episode – that of Cripps – was clearly successful. The annual reduction in the rate of wage inflation was almost *two percentage* points. The 1956 episode averaged out at virtually zero. The 1961 freeze was highly successful but for a single quarter only and was followed by some catch-up effects which at least offset the gains during the freeze. This is seen in the chart as the sequence of wage rises in excess of those predicted in the absence of controls peaking at almost 3 per cent in 1963. The 1966 freeze is seen as highly successful but again very short-lived. It lowered wage change by more than three percentage points below the level predicted in the absence of controls. However, it was quickly followed by oversized wage rises of more than four percentage points in 1967.

Controls don't work on wages

The general picture concerning the effects of controls on wages, given the actual degree of labour market demand pressure and state of inflation expectations, is of a successful immediate postwar policy episode followed by a zero average thereafter. The study by Lipsey and Parkin and the large literature which grew out of this work did not explore the effects of the most recent controls introduced at the end of 1972. The only study done recently enough to examine

that episode is by Frank J. Reid of the University of Toronto though his study is not yet published.[9] Reid's study whilst more sophisticated than the earlier ones agrees with earlier findings on the success of the Cripps policy and on the temporary success of freezes. He finds that the freeze imposed during the first quarter of 1973 was also successful. However, his conclusions about the overall effectiveness of controls do not differ from my own.

About prices and expectations

The analysis of the effects of controls on the behaviour of wages which we have just reviewed leaves several questions in the air, two of which we now address. The first is, even if controls can temporarily hold wages back, do those effects feed through to prices? Second, do controls affect expectations of inflation, thereby reducing wage and price rises in a way that would be missed by the procedures described above? We take up each of these questions in turn.

The linkage between wages and prices is by no means an exact one even in the absence of controls. We can however, use the same procedure as described above to calculate that relationship (including an allowance for changes in import prices and productivity) for periods when controls are not operating and then use that relationship to predict the rate of price change which would have taken place given the rates of wage, import price, and productivity change. After conducting such an exercise, Lipsey and Parkin calculated that during the Cripps policy period prices *rose faster* by three-quarters of a percentage point per annum on the average than predicted, thereby partly though not wholly negating the successful reduction in the rate of wage inflation during that period.[10]

Prices not affected

A similar situation arose during the wage freeze of 1961. The only solidly successful reduction of the rate of price inflation relative to wage inflation was in 1956. For the remainder of the time, there is no discernible change in price behaviour. The implication of this is that, to some extent, 'successful' reductions in the rate of wage change

are offset by rising profit margins but, on the whole, the behaviour of prices under a controls program is not very different than would have occurred in the absence of controls.

Expectations

Do controls affect expectations of inflation thereby reducing both wage and price rises in an almost direct manner? This question has been addressed in a study by Carlson and Parkin.[11] Using the results of a monthly survey of individual expectations of future price increases they estimated a time series which measures variations in inflation expectations. The authors determined that inflation expectations are adjusted in the light of current inflation experience but are not influenced by the presence or absence of controls. This is broadly in line with results obtained by a rather different procedure for U.S. experience. For that country, changes in rates of interest on assets with various terms to maturity have been used to make inferences about the relationship between expectations about inflation and the length of time into the future about which expectations are held. Thus, for example, a person investing money for three months is thought to be concerned about (and have expectations about) the inflation rate three months in the future. Similarly for people investing for six months, two years, ten years and so on.

What emerges from these studies is that the short-term (three months ahead) expected inflation rate falls during a freeze but that longer-term expectations are little affected. These results are of course entirely in line with the notion that people form their expectations about economic phenomena in a rational manner using whatever information is available for the purpose. Controls have been seen to fail so often in the past in the U.K. that rational people's expectations are influenced little by their imposition.

IV THE SIDE EFFECTS OF CONTROLS IN THE U.K.

Four major side effects of controls were identified in the introduction to this chapter; resource misallocation, income

redistribution, a deterioration in industrial relations, and an increasing disregard for the rule of law. We now examine those assertions more fully. Unfortunately, important though these areas are, they are less easily documented and have been less comprehensively studied than the effects of controls on the rate of inflation itself. However, there is a good deal that can be said.

1. On misuse of resources

First let us look at resource misallocations. The most clear and obvious resource reallocation that takes place when comprehensive wage-price controls are introduced is that involved with the very process of administration of the controls. First, a statutory agency of some kind is usually set up which typically takes the cream of the civil service and brings in talented people from industry and the labour unions as well as from the legal and accounting professions. This, however, is just the tip of the iceberg. Just as government has to set up its own statutory body to handle the controls so major unions and firms have to hire specialist services to plead with, argue with, and make cases to the statutory body. It is very hard to quantify the loss from this resource reallocation and it indeed has been variable. Some controls in the British case hardly used any resources of this type at all but others, most notably that set up in the middle 1960's under the National Board for Prices and Incomes, absorbed an enormous amount of scarce talent.

The classical economic analysis of resource misallocation, in the face of relative prices that do not reflect market conditions, probably does not apply very seriously to the operation of wage-price controls. If the controls were totally inflexible and made rigidly to stick then such misallocations would occur and possibly indeed they do occur on a relatively limited scale for those short periods (usually not longer than three months) when controls have been absolutely rigid. However, I suspect that the resources expended in evading the controls are sufficient to ensure that relative prices do adjust to reflect underlying changes in supply and demand. Precisely how this is achieved will depend on the nature of the control regime.

Often it is possible to avoid the controls while remaining within the letter of the law. On the prices front this is most easily done by the skilful use of inventory and asset valuations designed to produce a particular impression concerning movements in unit costs. On the wages front there are sufficient possibilities for regrading workers so that, although the pay scales for particular jobs stay within the guidelines, the actual wages earned by any particular individual goes outside those limits. On occasions, however, it has been easier to avoid the controls by actions which are technically illegal. In these cases it is terribly hard, indeed impossible in the absence of court cases of which there have been very few, to provide documentary evidence. However, it was common knowledge (but based entirely on hearsay) that many British firms during the most recent phase of wage-price controls were evading the controls by writing invoices which sold output to subsidiaries overseas and then reimporting the material from the overseas subsidiary or agent at a price sufficiently high to ensure that their costs as a result of rising import costs were adequately large to justify the price which they wanted to charge for their output. In order to do this it was not necessary to incur the shipping costs of actually exporting and reimporting the goods. All that was necessary was to generate the documentation. This, of course, is a very simple procedure to pursue and almost an impossible one to police.

Although I have suggested that the classical resource misallocations arising from the fixing of disequilibrium relative prices are probably not serious in most cases, there is one aspect of the way in which controls were applied in Britain which probably did have an adverse effect on resource allocation. That is the tendency for wage controls to be written in such a way that they discriminate against the more highly-paid members of the community. In Britain there were often limits specified in terms of the flat rate of money increase. This of course would translate into a much smaller percentage increase for the better off than the poorest members of the community. Of course, it is usually sought to justify this type of arrangement in terms of equity arguments. However, that misses the point. High wages are

paid to those whose output is most valuable. If a government regulation tells employers that they may not pay their highly-skilled workers as much as they are worth, then firms will either have to find other ways of compensating those employees or run the risk of losing some of their services.

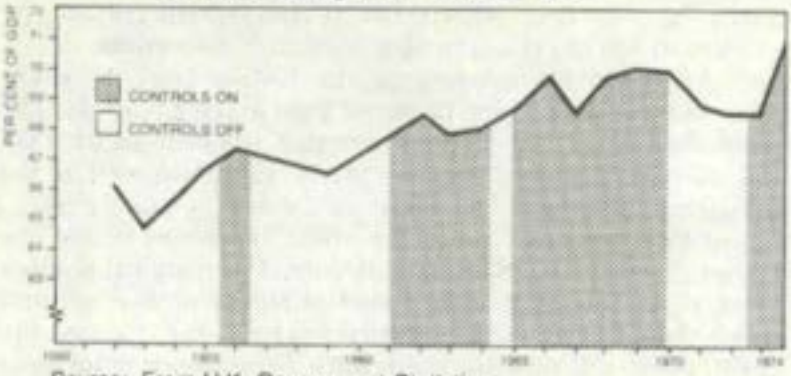
At the other extreme in the British case, the lower paid workers were more favoured than average workers. The permissible wage rise of the lower paid has been higher than the average, and has become the minimum as well as the maximum raise possible. This, of course, is exactly like a minimum wage law. It has the effect of pricing out of the labour market certain lower skilled and low marginal product workers. It therefore raises the unemployment rate amongst those classes of workers and carries with it the risk that the government will misread the resulting rise in unemployment and see it as a signal to stimulate aggregate demand, thereby generating even more inflationary pressures for the controls to attempt to contain.

A more serious consequence of the policy is the way in which price controls have been applied in the public sector especially during the recent 'social contract'. Government subsidies have been widely used in an attempt to hold down the price of public sector produced gas, electricity, public housing and public transport. Also, food has been subsidized. This has resulted in an enormous increase in the public sector deficit and borrowing requirement and far from reducing inflationary pressures has exacerbated them.

2. On the redistribution of income

The second major area in which controls have side effects is in the arbitrary redistribution of income which they cause. The first feature worth looking at here is that between labour income on the one hand and profits on the other. Chart 5 illustrates the share of employment income in the post-war years. Here we see that income from employment as a percentage of gross domestic product fell between 1952 and 1953, then climbed to 1956, fell slightly down to 1959, then rose to a peak in 1962 when it fell for one year, then rose to another peak in 1966 when it fell for one year, then, after peaking in 1968-69 took a prolonged slide down to

Chart 5 — Income from Employment as a Percentage of Gross Domestic Product, United Kingdom 1952-1974



Source: From U.K. Government Statistics.

1973 after which it surged forward again. Taking the period as a whole there has been a tendency for the share of income from employment in national income to rise. That share in 1952 was a little over 66 per cent and by 1974 had reached almost 72 per cent.

The factors making for that trend increase in the share of employment income would take us beyond the scope of this study. Furthermore, there is still a good deal of controversy surrounding that question. It seems likely that at least one of the main contributing factors has been the increased market power of labour that arises from a persistent commitment to a full employment program. However, despite the fact that there has been a trend increase in income from employment, there have been five occasions on which labour's share has fallen. Four of those are associated with the application of wage-price controls. This suggests that controls bite more heavily on employment income than they do on prices of final output and than they do, therefore, on profit margins. This would not be surprising in view of the fact that it is possible to single out and widely publicize wage settlements in particular sensitive sectors. In contrast to this, outside a few key products in the public sector, it is very difficult to pin down one or two key products for high publicity and rigid control.

It would be foolish to claim that the connection between controls and the dips in labour's share in national income are at all strong. There are several continuations of the reduction in the share of income from employment which run beyond a control period and two which precede a control period. Thus there are periods outside controls when labour's share has fallen. However, what is noticeable is that whenever controls have been in operation, labour's share has also fallen. This is not to say that because controls apparently have some potential for curbing the rise in labour's share that they are therefore doing a good job. There are other ways in which labour's share could be controlled if indeed it was desirable to control it: most notably by generating a competitive environment in labour markets which made workers responsible for getting their supply price right rather than placing all the responsibility for employment on the aggregate demand management policies of the government.

Much less easy to document are movements of relative wages which result from controls. There must be a strong presumption that the weak will lose under a control regime despite clauses favouring low wage groups. Governments usually try to avoid head-on confrontations with major and powerful groups of organized labour and therefore one way or another wage settlements for such groups are likely to be further from the guidelines and closer to the original claims than are those of weaker groups.

Also, not at all well-documented but highly likely, are redistributions within the corporate sector arising from the fact that some prices are more easily pegged than others. Highly-standardized products, for example, are easier to police than are highly-specialized items.

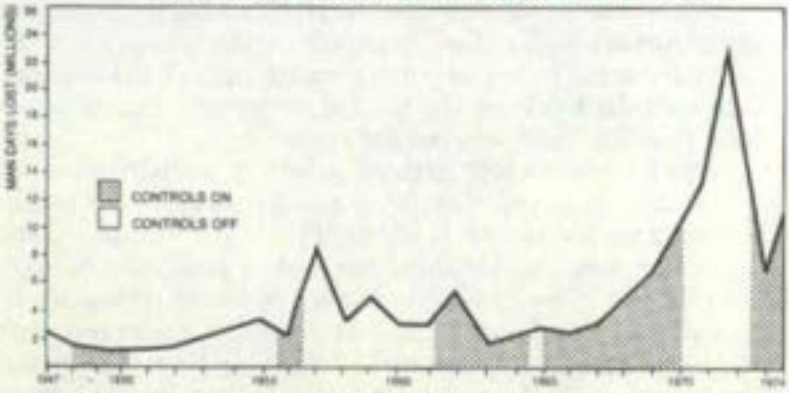
Possibly the most serious arbitrary redistribution of income in the British control experiments has been within the public sector and between the public and private sectors. Within the public sector there has been a great deal of wage disparity. As a rough approximation it seems reasonable to say that the private sector has probably on the average not been much affected by controls. In the public sector the administrators and those directly and indirectly involved in

the administration of the state's increasing economic interventionism have done very well. Real wages of administrative civil servants in Britain have increased as rapidly as those of any group in the economy. However, other public sector employees such as doctors, nurses, refuse collectors, teachers, academics and the like have all lost out over the past few years. Thus, the general pattern is that the administrative civil servants have done best, private sector employees have about held their own, while other public sector workers lost.

3. On industrial relations and strikes

The third major area in which controls have had a clear and devastating effect on the British economy has been in industrial relations. The British strike record is one of the most widely-known facts about that country in the rest of the world. That strike record, in terms of number of working days lost each year, is set out in Chart 6. What is significant about that chart is the strong trend growth in working days lost all through the 1960's. The very high peak of almost 24 million working days lost in 1972 is due almost entirely to the introduction in 1971 of the 'infamous' Industrial Relations Act. That Act, introduced by a Conservative government, generated a great deal of hostility from the labour

Chart 6 — Strikes in the United Kingdom, Number of Working Days Lost Annually 1947-1974



Source: U.K. Department of Employment Gazette.

movement and industrial relations in the period were very bad for reasons completely unconnected with controls. However, apart from that peak it is clear that controls have been associated with a tendency for the frequency of strikes to rise. The only exception to this is the relatively placid period of the immediate postwar years, at a time when there was a certain euphoric support for the first postwar Labour Government on the part of the newly-demobilized labour force.

In the period of the middle 1950's and throughout the 1960's we see that the more controls were prolonged, the higher was the volume of strike activity. This also seems to have applied during the reintroduction of controls in 1973-74. Of course, correlation does not prove causation. There seem to be three possibilities: i) controls cause strikes, ii) strikes cause inflation which lead to controls, and iii) some third outside factor both generates controls and strikes. The obvious candidate in this latter case is inflation itself. That is, a rising inflation rate could be thought of as both bringing on controls and generating more strikes. Unscrambling these three alternative possible causation theories is not at all straightforward. However, if we try to explain the variability of the inflation rate using the conventional hypothesis that the rate of inflation is higher the higher is the state of inflation expectations and the greater is the pressure on aggregate demand then we find that we can explain pretty well all of the variability of Britain's inflation rate and that there is no independent role left for strikes.[12] Thus, it seems fairly safe to conclude that strikes do not cause inflation.

Does inflation cause strikes though? In a study of the determination of strike activity in the British economy, Pencavel [13] has shown that there is a partial correlation between inflation and strikes. However, we must be very cautious how we interpret this correlation. *A priori* there seems no reason at all why a high rate of inflation should lead to a high volume of strike activity. We would expect strikes to arise because of a mismatching of expectations about inflation between the two sides of industry. On the face of it, it is very difficult to see why the two sides of industry should take different views about the rate of inflation in a

way that is systematically related to the degree of inflation. It seems much more likely that both sides of industry take broadly the same view but that because of government regulation labour unions need to demonstrate more strongly their determination to see their expectations given effect to.

Although one cannot be sure, it seems that the most plausible interpretation of the persistent increase in strike activity in the 1960's and the upturn again in 1973-74 is that it was caused by the government placing itself in a situation of confrontation with labour unions leaving them with the option of accepting a cut in real wages or using their market power, displayed through the strike weapon; faced with these alternatives, organized labour has opted for the latter.

4. On respect for the rule of law

This leads naturally into the final major and perhaps most dangerous side-effect of controls, namely the disrespect which they engender for the rule of law. The most effective way of ridiculing a legal system is to enact laws which have no way of being implemented. Perhaps the best example is that of King Canute standing on the beach and ordering the tide to stop. Although it looks less ridiculous it is in the same category of laws for a parliament to legislate that wages and prices will not rise or will not rise by more than a certain amount. It is akin to attempting by statute to repeal the law of gravity. When, as would be predicted, the law begins to be ignored or worse, when strong and well-organized groups line up against the law, this raises questions concerning the sovereignty and authority of parliament. In Britain, especially during the most recent phase of controls in 1974, this reached the amazing pitch of leading to a general election campaign on the central theme "Who Governs Britain – Whitehall or the Unions?" That particular episode illustrates this point most vividly.

In the winter of 1973-74 following the oil price rise of the fall of 1973 a major pay claim was put in to the Heath Government by the coal miners in the U.K. The miners had by that time suffered a relative fall in wages largely as a result of their weakening competitive position in a world of

cheap alternative sources of fuel and of a declining industry. However, as a result of the oil price rise, coal became a more viable source of energy. Also, the miners' union was somewhat more centrally and tightly organized by 1974 than it had been in earlier years. The combination of these two things enabled the coal miners to put in a large but, many would have judged, not unrealistic wage claim. The claim, however, was well outside the guidelines of the prices and incomes control program then in force. The Conservative Government dug in its toes, refused to meet the miners' demands and this led to a prolonged and very costly coal strike. The strike led to a massive reduction in electricity generation and eventually to most of the British economy moving onto a three day working week. This particular episode serves to illustrate, in fact, all four major side-effect arguments that have been advanced above. Here we have a clear case in which the controls led to a massive reduction in economic welfare as a result of lost output. They also were an attempt to force through an arbitrary distribution of income in opposition to undoubted market forces pointing in the direction of an increase in the relative wage of coal miners; they produced a crisis in industrial relations close to the proportions of the British General Strike of 1926 and finally brought about the fall of the Health Government in February 1974.

Of course, it could be argued that the particular policies being pursued by that particular government at that particular time were very unfortunate and were not of the essence of wage-price controls but just one extreme example of them. True, that episode was extreme, but it is the extremes that most vividly illustrate the dangers in pursuing policies such as these.

It has been argued that controls are counter-productive and that they do not control inflation and in addition have damaging side-effects. It may be thought that Britain's current control program contradicts to some degree these conclusions since with the latest episode of controls in operation, the rate of inflation is reported to be moderating. However, it would be wrong to attribute that inflation moderation to controls. Monetary policy has been on a

severely contractionary path since mid-1972 and it is that which has produced the present unemployment level of one million plus and has reduced the inflation rate. The lesson from the latest British experiment with controls is entirely in line with that of the previous episodes.

Notes

1. Among the earliest price and wage controls were those of Diocletian in the third century A.D.
2. Arthur W. Marget, *The Theory of Prices*, Vol 1. Kelly, New York 1966. Reprint of Economic Classics edition gives a superb and thorough history of the theory of money up to the middle 1930's.
3. For a detailed survey of the debate on the question, see David Laidler and Michael Parkin, "Inflation: A Survey," *Economic Journal*, December, 1975: Michael Parkin, "The Causes of Inflation:Recent Contributions and Current Controversies," in Parkin and Nobay (Eds) *Current Economic Problems*, Cambridge University Press, 1975; and Michael Parkin, "Where is Britain's Inflation Going?" *Lloyds Bank Review*, July 1975, Number 117, p. 1-13. (Note that there are some discrepancies between the charts in the present chapter and in the Lloyds Bank Review article. Those in this chapter are correct.)
4. The narrow money supply is used because there are good reasons to believe the broader definitions to contain serious distortions, especially in 1971-3. (See my Lloyds Bank Review article referred to in footnote (3) above.)
5. The 1964 starting date is selected because Britain's money supply data were not compiled on a comparable basis prior to that year.
6. For a convenient though somewhat technical summary source of much of that literature, see *Incomes Policy and Inflation* edited by Michael Parkin and Michael T. Sumner, University of Toronto Press, 1974.
7. For a detailed survey see Parkin, "The Causes of Inflation," *op. cit.*
8. See Richard G. Lipsey and Michael Parkin, "Incomes Policy: A Reappraisal," *Economica*, May 1970, reprinted as Chapter 4 in Parkin and Sumner (Eds.), *Incomes Policy and Inflation*, University of Toronto Press, 1974. See also for a survey of the econometric evidence on the effects of incomes policy-wage price controls, Chapter 1 of that volume.
9. Frank J. Reid, "The Rotation Hypothesis of Incomes Policy:An Empirical Test for the U.K., 1948-1973," University of Toronto, Department of Political Economy, 100 St. George Street, Toronto 5. (Mimeo)
10. See Lipsey and Parkin, *op. cit.* Figure 5 and discussion.
11. John A. Carlson and Michael Parkin, "Inflation Expectations," *Economica*, May 1975.
12. See Laidler and Parkin, *op cit.*
13. See John H. Pencavel, "An Investigation into Industrial Strike Activity in Britain," *Economica*, N.S. vol. 37 (147) p. 239-56.

CHAPTER 6
The USA, 1971–74: How Many Matzo Balls in the Soup?

(i) Michael R. Darby
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Among the books he has written is *Confessions of a Price Controller* (Dow-Jones Irwin, 1974) with Louis Neeb.

The USA, 1971–74: How Many Matzo Balls in the Soup?

(i) Economic 'Stabilisation' – the real effects*

Michael R. Darby

1. INTRODUCTION

President Richard M. Nixon announced his Economic Stabilization Program (ESP) on August 15, 1971. This program – popularly termed price and wage controls – was initially immensely popular and similar programs were soon established in other countries. The program expired on April 30, 1974, after an election-year Congress refused to renew authorization. This paper examines the nature and effects of the program as it evolved over time.

The most surprising feature of the program was that nearly the only enforced restrictive ceiling was that on increases in wages in unionized firms. In effect, the ESP was little more than a scheme for regulating the monopoly power of unions. When this rein was relaxed in January 1973, the program became a shell imposing administrative costs on many industries and serious effects in a few, but mostly 'full of sound and fury, signifying nothing'.

The ESP is generally credited with reducing the rate of

*from Michael R. Darby, "The U.S. Economic Stabilization Program of 1971-74" in Michael Walker, ed, *The Illusion of Wage and Price Control*, Fraser Institute, Vancouver 1976.

inflation during the first eighteen months of its existence, but in the last fifteen months inflation was recorded at a higher rate than would otherwise have occurred as prices 'caught up'. Taken as a whole, the ESP did not appear to have any effect on the average rate of inflation from the second quarter of 1971 to the third quarter of 1974. The reported swings in the rate of inflation appear to reflect initial hidden reductions in the quality of products. Such reductions were undertaken to avoid administrative costs involved in making large explicit price changes. After January 1973, these administrative costs were reduced or eliminated and firms began to restore quality.

II ORIGINS OF THE AMERICAN INFLATION

Price and wage controls were politically popular in the United States in 1971 because of widespread dissatisfaction with the rate of inflation then being experienced. Controls were popularly interpreted as strong political action to 'do something' about inflation.

The causes of inflation

Persistent inflation is always and everywhere a monetary phenomenon, as has been ably demonstrated by other essays in this series. That is, leaving aside year-to-year wiggles around the basic trend, the price level grows if, and to the extent that, money is created faster than the normal growth in the public's desire for money expressed in terms of the real goods and services that it can buy. The average price of goods and services must rise because until it does people will think that they have more cash than they desire and attempt to adjust their position by spending the 'excess'. This process will continue until prices rise and people's desire for cash correspondingly rises to absorb the available supply.

This relation is not perfect over any short period of time. In particular, prices and wages do not adjust immediately to an increased rate of money creation and so later must rise faster for a time – like a late starter in a race – to catch up. This cyclical adjustment of the rate of inflation to a change in the growth rate of the money supply is the

source of much confusion. At first, an increased rate of money creation induces increased spending and little increase in inflation so that real spending grows abnormally rapidly and unemployment falls. In time, workers increase their wage demands and inflation and unemployment rise while growth of real income and spending becomes abnormally slow. The growth rates of wages and prices seem disproportionate to the growth of money during this catch-up period and talk of 'cost-push inflation' becomes popular. When the catch-up is completed, the rate of inflation falls but to a rate higher than existed before the increase in the rate of money creation.[1]

Pre-control monetary policy in the U.S.

As in all industrialized countries, the growth rate of the U.S. money supply is determined by the central bank – in the case of the U.S., the Federal Reserve System, popularly called the Fed. For complex reasons peripheral to this paper, the Fed's monetary policy from 1963 to the start of controls can be characterized as accelerating money creation, except for slow-downs in the second half of 1966 and in 1969. As a direct result, the trend rate of inflation also accelerated, to the protest of the populace and the discomfort of the politicians.

The wage-price spiral

Politicians of course denied blame for the results of government policy and instead encouraged myths attributing inflation to greedy businessmen and greedy unionists. Increased inflation implies more rapid growth in prices and wages, but these are symptoms not causes. Still, businessmen were quite willing to hang any charge on unionists and so popularized the myth with respect to their adversaries. Unionists were pleased to return the compliment. With so much propaganda laying blame for inflation to the monopoly power of business or unionists, the public and press largely overlooked the undramatic money supply data and the careful complaints of academics. So the pressure rose to do something about the supposed villains.

III THE NATURE AND EFFECTS OF THE ECONOMIC STABILIZATION PROGRAM

On August 15, 1971, President Nixon announced the imposition of a 90-day freeze on all prices, rents, wages and salaries except for raw agricultural products and imports. This action, variously termed as Freeze 1 or Phase 1, was taken under authority of the Economic Stabilization Act of 1970, as amended. The Act had been passed by a Democratic Congress in an election year to provide debating ammunition against the Republican President who had pledged not to use the 'standby' authority to control prices and wages.

Phase I (Freeze I) was followed by Phase II, Phase III, Freeze II, and Phase IV, each with significantly different rules and regulations. The essential features and effects of each phase will be considered separately below.

Leaving aside the brief freezes, the basic philosophy of the controls was a cost-plus theory of pricing. A typical statement was:-

> "The standards announced by the Pay Board and the Price Commission imply the following arithmetic: If compensation per hour of work rises by 5.5 per cent per annum, and if output per hour of work rises by 3 per cent per annum, labor costs per unit of output will rise by approximately 2.5 per cent per annum. If prices rise in the same proportion as labor costs, which are the largest element in total costs for the economy as a whole, then prices will also rise by 2.5 per cent, a rate within the range of the goal set by the CLC." [2]

Price and wage rules were set relative to historical base periods for individual firms and there was no uniformity in permissible prices or wages between firms.

Exemptions were granted based on the size of firms (for prices), on the number of employees (for wages), on the industry, and on the level of wages.[3]

1. Phase 1 – surprise attack

The initial Freeze was a surprise action aimed at avoiding strategic price and wage increases while a more sophisticated

control program was formulated and implemented.

Just prior to the Freeze, the rate of inflation was running about 4.5 per cent per annum; so after the end of a 90-day freeze the level of prices would be about one percentage point below the level that market forces would have produced if the market price level had continued to grow at about the same rate as previously. Even this is a high estimate of the difference between what we might call the 'ceiling' and the 'market' price levels however. Since the growth rate of wages normally exceeds the growth rate of prices by the amount of productivity growth, a successful freeze on wages might cause the price level to fall over time. If this is to happen, the freeze on wages must not result in labor shortages. In fact, firms were able to hire increased quantities of labor at the frozen wage scales and employment grew at the rapid rate of 4.2 per cent per annum from August to November, 1971.

Wages the target

The major economic rationalization for the ESP was that the wage demands of nonunionized workers[4] and the agreed wages in union contracts included a substantial adjustment for expected inflation. It was argued that the ESP could speed the adjustment to a lower rate of inflation by reducing inflationary expectations and abrogating union contracts. Thus the temporary increase in unemployment that would have been associated with a decrease in the growth rate of the money supply would be reduced or eliminated. As will be shown below, the Fed increased money supply growth to new heights during the Freeze instead of reducing it. Nevertheless, during the brief life of the Freeze the hoped-for reduction (or perhaps postponement) of wage increases seems to have occurred.

The price freeze restricted most prices only trivially if at all; the market price for some goods actually rose significantly because of increased demand or cost conditions. This was especially true for restaurant meals and processed foods as prices of raw agricultural products were exempt from controls. Where it was difficult to conceal reductions in quality or portions, products became unavailable except in new

higher priced 'deluxe' versions (the-cherry-on-the-top phenomenon).

2. Phase II – wage and price controls?

The Phase II program (November 14, 1971 – January 10, 1973) bore little resemblance to standard ideas of price and wage controls. No economy-wide regulations were issued as to maximum permissible prices for certain products or maximum permissible wage rates for certain types of labor. Instead regulations were applied on a firm-by-firm basis. Subject to exceptions and exemptions, there were three key constraints imposed on firms: (1) Profit margins were limited to the average of the best two of the three fiscal years preceding Phase I. (2) Wage scales were limited to a 5.5 per cent per annum rate of growth. (3) Large firms had to obtain prior approval for any increase in prices (firms with sales of $100 million or more) or wages (firms with 5000 employees or more). These constraints, as well as other subsidiary regulations, were supposed to be enforced by a staff of less than 4000 people.[5]

The price formula

The general standard for price increases was that prices could increase proportionately to increases in costs. But this is exactly what happens in any pure inflation and so provided no real constraint for most firms. Only where major shifts in relative demand or supply increased the market return to factors of production owned by the firm – notably in the lumber, oil, and leather industries – was the profit margin rule a serious limit. Most firms required only a little creative accounting[6] to meet the profit margin ceiling.

With prices essentially uncontrolled – so long as they rose in normal proportion to costs – the program could affect the rate of inflation only by reducing the rate at which costs were growing. This was the role of the wage controls.

Wage controls

Generally wage controls are very easy to evade as long as employer and employee both find it advantageous to do so.

For example, the number of hours worked can be over-reported or a spurious promotion made with no real change in duties. It will be in the interest of employers in competitive labor markets to evade the controls as otherwise they will lose employees to those who do so.

Unions the target

This is not true for unionized firms. U.S. labor laws in effect give unions the power to impose considerably higher wages than required to obtain the number of employees that the firm is willing to hire at those wages. Under the ESP, the maximum wage demands that firms would be required by the courts to meet were limited to a 5.5 per cent per annum increase. Nearly all unionized firms could still hire all the employees they desired under the controlled wage rate and so had no incentive to evade the wage controls. In effect, the government imposed a price regulation on the unions who had previously been granted monopoly power. It may not be surprising that the Nixon administration should use the Economic Stabilization Act to benefit the owners of unionized firms at the expense of union leaders and members[7] given the general support of the former and opposition of the latter in the 1968 and 1972 Presidential elections.

Generally, firms in competitive markets could and did easily evade the wage ceiling where it was less than the market wage. Unionized firms were quite willing to abide by the reduced wage scales. The only real enforcement of the wage ceiling was the unwillingness of the courts and the ESP administration to approve union contracts which exceeded it by much. Little actual evasion was required by non-unionized firms as low-wage and small-firm exemptions excluded most private nonfarm workers from any controls.[8] Significantly, the small-firm exemption did not apply to the heavily-unionized construction industry regulated under the Pay Board's Construction Industry Stabilization Committee.

Effects on wages and employment

The impact of the controls on union wages was to increase the number of workers which unionized firms were willing

to hire. As a result some workers were shifted from less productive work in non-unionized forms to more productive work in unionized firms and total output increased. Unfortunately, there is no satisfactory way to estimate the precise net increase in total output which resulted. Earlier estimates of the reduction in U.S. real output due to unions' monopoly power to set wage rates were approximately 0.3 per cent of gross national product at most.[9] So although the precise increase in output due to the reduction in union power is unknown, it must have been at most about one quarter of one per cent. Even if the demand for money in terms of real goods and services were increased proportionately, [10] this would imply at most a 0.25 per cent decrease in the price level compared to what it would otherwise have been. So the increase in real output and the reduction in the price level due to Phase II wage controls were both relatively trivial.

Prices up, quality down

About 1700 large firms were required to obtain prior approval from the Price Commission in order to raise prices. In granting increases, the Price Commission did not adhere to the general regulations. For example, the excess of wage increases over 5.5 per cent per annum even where approved by the Pay Board due to some provision of law might not be included in allowable costs. Historical averages of industry productivity growth were substituted for firm-by-firm experience. However 'cost justified' large price increases were not approved. Firms could and did avoid the administrative costs of separate applications by entering into 'term limit pricing' agreements permitting them to raise prices at an average rate of, say, 1.8 to 2.0 per cent per annum with no single price to be increased by more than an agreed amount such as 8 per cent.

Although stated prices were controlled, there was no staff on the Price Commission to attempt to control the quality of goods. So firms which would otherwise have increased prices by 4 per cent were free to increase prices by the approved amount, say 2.5 per cent, and to make up the difference by reducing quality so that unit costs fell, in this

case by 1.5 per cent. So long as the quality reduction was covert and profit margins did not exceed the firm's allowable limit, no penalities were incurred.

Government statistical agencies find it difficult to correct for quality changes in normal times; it is therefore not surprising that they should miss most such covert deterioration in quality. As a result, the reported price index appears to have fallen steadily below the 'true' price level – the price level adjusted for the changing quality of goods – during Phase II. Section III below presents estimates of the true changes in the price level adjusted for such omitted changes in quality. These estimates indicate that the reported price index rose about 0.2 per cent per month or 2.5 per cent per annum less than the true price level.

Phase II controls were generally quite popular except with unionists. The President had taken apparently dramatic and effective action which reduced the apparent rate of inflation with virtually no allocative ill effects.[11] Nevertheless, with the Presidential election over in November 1972 and increasing popular doubt about the reported low rates of inflation, the program had outlived its political usefulness by the end of the year and change was in order.

3. Phase III – prices catch up.

The Phase III program (January 11, 1973 through June 12, 1973) removed the requirements for prior approval of price increases except in a few listed industries. The profit margin limitation remained in force as did the 5.5 per cent per annum standard for wage increases. Prior approval of wage increases was largely discontinued as well.

The main change was the removal of the requirement that large firms receive prior – and arbitrarily limited – approval of price increases. As a result, these firms were free to increase their prices not only in proportion to the increase in costs required to produce a unit of given quality but also in proportion to the increased costs necessary to restore the previously degraded quality. So whereas in Phase II the rate of inflation had been consistently *underreported* in the official price indices, with the beginning of Phase III the rate

of inflation was *overreported* because of a failure to correct for the restoration of quality.

For these reasons, the consumer price index rose at a rate of 9.0 per cent per annum from January to June 1973 as compared to 3.5 per cent per annum from July 1972 to January 1973. In something of a panic Phase III was abandoned.

4. Freeze II and Phase IV – opposition becomes unanimous.

Freeze II (June 13, 1973 to August 11, 1973) was imposed to permit reformulation of stricter controls. All prices except rents and raw agricultural products at first sale were frozen at their June 1-8 levels. Wages, however, were allowed to rise as under Phase III. So, unlike the first freeze, firms faced price ceilings which fell relative to the market level of prices. Shortages and outright cheating became more common. Food shortages in grocery stores forced the administration to begin Phase IV food regulations on July 18, 1973.

The fiasco which was Freeze II was soon replaced with Phase IV (August 12, 1973 to April 30, 1974). Phase IV continued the relaxed Phase III wage controls and reinstated Phase II requirements for prior notification and approval of price increases by the largest firms, with the exception that applications not acted on in 30 days could be implemented. This permitted the ESP administration to allow price increases where required to avoid shortages without any explicit approval. The profit margin limit was replaced with a limit on the dollar amount of net income per unit – profits were permitted to increase only in proportion to unit sales.

The unit profit limit was hard to enforce but was sufficiently restrictive that most remaining supporters of controls on the business side joined unionists in opposition. Much of the general public had also lost its naive faith in the efficacy of controls.

Besting the bulge

The main thrust of Phase IV, however, was gradual decontrol. At the end of Phase II, owing to its failure to account for the decline in quality, the government price index underreported the 'true' price level by about 4 per cent.

By the end of Phase III, this difference was reduced to about 2.5 per cent.[12] The main objective of Phase IV was to spread the 'bulge' in the reported rate of inflation over as long a period as possible. The idea is a simple one; if the true rate of inflation were a constant 6 per cent per annum and the 2.5 per cent gap between the reported and true price indices were eliminated over a year, then the reported rate of inflation for that year would be 8.5 per cent per annum. If instead the gap was eliminated over six months, the price index would rise in those six months 5.5 per cent or 11 per cent per annum which would look much more alarming.

In the first four months of Phase IV, industries were selected for decontrol primarily to eliminate or prevent shortages of basic materials. As it became increasingly unlikely that an extension of the Economic Stabilization Act would pass Congress, the pace of decontrol accelerated in 1974. The Cost of Living Council (the ESP administrative body) devised a technique for spreading the inflation bulge beyond the expiration of controls. This was to exchange decontrol for an agreement by the major firms in an industry as to pricing policy for some months after control. As the April 30th expiration date became a certainty, the Council's ability to persuade firms to enter such agreements dried up.

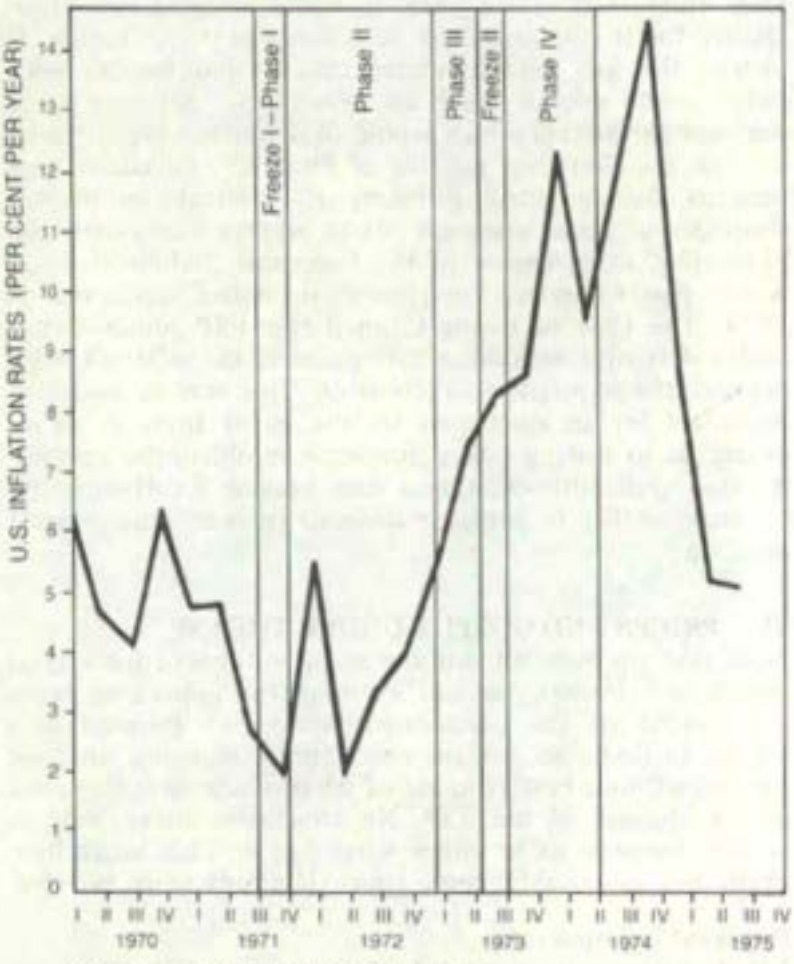
IV PRICES AND OUTPUT UNDER THE ESP

Now that we have set out the main features of the various phases and freezes, we can examine the impact on prices and output of the Economic Stabilization Program as a whole. In doing so, we are necessarily comparing what *did happen* withour best estimate of what *would have happened* in the absence of the ESP. No conclusive answer can, of course, be given as to either what was or what might have been, but reasonably good approximations seem possible.

Reported inflation rates

Let us first examine what *did* happen. Figure 1 shows the rate of inflation as measured by the 'price deflator for gross national product (GNP deflator)'. This price series is calculated for each quarter by the government as the ratio of two

Figure 1 — U.S. Inflation rates as estimated by the GNP Deflator, 1970-1975



Source: U.S. Department of Commerce.

numbers. The number in the top of the ratio is the government's estimate of total spending in the economy during the quarter. The number in the bottom of the ratio is the government's estimate of the value of total spending in terms of prices that prevailed in some base or benchmark period. Calculated in this way, the price series has a value of 1, in the base period and values in subsequent periods that reflect movements in the prices of goods away from their level in the base period. The price series calculated in this way is called a 'deflator' because it can be used to deflate or translate current spending estimates into spending estimates at base year prices. The GNP deflator is the U.S. price series with the broadest coverage and includes price information about the whole range of spending in the U.S. As is evident from Figure 1, the reported growth rate of the GNP deflator during Freeze I and Phase II (third quarter 1971 through fourth quarter 1972) dropped to 3.2 per cent per annum compared to an average inflation rate of 5.2 per cent per annum in the preceding six quarters. Shortly after the advent of Phase III during the first quarter of 1973, inflation, as estimated by the GNP deflator, rose above the previous average and did not return to the 5 per cent per annum range until the second and third quarters of 1975. It is therefore quite easy to understand the popular impression that Phases I and II were effective in reducing the rate of inflation whereas the rest of the ESP was not.

Inflation rates corrected for quality changes

The earlier discussion of Phase II showed that there were considerable incentives for large firms to evade the administrative limits on price increases through covert reductions in the quality of their products. In later phases relaxation of prior approval and decontrol permitted restoration of previously degraded quality. The nature of the ESP thus leads us to suspect that price increases (corrected for quality changes) were *underreported* through the fourth quarter of 1972 and thereafter overreported until the decontrol process was complete.

Fortunately, there is a way to obtain estimates of the inflation rate (the GNP deflator) corrected for changes in

quality. Before considering how I actually did that I want to give an example of how it is done using a more everyday example. Suppose that we were interested in measuring the rate of increase in the price of hot chocolate mixes from 1973 to 1974. Suppose that we knew the total number of boxes sold in 1973 and the total dollar amount spent on chocolate mixes; by dividing total dollars spent by the total number of boxes sold we would get the average price of a box of hot chocolate mix. Assuming that the information was available, we could perform the same calculation for 1974 and then calculate the percentage increase.

The situation would be made more complicated if we had reason to believe that the quality of the mix had changed from one year to the next. Suppose, for example, we found that 1.5 teaspoons of the 1974 vintage were required to brew an excellent cup whereas only 1 teaspoon of the 1973 mix was required – a difference caused by the percentage of cocoa in the mix. We would have to conclude that the quality of the mix had fallen. As a result, our price calculation would have to be adjusted to reflect the decline in quality. One method of making the adjustment that parallels the method of adjustment that I use later to correct the GNP deflator can be described as follows.

The nature of the ordinary calculation described above is essentially that of dividing a total spending number (dollars spent on chocolate mixes) by a measure of quantity or output (number of boxes of mix sold). By simply using a different, quality-adjusted measure of output with the same total spending number we arrive at a quality-adjusted price of chocolate mix in 1973 and 1974. In the present case, it would be appropriate to use the number of ounces of raw cocoa used in the preparation of one box as an adjustment factor to derive an adjusted output number. Having done this we would find that hot chocolate mix had increased in price by a larger amount that the simplistic calculation – based on the assumption of unchanged quality – had led us to believe.

In the case of total spending in the economy (GNP) and the associated price (GNP deflator) the adjustment procedure is the same as that just described. However,

because a quality-adjusted output number is not readily available, the procedure is more complicated. In calculating the price of total output for the economy, government divides total spending in the economy by an estimate of total output. To calculate the quality-adjusted or 'true' price of total output I divided total spending by my own estimate of total output.[13] In the case of hot chocolate mix we would have been able to use input of raw cocoa as an adjustment factor. In the case of total output, for reasons discussed below, I have used the input of labour to make the adjustment.

First, I estimated the growth rate of quality-adjusted real output (GNP). I made this estimate using a trend or normal growth rate adjusted for the quarter to quarter change in the percentage of the labor force unemployed. This procedure is derived from a well-established relationship between output and employment known as Okun's Law.[14] Since the Law is based on statistical regularity and the period of controls was not 'regular' in that sense, our estimates are subject to two sources of error. To the extent that the controls reduced union power, the relationship between output and employment imbedded in Okun's Law would tend to underestimate real output. On the other hand, shortages and administrative costs may have reduced the amount of output forthcoming from a given amount of output forthcoming from a given amount of effort and therefore the output estimate would tend to over-estimate actual output. Since both of these sources of error were of trivial magnitude and offsetting in their effect on the output estimate I did not attempt to adjust Okun's Law to take them into account.

Having calculated a quality-adjusted growth rate for total output it was a simple matter to use this growth rate to calculate estimates of the level of total output and hence a quality-adjusted price of total output.

Table 1 shows that the apparent sharp decline in the rate of inflation during Phases I and II was a statistical illusion. Indeed, the average rate of inflation corrected for quality changes rose slightly during the first six quarters of the ESP. Nor do the corrected data show such a dramatic

increase in the average rate of inflation during the latter part of the control period.

The statistical illusion

Table 1 – Actual and Quality-Corrected Inflation Rates, U.S. 1970-1975

Periods	Average Rate of Inflation	
	Government Data	Corrected for Quality Changes
1970-I – 1971-II	5.2	5.2*
1971-III – 1972-IV	3.2	5.4
1973-I – 1974-III	9.0	7.0
1974-IV – 1975-I	11.4	11.4*
1975-II – 1975-III	5.1	5.1*

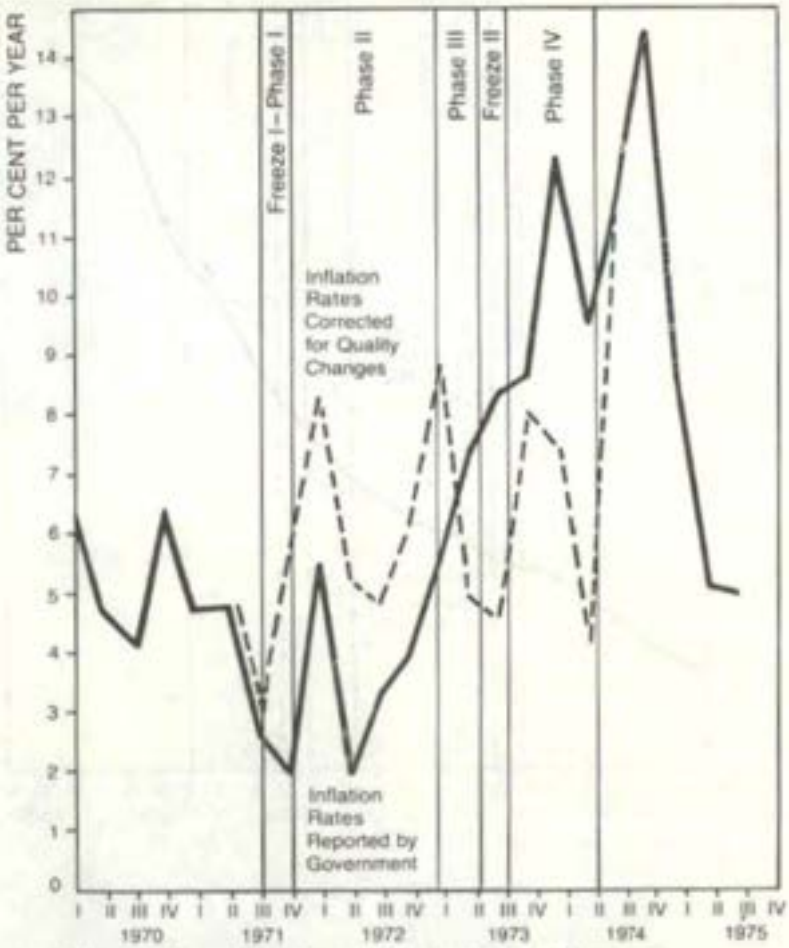
Compounded annual rates of change over previous quarter in GNP deflator (per cent per annum). Corrected data for periods not affected by the ESP (marked with asterisks) are identical to the government data.

Sources: See Figure 2.

Figure 2 shows the estimates of the inflation rate corrected for quality changes together with the inflation rate reported in the government data. As would be expected from the detailed examination of the ESP regulations, the initial freeze involved little evasion, but the government data underreported inflation during Phase II and then overreported inflation in the succeeding Phases.

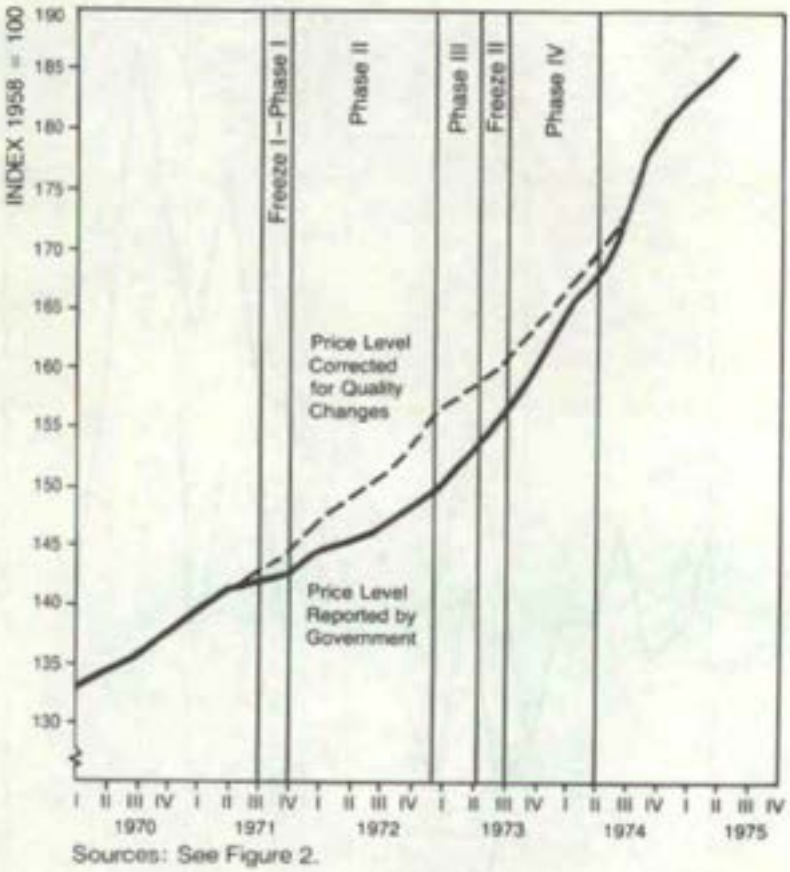
An alternative way of illustrating the effects that quality variation has on the reported price of total output is by comparing the reported and corrected estimates of the national price level. This is done in Figure 3. The difference between the reported and corrected price level represents the accumulated effect of quality degradation. This difference grows during Phase II and is thereafter reduced. The trend of the corrected price level appears little affected by the ESP.

Figure 2 — Reported rates of inflation compared with rates corrected for quality changes, U.S. 1970-1975



Source: Reported data — U.S. Department of Commerce.
Corrected data — Computed from data in M.R. Darby, "Wage and Price Controls: Further Evidence," in K. Brunner and A. Meltzer (eds.) Carnegie-Rochester Conference Series.

Figure 3 — Reported price level compared with price level corrected for quality changes, U.S. 1970-1975



Sources: See Figure 2.

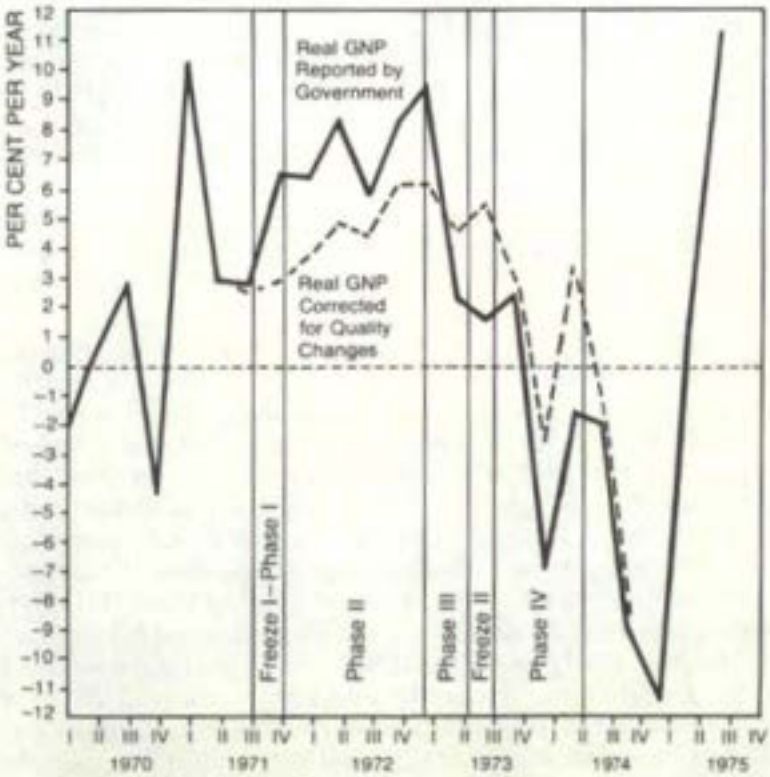
Output changes

As we saw earlier, if the assumption is made that quality has not changed, but it has in fact changed, then calculations based on that assumption will yield an overestimate of real

GNP. Figure 4 compares the growth rates of real output as reported in the government data with those of the corrected data implied by Okun's Law. Figure 5 does the same for the reported and corrected estimates of the level of real GNP.

The corrected data show slower growth rates through the first quarter of 1973, and faster growth rates thereafter.

Figure 4 — Reported growth rates of real Gross National Product compared with growth rates corrected for quality changes, U.S. 1970-1975



Sources: See Figure 2.

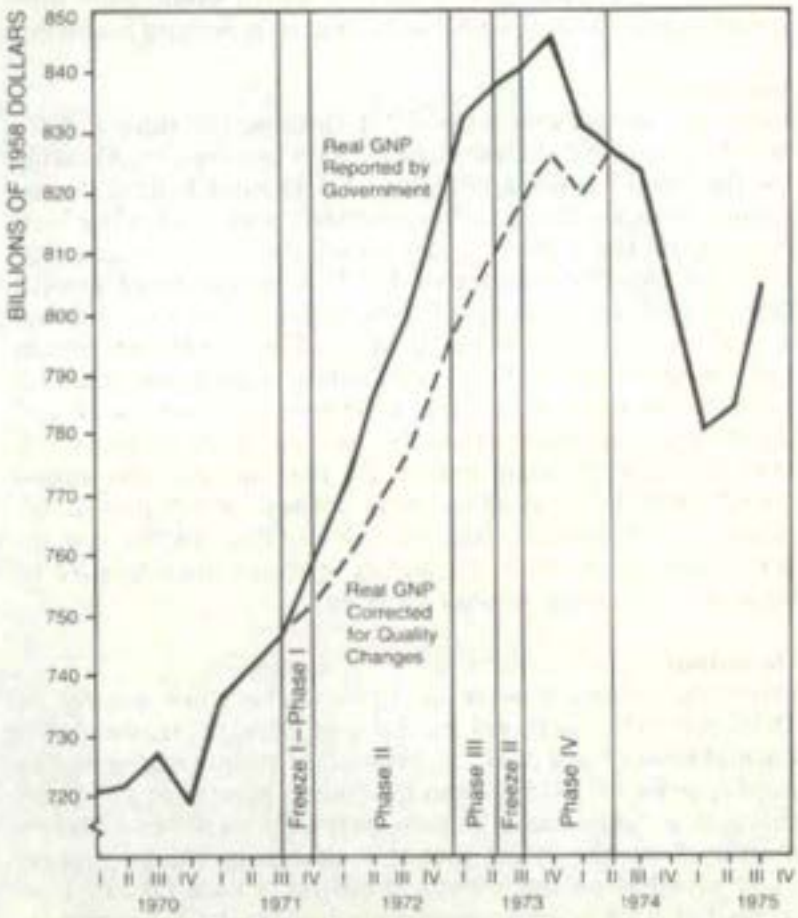
Some confirmation for the correction procedure is provided by the much closer agreement of the corrected data during 1973-74 with the behaviour of such physical unit series as industrial production, employment, and railway box car loadings. These series did not seem to fall nearly as much as would be expected from the reported fall after the fourth quarter of 1973 in real GNP. Indeed, employment continued to rise through September 1974. Thus the corrected data show about the same effect from the October 1973 – March 1974 Arab oil embargo as would be expected from a major strike of similar duration.

Monetary policy during the ESP

The dominant influence on the behaviour of prices and output – at least over periods of several quarters – is monetary policy. So to discover whether the (corrected) price and output behaviour was different because of the ESP, it is necessary to make some assumption as to what monetary policy would have been in the absence of the ESP. There is no obvious alternative monetary policy that one may suppose the Fed would have followed in the absence of the ESP; so the discussion will assume that monetary policy would have been the same in the absence of ESP as it was in its presence.

This assumption may be unduly favorable to controls because the growth rate of the money supply was sharply increased to 8.0 per cent per annum from December 1971 through June 1973 as compared to the previous trend of about 6.0 per cent per annum. It may well be that the effect of the ESP on the reported data reduced the Fed's concern over inflation. The ESP was supposed to reduce the expected rate of inflation and hence ease the adjustment to lower rates of money supply growth and inflation. Apparently the Fed did not get the message since it increased the money supply growth rate when it should have reduced it. So previous progress against inflation – achieved at a cost that included the 1969-70 recession – was thrown away and the U.S. had to suffer another deceleration of money supply growth from July 1973 through January 1975.

Figure 5 — Reported real Gross National Product compared with GNP corrected for quality changes, U.S. 1970-1975



Sources: See Figure 2.

V. LASTING EFFECTS OF THE ESP

The first question is whether the ESP had any lasting effects on prices and output or whether any early effects were washed out after the policy ended? We can answer this question by using government data for pre-ESP and post-ESP magnitudes with little concern about a bias arising from the effects of controls. At this writing, the latest available data is for the third quarter of 1975 which would seem sufficiently past the end of ESP to be free of reporting problems.

On prices

From the second quarter of 1971 through the third quarter of 1975, the GNP deflator rose by 31.9 per cent.[15] Allowing for the usual lag of 1.5 years for price changes behind money supply changes, this is to be compared with a 31.0 per cent increase in the money supply from the fourth quarter of 1969 to the first quarter of 1974. Now the trend growth rate of the real quantity of money demanded over the last several decades is between 0 and 0.5 per cent per annum depending on the method of calculation used. So over 4.5 years the increase in the price level should be between 0 and 2 percentage points less than the increase in the money stock over the corresponding period. So the fact that the actual growth in prices *exceeded* that of money by 0.9 percentage points would indicate that the overall effect of the ESP on prices was either nil or to slightly increase them relative to what they otherwise would have been.

On output

From the second quarter of 1971 to the third quarter of 1975 real GNP increased by 8.4 per cent. [16] However, the unemployment rate was 2.4 percentage points higher in the third quarter of 1975 than in the fourth quarter of 1971 and this had a depressing effect on output growth. In order to abstract from the effect that this change in the unemployment rate had on the growth of output, I used Okun's Law to predict what output would have been had the unemployment rate been the same. By my calculation, if the unemployment rate had not changed then real output would have risen 15.6 per cent (or 3.5 per cent per annum) had

unemployment been the same. This growth rate is a bit higher than the trend growth rate of 3.1 or 3.2 per cent per annum over the last century but less than the 3.7 per cent per annum trend of the 24 postwar years before the controls. So, except to the extent that the unemployment rate in the third quarter of 1975 was influenced by the ESP, there is, in the case of output as well, no evidence of a lasting effect of the ESP.

Short-run effects of the ESP

There are no models which can consistently predict the rate of inflation in any particular quarter with an accuracy of, say, plus or minus one percentage point. Because it is difficult for us to ascertain what prices would have done in any particular quarter in the absence of controls it is correspondingly difficult to ascertain what the effect of controls was in any particular quarter. As we have just seen, this does not preclude an assessment of the overall effect, but does render difficult the assessment of particular short-run periods like Freeze I which lasted for only one quarter.

On the basis of my research I would have to conclude that the quality-adjusted price data behave very much as would be expected from the behaviour of money supply growth and that controls had no discernible effect in particular quarters except in two instances:

(1) Freeze I reduced the level of prices relative to the predicted level by about 1 per cent during the third quarter of 1971 and the fourth quarter of 1971, but this was mostly caught up during the next two quarters.

(2) The very high rate of inflation during the fourth quarter of 1974 was considerably higher than would be expected but this appears to have been largely offset by the reduced rates of inflation during the second quarter of 1975 and the third quarter of 1975.

The effects of Freeze I were seen in Section II to reflect a brief increase in the number of employees who could be hired at the frozen wage because of reduced expectations of

inflation. The temporary real reduction in the price level was reflected in a temporary increase in employment and real output.

The 14.4 per cent per annum rate of inflation in the fourth quarter of 1974 was about 6 percentage points higher than would be expected from past monetary policy. This anomaly may have been caused by strategic price increases due to widespread fear that controls would be reimposed and to an illusion that such price increases were possible; an illusion fostered by a naive public acceptance of the over-reported rates of inflation during the decontrol period. While this price behaviour undoubtedly worsened the recession caused by the July 1973 - January 1975 deceleration of money supply growth, it is too tenuously related to be fairly attributed to the ESP.

VI. EVALUATIONS AND CONCLUSIONS

The major direct effect of the Economic Stabilization Program was to impart a significant bias to government price indices such as the GNP deflator: inflation was underreported during Phase II and overreported thereafter through the decontrol period. America is blessed with statistical bureaus staffed by diligent, honest civil servants who would never go along with fudging the data. The ESP's combination of arbitrary price ceilings on large firms and a tiny enforcement staff induced firms to provide 'prefudged' data to the statistical bureaus which in turn used it in all good faith to compute the price indices. Given the difficulties which these bureaus face in correcting for overt changes in quality, they can hardly be blamed for missing such covert changes.

When the data are corrected for quality changes, only Freeze I seems to have been successful at the stated goal of reducing the rate of inflation. Even that success was balanced by more rapid inflation in the next few quarters. The growth in the price level from the last pre-ESP quarter to the latest post-ESP quarter was certainly no less rapid than would have been anticipated in the program's absence. Similar, real income growth was stimulated during Freeze I, but any such effect soon washed out. So, as a means of reducing inflation and increasing real income, the ESP was a failure.

Early defenders of the ESP had argued that while the program could not reduce inflation of itself, it could ease the adjustment to a lower rate of inflation brought about by monetary policy. The idea was to reduce inflationary anticipations by a bold political stroke so that the temporary increase in employment associated with reduction of inflation rates would be moderated. Unfortunately, the Federal Reserve System instead of reducing the growth rate of the money supply significantly increased it and hence the inflation rate. This may have reflected a naive acceptance of the underreported Phase II inflation rates or simply a feeling that the ESP relieved the Federal Reserve System of responsibility for controlling the inflation rate. It is a nice question whether it is politically feasible for the central bank to continue monetary restraint after the imposition of such a program.

Phase II in effect subjected unions to regulation of their monopoly power. But the lost output due to union power is normally a trivial percentage of total output so any reduction in union power could only result in a trivial percentage gain.[17] Against this gain must be weighed the loss of output due to the administrative costs of the program and misallocated resources in the industries restrained at one time or another by controls. It would be difficult to conclude that benefits significantly exceeded the costs.

In sum, the Economic Stabilization Program was little more than a huge public relations scheme. Some were hurt, some were helped. A few quarters showed lower inflation rates than would be expected, others showed higher inflation rates. Many people still believe that Phase II was a success and if such a program were implemented without the mistakes of Phases III and IV, a controls program would be effective. This conclusion was seen to rest on biases in the data reported by the government. For little economic gain if not a small loss, people's civil rights to own property and enter into exchanges with consenting adults were limited. The resulting deterrent to future investment may well be the only important and lasting effect of the program.

Notes

1. For a complete analysis, the interested reader should see Michael R. Darby, *Macroeconomics: The Theory of Income, employment, and the Price Level*, New York: McGraw-Hill, 1976, especially Chapter 7.
2. U.S. Council of Economic Advisers, *Economic Report of the President* 1972, Washington: Government Printing Office, 1972, p. 96.
3. Low-wage employees were exempted by statute.
4. Note that only 20 to 25 per cent of the U.S. labor force belong to unions.
5. U.S. Council of Economic Advisers, *Economic Report of the President* 1973, Washington: Government Printing Office, 1973, p.66.
6. Such as 'conservative' valuation of end-of-period inventories so as to increase the reported cost of goods sold and reduce the reported net income.
7. Workers in nonunionized firms and consumers also benefited – while owners of nonunionized firms were hurt – from the regulation of the unions' monopoly power, but the dollar amounts *per individual* in these much larger groups was much smaller than for those directly involved with unionized firms.
8. Fifty six per cent were exempted as of July 1972 according to U.S. Cost of Living Council, *Economic Stabilization Program Quarterly Report*, Covering the Period July 1, 1972, through September 30, 1972, Washington: Government Printing Office, 1972, p. 33-34.
9. Albert Rees, "The Effects of Unions on Resource Allocation," *Journal of Law and Economics*, October 1963, 6: 69-78. Rees estimated that there might be a similar reduction in real output because of wasteful work rules, but these were not covered by the ESP.
10. Money demand in fact increases less than in proportion to short-run changes in output.
11. The lumber, oil, and leather industries (accounting for a bit less than 2 per cent of gross national product) were the only ones with significantly restrictive profit margin ceilings. Evasion was nevertheless quite easy in the multiproduct and deconcentrated lumber and leather industries and added little to the consumers' cost of those products. Oil was relatively easy to control as to both price and quality and shortages of fuel oil arose.
12. See Section III below for more detail on these estimates.
13. By the method of calculation, growth in real GNP will be overreported to the extent that the rate of inflation is underreported: so an independent estimate is necessary.
14. Arthur Okun, "Potential GNP: Its Measurement and Significance," *1962 Proceedings of the Business and Economic Statistics Section of the American Statistical Association*, p. 98-104.
15. Or 6.7 per cent per annum.
16. Or 1.9 per cent per annum.
17. The dollar amount is nonetheless on the order of $2 billion which is not trivial in itself.

(ii) "Is prostitution a service industry or a regulated utility? — Dilemmas of a Price Controller."*

C. Jackson Grayson

I INTRODUCTION

On the 18th of October, 1971, I assumed responsibility for the Price Commission in the conduct of Phase II of President Nixon's Wage and Price Control program. A detailed account of the 15 months of the program is to be found in my book with Louis Neeb, *Confessions of a Price Controller.* The purpose of this essay is not to reiterate that ground but to attempt to draw out of it lessons for the future. In the course of the essay I will draw several conclusions about wage and price controls policies that arise not from a detailed economic analysis, but from common sense reflections on my experiences during Phase II.

II THE MAKING OF POLICY

In coming to the task of Chairman of the Price Commission I was new to the economic policy 'game' and certainly shared some of the popular delusions about the way in which the policy process worked. In particular, and without having given the matter much thought, I was under the impression that economic policy was conducted in a very precise fashion in a milieu somehow above the foibles of human nature. It is easy to understand how and why I might have had that

*from C. Jackson Grayson, "A View from the Outside of the Inside of Upside Down", in Michael Walker, ed, *The Illusion of Wage and Price Control*, Fraser Institute, Vancouver 1976.

impression. I think that the average person wants to think that somewhere somebody does know exactly what is going on and what needs to be done about it. Few people want to believe that the policy-making process is as uncertain (perhaps more so) and as subject to human frailty as the economic behavior that policy attempts to control.

In the course of the next few pages I want to relate something about my view of policy-making at the national level. I want to explain why it is inherently a confused sort of occupation and I want to imbue the reader with a healthy skepticism for the ability of central control to solve economic problems.

Information overload

One of the main reasons why the policy-making process in general and wage and price controls in particular are inherently difficult is because they are attempting to regulate the most sophisticated information system that the world has ever seen – namely the North American market economy. Information from market decisions leads to decisions that determine the production, income and spending activities that, taken together, are the economy. It tells people when to hire more (or fewer) people and machines, it tells people how much they can expect to pay for a mind-boggling menu of products, it allocates scarce resources to their most valued use, it causes new firms to come into existence and others to leave industry. It tells people where they should live and under what general conditions, and so on.

The information system is the network formed by free people buying and selling and the signals are the variations in and the levels of wages, prices, interest rates, rents and, unfortunately, taxes.

What the system does

Very often the best way to determine the contributions of people or things to an ongoing process is to see what happens in their absence. The system of price controls in the U.S. attempted, for a time, to replace the U.S. market mechanism. (I say 'attempted' because the market is like a balloon – when it is squeezed, activity simply moves in the direction

of lease resistance. Much evidence of legally permissible evasion of the spirit of controls was beginning to emerge early in the program.) To the extent that the program was effective, it began to produce an astonishing variety of evidence on the job that the market mechanism had been performing.

Shortages of products (ranging from natural gas to molasses) began to appear as slow-to-rise controlled prices told producers 'don't make more' and told consumers 'buy more'. Some products (fertilizer for example) were exported and sold at market prices elsewhere rather than at controlled prices within the U.S. Certain chemical derivatives of petroleum could be purchased only by bartering other chemicals in exchange. In the case of lumber products, virtually all of the classic distortions associated with price control appeared.

For example, log prices were not controlled, but the price of finished lumber was. Predictably, this led to a shortage of finished lumber, produced an array of artificial middlemen and active black markets. Ultimately, our efforts to control lumber prices led to reduced production and an increase in the export of lumber.

In short, most of the products and services that we take for granted in our everyday lives can be taken for granted only because there is a functioning price system. A system that, despite its imperfections, delivers just the right quantity of California lettuce to Montana or Alberta, Canada; and decides the relationship between raw log prices in California and the price of finished lumber in Boston. As we discovered when we tampered with, and effectively suspended, the operation of the price system, we could no longer rely on the system itself and were forced to get more and more involved with what were, before controls, essentially automatic functions.

The problem that policy-makers must cope with, if they are determined to control the system, is the endless detail that is involved in the operation of the system. To control the system and yet keep it running smoothly, the authorities must intercept all of the signals coming from the system (and there are hundreds of millions), interpret

them, appropriately change them (assuming they know how) and retransmit them.

To be effective the controllers must replace the automatic aspects of the system with discretionary, centralized decisions. In point of fact, such wholesale replacements is not possible and the most that the authorities can hope to do is to influence a very few of the signals.

What a tangled web

So, there is no omniscient policy maker who knows what exactly is going on and what exactly must be done. There are only men with some understanding of how the system works and some ability to change the signals. Owing to the almost unlimited ability of the system to change and adapt, the policy-maker can never be sure that the most recent change in policy was the correct one. He can be sure, however, that it won't be the last one.

What we at the Price Commission continuously found was that everything is related to everything else and there was, accordingly, no such thing as one intervention. We were drawn inevitably and progressively deeper into the system and the temptation to limit the necessity for our involvement by arbitrarily changing the system was very great. Herein lies the real danger from centralized control, that is, that an inability to handle the overload of signals, both incoming and outgoing, may produce attempts to simplify the system and hence jeopardize its survival.

III PRICE CONTROLS APPLIED – A RELENTLESS TIDE OF DETAIL

In this section I want to discuss the important role that complexity plays in the operation of a control program. Complexity lies at the base of the difficulties that a would-be price controller faces – it manipulates the thinking of those who would design a control strategy, it frustrates the controller and his agents and ultimately it leads to the collapse of the control system. I want to spend some time on this

notion because although complexity exists in every instance of central economic policy, the effects are nowhere as clear as they are in the case of wage and price controls. To that extent we can regard wage and price controls as a 'case study' in 'applied economic policy'.

Most forms of economic policy attempt to achieve a change in the course of economic activity by operating through the signalling mechanism as it exists. For example, a change in the personal tax rate reduces take home pay and thereby signals people to reduce their expenditures. Subsidies to particular industries strengthen the 'produce more' signals and encourage production that might not otherwise have occurred.

Wage and price controls, on the other hand, by design prevent the signalling mechanism from working. Ostensibly, the goal is to prevent wages and prices from increasing or to limit the rate at which they increase. In effect, however, controls eliminate the relative movements in wages and prices that do the signalling work. For example, the rise in wages in an area of the country with a labor shortage will not be allowed to occur under controls. The rise in price of particular sorts of building materials that would signal to builders to substitute other materials and signal to producers to increase their outputs of the materials in short supply will not be permitted to occur. The list of signals, under controls, that will not be transmitted in the market place is almost endless.

Life goes on

Although for a time wage and price controls can remove the flow of information in the economy, they cannot remove the functions that the information flow performs. Commodities in short supply must be rationed somehow; a shortage of skilled tradesmen must somehow be placed in the most valuable jobs. It is this sort of fact that haunts wage and price controllers, that leads to elaborate evasion schemes and that ultimately leads either to the abandonment of controls or the imposition of progressively more stringent and pervasive central control over economic activity.

Not only prices and wages

Controls on wages and prices are not just that, they are also controls on the flow of all the resources of an economy. What do I mean by that? Well, when we at the Price Commission were making decisions about the justifiability of a price increase we were effectively deciding about the value of the products involved. A decision not to allow the requested price increase on commodity A, but to allow it on commodity B, meant that we were restricting the ability of the producer of commodity A to compete for resources to use in the production of commodity A. In many cases this meant that less of commodity A was produced.

When we started Phase II we inherited from the Phase I Freeze a 400 page book of problems of industries, firms and individuals being squeezed to the point of bankruptcy, shortages and law suits when Freeze prices were set below the costs of production. There were impending shortages of products ranging from applesauce to peanut butter. Obviously, our actions to allow or not to allow price increases involved more than the rate of increase in the consumer price index.

The impossible dream

The difficulty of taking over the wage-price signalling mechanism is indicated by the fact that during the first three weeks of Phase II there were nearly 400,000 inquiries about the program. In terms of getting down to the nitty gritty, had the Dow Chemical Company and the Commission not agreed to an across the board increase of 2 per cent we would have had to examine nearly 100,000 submissions on different products for that company alone. A similar story could be told about the 1,500 largest companies with which a similar across the board average increase was negotiated. While the average increase saved the bacon in terms of the administrative burden that we had to bear, it gave the Commission less control over individual product prices since the companies could increase selected prices by as much as the market would bear. (Eventually, we had to establish a limit because of public opinion). In retrospect, though, it seems likely that this averaging provision helped the economy

avoid some of the more serious distortions that wage and price controls can cause and were causing during the Phase I Freeze.

Enforcement

It is clear to me that it is in general quite impossible to literally control prices in an economy as large as that of the U.S. or Canada as long as we retain our free society. History teaches us that even in the presence of the severest form of coercion, attempts to control wages and prices have not been successful except when there has been a general support for them. Being totally honest I have to say that I don't think that our efforts in Phase II would have been successful without the whole-hearted support of the firms subject to control. Even in those cases where violations were discovered there was little evidence that there was intent to act in a manner out of keeping with the spirit of the controls.

"Is prostitution a service industry or a regulated utility?" This, possibly tongue-in-cheek, request from a legal brothel in Nevada indicates the reason why controls cannot work in an adversary climate. The possibilities and incentive for evasion grow at an increasing rate the longer controls are in force. If there is a determination to avoid the spirit of controls, then the actual words of the control legislation and the enforcement machinery have to be extraordinarily complex. Enforcement of law in the system of justice common to free societies takes the form of a judicial procedure. Accordingly the handling of all compliance checks, including the filing of statistical evidence, has to be handled in a legally appropriate manner so that the material can be used in a court of law.

In some cases the potential size of this task precluded the Price Commission from establishing controls where they were thought to be necessary. The service industry is a good example. The Commission initially voted to put a 3 per cent ceiling on price increases in the service industry. We reversed that decision for two reasons. First of all, there are

millions of service firms and the Internal Revenue Service, which was acting as our enforcement arm, didn't think they could enforce the regulation. Secondly, the staff of the Commission felt that it would not be possible to devise forms to secure data in a form proper for analysis and decision-making. In another case, we recontrolled the lumber industry only to have to back off, owing to an avalanche of paper.

The blinding light of science

People are surprised that in an age of computers and sophisticated data processing that mere operational details could be a determining factor in the control process. For example, it was suggested to me on more than one occasion that the Price Commission ought to use some of the sophisticated mathematical decision-making models that have been developed with the advent of large, high speed computers. In fact, I think that some people assumed that we were using highly-sophisticated econometric models to 'fine tune' the economy. We did look at such models, but the builders were the first to admit that these models were not useful for our purposes. In fact, there are no models of use in 'planning' a detailed control system available and my considered opinion is that they are not likely to be forthcoming in the future. I should add that I am not opposed to models and computers in principle and am a member in good standing of the Operational Research Society of America.

No escape

I have perhaps said enough by now to convince the reader that wage and price controls are, by nature, a bureaucratic nightmare. There is no easy way to proceed, no escape from the remorseless tide of detail that is the inevitable consequence of attempting to interrupt the normal current of economic affairs. There is also no escape from the conclusion that detailed regulation breeds a restiveness in those being regulated that eventually must lead either to the collapse of the controls or the adoption of more coercive measures.

IV THE SIDE EFFECTS OF CONTROL

The wishful thinking that produces wage and price controls is the expression of a belief that controls can stop inflation. That belief is the subject of careful analysis elsewhere in this volume. Also, Professor Michael Darby has made an effort to assess the impact that the Economic Stabilization Program (ESP) of which Phase II was a part, had on the rate of inflation. Whether the program was a successful anti-inflation device or not, it certainly had the side-effects or costs and leaving to the reader to assess Professor Darby's work I want in this section to address myself to the side effects that I observed.

Equity

Our first realization in the Price Commission was that if the control system was to be manageable it had to be simple. In the face of the complexity of individual circumstances that we proposed to control we knew there would be a mismatch – we knew there would be unequal treatment of equals. But, our objective was action and the ability to act. And so our first conscious decision was to be simple and to be arbitrary.

It seems to me that inequity is an inevitable consequence of the sort of wage and price control program that we attempted to run in Phase II. In a program of this sort there isn't the time or the resources to permit the detailed regulation that equity demands.

Another sort of inequity that may be associated with controls relates to the fact that, for the majority of firms, compliance was more or less self-regulated. The chances that a small firm violating the controls would escape detection were very large. Hence those who did – and I have no doubt there were some – gained at the expense of those who did not. It is an odd law, indeed, that confers advantages on those who ignore it and punishes those who comply. We have to accept, however, that such could well have been the case.

Distortions

Another of the costs associated with controls that has been discussed in previous sections is that of the distortions that controls produce in the system. In some cases these distortions occur directly as a result of the fact that controls treat the symptoms of inflation and not its causes. For example, rising world demand for some products caused world prices for these products to rise – a phenomenon unrelated to the 'cost-push' we were trying to control. The presence of controls in the U.S. simply meant that domestic supplies were exported. The shortages that ensued were a direct consequence of controls.

In other cases the distortions arose from the attempt of firms to avoid inequities built into the controls themselves. Companies trapped by the controls with low base-period profit margins were beginning to consider selling out to companies with higher base-period margins or shipping their capital out of the country. In the case of the labor market, instances of false job upgrading – which were actually 'raises' in disguise – were reported on a scattered but increasing basis.

The security blanket effect

Perhaps the most disturbing but least obvious effect of a wage and price control program is the impact that it has on people's perceptions of, and attitudes toward, economic reality. In particular, it is my feeling that controls give people a false sense of security. They create the illusion that 'the problem is being solved' – that 'everything is under control'. The fact is, as is evident from the experiences I related above, that *the more centralized decision-making becomes, the less control is actually exercised over economic activity. Centralized decision-making cannot replace the countless millions of decisions that are made in the market automatically. The most likely effect of centralized decision-making is not more control over economic activity, but less economic activity, less productivity and in the end more inflation.*

The other aspect of controls as an instigator of a false sense of security lies in the possibility that they will distract public attention from the true causes of inflation. For example, there is some evidence that the control program in the U.S. was used as a damper to temporarily keep the lid on inflation, while the money supply was being increased at an inflationary rate. Ultimately, inflation seems to be a monetary phenomenon and is not brought under control until the growth in the money supply has been checked. *To the extent that wage and price controls permit excessive monetary expansion in the short-term, they are counter-productive and are against the public interest.*

PART C

THE AUSTRALIAN EPISODE

7. The Lucky Country Joins the Club

CHAPTER 7
The Lucky Country Joins the Club

(i) Lee Eckermann

(ii) Peter Samuel

THE AUTHORS

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The Lucky Country Joins the Club

(i) Recession, price control and incomes policy in Australia

Lee Eckermann

I INTRODUCTION

Although the Australian experience with an incomes policy has been somewhat patchy, there is considerable evidence to suggest that during those periods when policies designed to restrain wage and price increases have operated, on balance their effect has not been beneficial to the economy.

For the 32 years from 1921 to 1953, the Australian basic wage was automatically adjusted, on a quarterly basis, in line with changes in the consumer price level. Wage indexation was reintroduced in April 1975, since which time it has remained a controversial element of government policy. Despite frequent attacks on the indexation system and warnings of its imminent demise, it lingers on. Nevertheless, its expected life has been considerably shortened by recent events, as will be detailed below.

Prior to 1973 there had been no active policy of price control since World War II. The establishment of the Prices Justification Tribunal in 1973 represents the first Australian experiment with price control in 30 years, albeit a semi-voluntary one.

Despite the recent excursions into a quasi-incomes policy, Australia continues to experience a rate of price inflation which is high both historically and relative to its trading partners, together with a high and increasing unemployment rate. In common with most western industrialized economies, Australia is currently in the grips of a prolonged and persistent recession, the likes of which has not been experienced since the Great Depression of the 1930s.

Because of the limited Australian experience with an incomes policy and because the recession of the 1970s has generated a considerable literature on that topic, this chapter on the Australian experience concentrates on the recent past. Although brief mention will be made of developments in the Australian economy over the past 30 years, attention will be primarily focused on the period since 1960 in general and since 1970 in particular.

II WHY HAVE INCOME POLICIES BECOME AN ISSUE?

This section deals with some general economic developments in Australia over the 2 decades to 1970, and then concentrates on the period since that time. When examining the latter time period, the impact of "incomes policy" as pursued in Australia will be analysed in some detail.

Prior to the onset of the present recession in the early 1970s, the pursuit by most governments in western economies of policies based largely on extensions of Keynesian ideas gave the appearance of working fairly well: the 2 decades prior to the appearance of stagflation were, by and large, characterized by relatively low rates of inflation and unemployment, and continual increases in total production of goods and services leading, by implication, to ever-rising living standards.

In Australia, for example, during the 1960s, the annual increase in the consumer price index averaged a modest 2.7% while unemployment averaged 1.8% each year and annual growth in real gross domestic product averaged 5.0%. As Table 1 indicates, Australia performed rather well in all 3 areas over that period compared with the experience of the major world economies.

TABLE 1: INFLATION, UNEMPLOYMENT, AND OUTPUT GROWTH AN INTERNATIONAL COMPARISON

Item	Australia (%)	U.S.A. (%)	Japan (%)	U.K. (%)	W. Germany (%)
1. Average annual increase in consumer prices:					
1960 to 1970	2.7	2.4	5.6	3.5	2.8
1971 to 1973	7.1	4.6	7.6	8.2	5.9
1974 to 1976	14.6	8.6	14.8	18.7	5.8
2. Average annual unemployment rate:					
1960 to 1970	1.8	4.8	1.0	2.2	1.1
1971 to 1973	1.6	5.5	1.3	3.2	1.1
1974 to 1976	3.7	7.3	1.8	4.0	4.0
3. Average annual growth in real GDP:					
1960 to 1970	5.0	3.9	11.1	4.9	2.9
1971 to 1973	4.9	5.1	7.7	3.0	3.7
1974 to 1976	2.3	0.9	2.5	− 0.1	1.0

Sources: OECD, Economic Outlook; OECD, Main Economic Indicators; United Nations, Monthly Bulletin of Statistics.

1. Economic Developments, 1950 to 1970

The twenty-year period to 1970 was, by and large, characterized by sustained economic growth with relative price stability and low unemployment. There was a high level of capital inflow which gave Australia a fairly healthy balance of payments position. This period also saw relatively small budget deficits and low rates of growth in the money supply, and a relatively constant distribution of aggregate income between wages and profits.

Output

As the figures in Table 2 indicate, the value of aggregate production in Australia (GDP) rose consistently over this period, at an average rate of almost 10% a year. Raw GDP figures, however, do not provide an accurate picture of

TABLE 2: OUTPUT GROWTH

Period	Average Annual % growth		
	Gross Domestic Product (%)	Real GDP (%)	ANZ Bank Index (All Groups) (%)
Quinquennial:			
1949-50 to 1953-54	15.5	4.6	6.3
1954-55 to 1958-59	6.7	4.3	6.4
1959-60 to 1963-64	7.6	4.5	5.6
1964-65 to 1968-69	8.7	5.5	5.2
20 years:			
1949-50 to 1968-69	9.6	4.7	5.9

Source: Australian Bureau of Statistics; ANZ Banking Group Ltd.

trends in output – because they are aggregate values, comprising the sum of thousands of "price times quantity" valuations, they give little clue to changes in quantities produced when prices also change over time. For example, during the Korean boom of the early 1950s, GDP rose by 20% in 1949-50, by 34% in 1950-51 and in the following year by a mere 7%. The first 2 figures include a large element of price increase, and do not represent growth in output of anywhere near these percentage figures.

The figures for real GDP, expressed in terms of constant prices, overcome this difficulty to a limited extent, and thus provide a better guide to movements in output. The figures show a fairly consistent upward trend in aggregate output in the Australian economy over this period of close to 5% of year. The ANZ Bank index, showing movements in the quantity (not value) of factory production confirm this consistent growth pattern, suggesting an average rise in manufacturing sector output of almost 6% a year.

However, this growth was by no means uniform across the various manufacturing industry groups. For example, the average annual growth in output over this 20 year period in some specific industry groups was: basic metals 8%; industrial machinery 3%; electrical apparatus 6%; building and construction materials 5%; chemicals and allied industries 8%; motor vehicles 11%; furniture and household goods 8%; food, drink and tobacco 3%; clothing and footwear 4%. Clearly, there were significant changes in the structure of production over these two decades.

Prices, Wages, and Factor Shares:

With the exception of the Korean War boom period, Australia experienced only moderate price inflation and a 2% to 3% growth in real wages over these 2 decades, as Table 3 indicates.

TABLE 3: PRICES AND WAGES

Period	Average annual % growth		
	Consumer Price Index (%)	Average Weekly Earnings (adult males) (%)	Minimum Weekly Wage Rates (adult males) (%)
Quinquennial:			
1949-50 to 1953-54	11.5	13.3	12.6
1954-55 to 1958-59	2.6	4.6	3.0
1959-60 to 1963-64	1.6	4.6	3.1
1964-65 to 1968-69	3.2	6.3	5.2
20 years:			
1949-50 to 1968-69	4.7	7.2	6.0

Source: Australian Bureau of Statistics:
Report of the Committee of Economic Enquiry (Canberra: Commonwealth of Australia, 1965) Vol. II; J. E. Isaac, "Industrial Relations", in R. I. Downing (ed.), *The Australian Economy* (London: Weidenfeld & Nicolson, 1973).

The rate of price inflation averaged a mere 2.5% over the 15 year period 1954-55 to 1968-69, while minimum wage rates increased by 3.8% and average weekly earnings by 5.2% a year. The rapid inflation and rate of wage increase in the early 1950s were, in fact, at similar rates to those experienced during the 1970s recession: in the 2 years 1950-51 and 1951-52, the CPI rose by 20% and 17% respectively, while minimum wage rates rose by 17% and 23%, and average weekly earnings by 20% and 22% respectively.

Concurrent with this fairly low rate of price and wage increase, the shares of total income going to labour and capital both rose slowly but steadily over the period (see Table 4). During the 20 years to 1968-69, the share of profits in GDP ranged from a low of 10.6% to a high of 14.9% (average 13.0%), while the share of wages and salaries in GDP ranged from a low of 43.2% to a high of 52.6% (average 50.3%).

TABLE 4: FACTOR SHARES*

Period	Annual Average	
	$\frac{W}{GDP}$ %	$\frac{\Pi}{GDP}$ %
Quinquennial:		
1949-50 to 1953-54	48.2	11.3
1954-55 to 1958-59	50.6	12.8
1959-60 to 1963-64	50.8	13.6
1964-65 to 1968-69	51.7	14.2
20 years:		
1949-50 to 1968-69	50.3	13.0

* $\frac{W}{GDP}$ = Wages, salaries, and supplements as a % of GDP

$\frac{\Pi}{GDP}$ = gross operating surplus of companies as a % of GDP

Source: Australian Bureau of Statistics.

Moreover, the decade of the 1960s saw only a marginal impact of the income tax system on wages and profits per unit of output, as indicated in Table 5.

TABLE 5: WAGES, PROFITS AND INCOME TAXES PER UNIT OF OUTPUT*

YEAR	$\frac{W}{\text{Real GDP}}$	$\frac{\text{NET } W}{\text{Real GDP}}$	$\frac{\Pi}{\text{Real GDP}}$	$\frac{\text{NET } \Pi}{\text{Real GDP}}$	$\frac{T}{\text{Real GDP}}$
1959-60	100	100	100	100	100
1968-69	128	124	145	138	159

* W and Π defined as for Table 4; Net W = W less personal income taxes paid; Net $\frac{\Pi}{L}$ = $\frac{\Pi}{L}$ less company income taxes paid; T = income tax revenue, i.e. the sum of personal and corporate income tax receipts of the federal government.

Source: Australian Bureau of Statistics.

Whereas total wages and salaries per unit of output rose by 28% over this decade, after-tax unit wage costs rose by 24%; and whereas total profits per unit of output increased by 45%, after-tax unit corporate profits rose by 38%. Aggregate tax revenue per unit of output from these 2 sources rose by 59% over this period. As will be seen below, the period since 1970 has seen a marked change in these relationships.

Unemployment

The 20 year period to 1968-69 was also characterized by a very low rate of unemployment in Australia, as Table 6 demonstrates.

With the exception of the "credit-squeeze" years of the early 1960s, the unemployment rate did not rise above 1.7% throughout this period, and the average annual rate for the 20 years was a low 1.3%.

TABLE 6: UNEMPLOYMENT

Period	Registered unemployed as a percentage of the work-force (annual average) (%)
Quinquennial:	
1949-50 to 1953-54	0.8
1954-55 to 1958-59	1.1
1959-60 to 1963-64	1.8
1964-65 to 1968-69	1.4
20 years:	
1949-50 to 1968-69	1.3

Source: Australian Bureau of Statistics;
Report of the Committee of Economic Enquiry (Canberra: Commonwealth of Australia, 1965) Vol. II.

Money Supply and Deficit Financing.

This period was also characterized by money supply growth averaging 7% a year, and federal government deficits averaging $250m. a year (see Table 7). These deficits ranged from around 2% to 11% of federal spending during these 2 decades.

TABLE 7: MONEY SUPPLY GROWTH: FEDERAL DEFICITS

Period	Average annual growth in M3 (%)	Federal deficit (annual average) ($m.)
Quinquennial:		
1949-50 to 1953-54	9.5	192
1954-55 to 1958-59	3.6	133
1959-60 to 1963-64	7.5	289
1964-65 to 1968-69	7.9	398
20 years:		
1949-50 to 1968-69	7.1	253

Source: Australian Bureau of Statistics;
Report of the Committee of Economic Enquiry (Canberra: Commonwealth of Australia, 1965) Vol. II.

Balance of Payments

Although there were relatively minor fluctuations in Australia's international reserves over these 20 years, the high lelve of capital inflow in most years was more than sufficient to offset the persistent deficit on current account of the balance of payments (see Table 8).

TABLE 8: BALANCE OF PAYMENTS

Period	Annual Average		
	Current Account ($m.)	Net apparent capital inflow ($m.)	Net monetary movements ($m.)
Quinquennial:			
1949-50 to 1953-54	– 104	145	40
1954-55 to 1958-59	– 280	270	– 10
1959-60 to 1963-64	– 338	480	142
1964-65 to 1968-69	– 890	865	– 26
20 years:			
1949-50 to 1968-69	– 403	440	37

Source: Reserve Bank;
Report of the Committee of Economic Enquiry (Canberra: Commonwealth of Australia, 1965) Vol. II.

The deficit on current account grew persistently over this period, from $70m. in 1949-50 to $460m. in 1959-60, and to $1,008m. in 1968-69. At the same time, net capital inflow also grew strongly, from $296m. in 1949-50 to $476m. in 1959-60 and to $1,157m. in 1968-69. The net result was to keep Australia's international reserves relatively constant over this period – they increased by an average of $37m. a year.

2. The Recession, 1970-77 – An Overview

The early 1970s saw sharp increases in inflation rates throughout the world. In 1974 and 1975, they reached a peak of more than double (and up to seven times) the rates which had persisted during the 1960s. The Australian inflation rate in 1974 and 1975, of 15%, was more than five times the 1960s average; the U.S. peak rate of 11% in 1974 was more than four times the 1960s average, as was the

Japanese figure of 23% in that year; German inflation reached a more modest 7% in 1974, two and a half times its recorded 1960s average; while inflation in Britain peaked at 24% in 1974, some seven times the average 1960s rate.

In line with the dramatic increases in inflation rates occurred a phenomenon which mainstream economic orthodoxy was at a loss to predict – namely, sharp increases in unemployment. The rate of unemployment in Australia began increasing in 1974 and has continued to rise ever since. Similarly, the proportion of the workforce unemployed has continued to rise in both Japan and Britain, while the unemployment rate peaked in 1975 in the U.S. and Germany since which time it has declined marginally.

Concurrent with the onset of inflationary recession in the early 1970s, rates of economic growth slipped back markedly from their former high annual levels, and most countries experienced either a very low rate of growth or an actual decline in real GDP in 1974 and 1975.

This is the environment, of depressed economic conditions generally, into which the question of an incomes policy has become an issue in Australia during the 1970s. Incomes policies came into prominence as a policy issue in Australia when it became apparent that orthodox demand-management policies were incapable of solving the twin problems of rapid inflation and high unemployment.

3 The Recession 1970-77 – A closer look

The mineral boom of the late 1960s led to a substantial growth in the Australian economy. Along with a very high rate of capital inflow ($2,400m. in 1967-68 and 1968-69 alone), Australia experienced a 9% growth in real GDP in 1968-69, followed by 6% growth in the subsequent year. With an increased rate of growth in the money supply in the late 1960s, the combination of demand pressure and cost-push fuelled by the boom led inexorably to a rise in the inflation rate. Then, in 1972-73, money supply growth more than doubled (to 26%, from 11% in 1971-72) – the result was a doubling in the inflation rate in 1973-74. (Note that

these developments occurred *prior* to the oft-cited OPEC oil price jump.) The marked jump in unemployment began late in 1974, and the labour market situation has continued to deterioriate ever since. It is useful to add perspective detailing some economic developments over the past few years.

Output

As Table 9 indicates, production continued its strong growth of the preceding two decades well into the 1970s. Then, in 1974-75 both real GDP and the ANZ Bank Index of Factory Production fell, and output picked up only marginally in 1975-76. In 1976-77, output growth increased, but is still significantly below pre-recession levels.

TABLE 9: OUTPUT GROWTH

Year	Real GDP (%)	ANZ Bank Index (All groups %)
1969-70	5.8	5.4
1970-71	4.4	4.4
1971-72	4.3	2.1
1972-73	4.6	5.5
1973-74	5.8	9.2
1974-75	−0.1	−6.6
1975-76	2.4	1.3
1976-77	3.4	3.2

Source: Australian Bureau of Statistics; ANZ Banking Group Ltd.

Once again, these movements in output were not evenly experienced through the economy. In the manufacturing sector, production of consumer goods was not as seriously affected in the latest two years as was output of producer goods: during the years 1974-75 and 1975-76, production of industrial machinery fell by an average of 6% each year, and output in the electrical apparatus and building and construction materials industry groups fell by 7% a year; production of motor vehicles declined by an average of 2% a year; food, drink and tobacco output rose by 0.4% a year,

and the clothing and footwear, and furniture and household goods industry groups recorded average output declines of 4% a year.

Prices, Wages and Factor Shares

The rate of both price inflation and wages' increase accelerated after the mineral boom of the late 1960s, as evidenced in Table 10. After reaching a peak rate of 17% (price inflation) and 26% (wages increase) in 1974-75, both decelerated subsequently – wages growth in particular fell dramatically in 1975-76. The latest fiscal year saw a marginal rise in the rate of price inflation and a slight fall in wages growth.

One result of the wages explosion in 1974-75 was a marked jump in the share of aggregate income accuring to wages and salaries (from 54% in 1973-74 to 59% in 1974-75), with a corresponding drop in the share of profits from 13% to 11%. This low relative level of corporate profits had not been experienced for 25 years.

TABLE 10: PRICES, WAGES & FACTOR SHARES*

PERIOD	CPI (%)	AWE (%)	$\frac{W}{GDP}$ (%)	$\frac{\Pi}{GDP}$ (%)	$\frac{NET\ W}{GDP}$ (%)	$\frac{NET\Pi}{GDP}$ (%)	$\frac{T}{GDP}$ (%)
Average Annual 1959-60 to 1968-69	2.4	5.5	51.2	13.9	43.5	10.2	11.4
1969-70	3.2	8.4	52.8	15.4	42.7	11.4	13.5
1970-71	4.8	11.0	54.5	14.3	44.8	10.0	14.0
1971-72	6.8	10.1	54.6	13.9	44.4	9.7	14.4
1972-73	6.0	9.1	53.6	14.2	43.9	10.4	13.6
1973-74	12.9	16.3	54.4	13.1	43.6	9.1	14.8
1974-75	16.7	25.8	59.2	10.9	46.3	6.8	17.0
1975-76	13.0	14.4	58.2	10.8	45.0	7.1	17.0
1976-77	13.8	12.4	56.5	12.0	42.9	8.4	17.1

* Note to Tables 4 & 5 for definitions of W, net W, Π, netΠ, & T.

Source: Australian Bureau of Statistics.

Note from table 10, however, that the impact of the tax system had a far more pronounced effect on profits than on wages. Despite the progressive personal income tax, the net (after-tax) share of wages in GDP was maintained at a relatively constant level prior to 1974-75 and following an increase in the two subsequent years the share fell in 1976-77 to 43%. The impact of company income tax, however led to a substantial fall in the net (after-tax) share of profits in GDP in 1974-75 – it decreased from 9% in 1974-74 to less than 7% in 1974-75, and only picked up marginally in 1975-76. Relatively strong growth in the latest year saw that ratio rise to 8% in 1976-77, still well below its historical levels. At the same time, the revenue obtained from personal and company income taxes increased as a proportion of GDP from 14% in 1971-72 to 15% in 1973-74, and to 17% in the latest years.

The effect of the income tax structure on corporate profits in particular is dramatically illustrated in Table 11.

TABLE 11: WAGES, PROFITS, AND INCOME TAXES PER UNIT OF OUTPUT*

Year	$\frac{W}{\text{Real GDP}}$	$\frac{\text{Net } W}{\text{Real GDP}}$	$\frac{\Pi}{\text{Real GDP}}$	$\frac{\text{Net } \Pi}{\text{Real GDP}}$	$\frac{T}{\text{Real GDP}}$
1969-70	100	100	100	100	100
1973-74	147	142	117	108	153
1974-75	187	177	117	93	207
1975-76	212	198	135	135	240
1976-77	228	212	165	156	268

* See Table 5

Source: Australian Bureau of Statistics

Whereas labor costs per unit of output doubled over this period (on both a gross and after-tax basis), corporate profits per unit of output rose by a mere 65% on a gross basis and by a minimal 56% on an after-tax basis. In 1974-75, net Π/Real GDP was 7% less than the level of 5 years before. Income tax revenue per unit of output, by contrast, rose by 168% over these seven years. These figures clearly reflect

the inappropriateness (to say the least) of corporate income tax based on historical cost accounting during a period of rapid inflation. Although there has since been a half-hearted attempt to implement appropriate changes to the company tax base, the level of corporate profitability has still to be restored to anywhere near the level necessary for an upsurge in investment spending.

Unemployment

As Table 12 indicates, the rate of unemployment remained at its historically low levels of around 1.5% until 1974. Since that time, the unemployment has continued to climb, and 1977 figures indicate that it is still increasing.

TABLE 12: UNEMPLOYMENT

Year	Registered unemployed as a % of the work force %
1969-70	1.0
1970-71	1.2
1971-72	1.6
1972-73	1.7
1973-74	1.4
1974-75	3.6
1975-76	4.6
1976-77	5.0

Source: Australian Bureau of Statistics

Money Supply and Deficit Financing

The level of both money supply growth and of the federal deficit remained at relatively low rates (i.e. at around historical rates) until 1971-72 as Table 13 demonstrates. Then, in 1972-73, the deficit jumped to $709m. and the money supply increased by a massive 26%. Whereas the deficit

jumped to unprecedented levels in 1974-75 ($2.6 billion) and 1975-76 ($3.6 billion), a semblance of greater monetary realism returned in those years and money supply growth returned to annual rates of 14% to 15%. Latest figures indicate a further wind-down in monetary expansion to around 11% in mid-1977. It is relevant to note that the most rapid increases in prices and wages occurred well *after* that explosion in money supply growth – they certainly did not precede it.

TABLE 13: MONEY SUPPLY GROWTH: FEDERAL DEFICITS

Year	Growth in M3 %	Federal deficit ($m.)
1969-70	6.2	191
1970-71	6.8	10
1971-72	10.5	134
1972-73	25.7	709
1973-74	13.7	293
1974-75	15.2	2,567
1975-76	13.8	3,585
1976-77	11.0	2,740

Source: Australian Bureau of Statistics

Balance of Payments

The rate of capital inflow fell to levels which had characterised the early 1960s consequent upon the Labor government taking office late in 1972 (See Table 14). Despite some currency realignments by Australia's monetary authorities in the years 1973 to 1975, it became clear that with Australia's inflation rate substantially in excess of that of its major trading partners, a devaluation of the Australian dollar was inevitable. As a result, Australia experienced a net outflow of capital in 1975-76 as speculation heightened concerning the exchange rate. This outflow was only the second recorded in more than 25 years (there was a minimal outflow of $22m. in 1952-53).

TABLE 14: BALANCE OF PAYMENTS

Year	Current Account ($m.)	Net apparent capital inflow ($m.)	Net monetary movements ($m.)
1969-70	– 760	796	37
1970-71	– 849	1,510	598
1971-72	– 375	1,878	1,442
1972-73	699	443	1,079
1973-74	– 744	183	– 569
1974-75	– 935	471	– 464
1975-76	– 840	– 180	– 1,020
1976-77	– 1,942	1,453	– 490

Source: Reserve Bank

The 17.5% devaluation of November 1976 and subsequent appreciations had the effect of reversing that situation, and Australia experienced a return to a net inflow of sizeable proportions once again during the first few months after devaluation. However it is apparent that the capital inflow well had dried up by June 1977. Following a capital inflow of $1,246 m in the three months ended February 1977, the inflow dwindled to $73 m in May, to $6 m in June, and August saw a net outflow of $198 m.

III AUSTRALIA, A "DEPENDENT" ECONOMY: A SPECIAL CASE?

Before examining the working of the Prices Justification Tribunal (the PJT) and of wage indexation, we must consider the question of whether or not Australia is a special case in some sense, and whether incomes policies may be more successfully implemented in this country.

The Australian economy is a "dependent" economy in that its terms of trade are essentially given and can, by and large, not be influenced by domestic economic policy. That is to say, Australia is a small country which is heavily reliant

on overseas trade, and it trades in competitive world markets in which it has little influence on either the prices it receives for exports or the prices it pays for imports. Changes in domestic conditions of supply and demand have little impact on export and import prices. More specifically, the Australian economy has the following characteristics: it is small compared with most of its trading partners; exports consist mainly of agricultural and mineral products and are produced in a capital-intensive sector; imports are primarily manufactured products and comprise mainly capital goods and producer goods which are not produced domestically.

It has been argued that the need for an incomes policy may be greater in such an economy than in an economy characterised by a dominant manufacturing sector and with some control over its terms of trade (see for example, Whitehead footnote). The argument is as follows: if domestic prices in a "dependent" economy such as Australia rise more rapidly than prices overseas, the economy will tend to experience balance of payments problems by way of cost-push pressure on exports. Exports become less profitable, as they are more difficult to sell overseas, and this will restrict both the flow of additional resources into the export sector as well as investment by enterprises already in that sector. The impact of this mechanism will be to retard export volume growth. At the same time, balance of payments pressure would result on the import side: with a higher domestic inflation rate than that experienced overseas, there will tend to be some increase in imports as Australians switch from locally-produced goods to the now relatively cheaper imported products.

Although the impact of these twin balance of payments pressures will be different in a dependent economy compared with a manufacturing country, they will nevertheless operate. The relevant question in need of answer at this point is the extent to which a wages and prices policy would alleviate the balance of payments pressures generated by inflation. Clearly, an incomes policy would have the desired effect on the balance of payments only if it proves successful in eliminating the cause of the dilemma, i.e. in reducing inflation. As indicated elsewhere in this volume,

there are strong theoretical grounds for doubting the ability of an incomes policy to lower the inflation rate.

Despite the fact that the Australian economy is a "dependent" economy, so long as economic policy is directed towards the effects of inflation (through an incomes policy) and not at its root causes, there exist no grounds for arguing a special case.

See D. H. Whitehead, *Stagflation and Wages Policy in Australia* (Melbourne: Longman, 1973).

IV PRICE AND WAGE REGULATION IN AUSTRALIA

The rapid increase in the rate of inflation during the early 1970s led to the establishment of the Prices Justification Tribunal in August 1973. And the wages explosion in the subsequent year led to the re-introduction of wage indexation (after a 22 year break). These are the 2 main areas in which "incomes policy" has been applied in Australia during the 1970s recession.

1. The Prices Justification Tribunal: a toothless tiger?

The PJT was established in 1973 by the Prices Justification Act (which came into force on August 1st of that year). The PJT was set up primarily to take an active role in restraining inflation in Australia, and is an administrative organisation which plays a "watch-dog" role in the determination of prices for most goods. The name given to this body indicates that the PJT is not overtly charged with the responsibility for controlling prices; rather, the stress is on its role in assessing the justification of price rises or proposed price rises.

Whilst the distinction between justifying prices and controlling prices may be difficult to accept in practice, it is clear that the operations of the Tribunal have, by and large, had little significant impact on Australian inflationary experience since the establishment of the PJT. Not only has the inflation rate risen dramatically since its inception, but also the great bulk of price increases which have fallen within the Tribunal's ambit since August 1973 have been accepted as "justified". In other words, to the extent that the vast majority of notices of proposed price increases have

been accepted by the Tribunal, there is a strong case for arguing that the establishment of the PJT has been a costly waste of time, effort, and resources, and that it has contributed very little to anti-inflationary policy.

The functions of the PJT are to inquire into the appropriateness of prices at which companies falling within the ambit of the Act supply or propose to supply goods and services. Companies to which the Act originally applied were those with a turnover of at least $20m. Those companies proposing to increase prices are required to notify the Tribunal of their intentions, and the PJT must, within 21 days, then notify the company concerned whether or not it intends to hold an inquiry into the appropriateness of that price. The Act provides both for exemptions from the procedure of the PJT and also for companies to substitute their original proposal with another.

Amendments to the Act in 1974 broadened the scope of the Tribunal's activities. Although only those companies with a turnover exceeding $20m. are required to notify the PJT of proposed price increases, the 1974 amendments gave the Tribunal general authority to inquire into and report on prices charged by all companies, regardless of turnover. In addition, the amendments require the Tribunal to inform companies of any lower price or whether they intend to proceed with their original proposal: a public inquiry is then held if the company does not accept the Tribunal's recommended price.

The PJT Act clearly points to the anti-inflationary role of the Tribunal, for if its deliberations lead the PJT to conclude that a particular price rise is not justified, it is required to report on what lower price would be justified. While the Tribunal may, therefore, recommend a lower price than that sought by a company, it cannot recommend a higher price than that proposed.

Note that the Act includes no provision for any authority for compelling observance of the Tribunal's recommendations. Although the 1973 Act made provision for fines to be imposed on companies if they fail to notify the Tribunal of proposed price increases or if they do not follow

the stipulated procedures, the PJT has no way of compelling the implementation of its recommendations.

2. The PJT in action

From the outset, the PJT has been predominantly concerned with its anti-inflationary role. The First Annual Report of the Tribunal spelt out in clear terms that it was using the resources at its disposal so as to achieve the greatest possible anti-inflationary impact. Thus, the PJT has adopted a short-term view, by concentrating on the immediate impact of proposed price increases; as a result, it has devoted little effort to a consideration of long-term aspects of pricing such as the increased availability of goods and services. That this emphasis on short-run effects was in accord with deliberate government policy during the early life of the Tribunal is evidenced by Treasurer Crean's statement in his 1974 budget speech . . . the Government expects the principal burden of restraint to fall on upper income groups, particularly through the impact on profits of the operations of the Prices Justification Tribunal . . ." *(Budget Speech, 1974-75).*

No effects on inflation

Yet when we examine the record, it is not at all self-evident that the Tribunal has had any noticeable beneficial effect on the inflation rate. Table 15 details movements in Australia's inflation rate since the establishment of the PJT, together with the number of price notices processed by the Tribunal each year and the share of GDP accruing to corporate profits.

One could be excused for making the observation that there appears to be a direct relationship between the number of notices processed by the PJT and the inflation rate: i.e., that the inflation rate increased along with the Tribunal's activity during its first few years of operation and has fallen with the recent decline in PJT activity. Moreover, there appears to be an inverse relationship between the level of PJT activity and the share of national income accruing to profits: i.e. the ratio of profits to GDP fell with increasing

PJT price "surveillance" and rose with the recent decline in the Tribunal's activity. A cursory glance at the Table suggests such correlations, albeit loose ones.

Whilst it may be overly simplistic to be dogmatic about these two observations, it is nevertheless tempting to suggest the implications of this line of reasoning: viz. that the lower the level of PJT activity, the lower will be the inflation rate and the higher the rate of corporate profitability!

TABLE 15: INFLATION, PJT ACTIVITY & PROFITS

Quarter	Annual inflation rate %	Number of price notices processed by PJT	$\frac{\Pi}{GDP}$ %
1973-74 S	10.6		
D	13.2	3,859	13.1
M	13.6		
J	14.5		
1974-75 S	16.0		
D	16.3		
M	17.6	7,502	10.9
J	16.9		
1975-76 S	12.1		
D	14.0	7,739	10.8
M	13.4		
J	12.3		
1976 S	13.9		
D	14.4	2,871	13.0

Source: ABS; PJT Reports

The PJT and investment risks

It is, of course, true that a number of factors have an important bearing on inflation and profit rates, but it is here suggested that PJT activity is in fact one such factor.

The rudimentary evidence given in Table 15 supports the view that the existence of a price-surveillance body such as the PJT disturbs the workings of the market.

One of the crucial results of the activities of the PJT has been to increase uncertainty and risk. By attempting to "normalize" profits, it has adversely affected the incentive to invest. In a market economy, the need for investment in a particular area is reflected in the opportunity for making above-average profit. The fact that such opportunities for making high profits tend to attract investment does not necessarily mean that the high profits will be indefinitely maintained, for self-correcting forces tend to come into operation whereby other investment is attracted into that area. This process will reduce profitability in that industry to something approaching "normality". Similarly, the existence of low profits in a particular industry suggest over-investment, that additional investment resources would be better employed in other areas.

Notwithstanding the claim that the PJT's attempts to control prices are well-meaning, the fact that the Tribunal attempts to ensure that all firms obtain roughly the same rate of return on funds essentially suppresses the market signals which indicate those areas where investment is or is not required. In other words, the Tribunal is using a concept of "normal profits" whenever it assesses whether a particular firm's profits are too high or too low; it therefore is implicitly taking account of only shortrun considerations of market performance and omitting any significant consideration of long-run factors. In so doing, the workings of the PJT have distorted the pattern of investment in Australia during the 1970s recession. The disincentive towards risk taking, as provided by the existence and operation of the PJT, has doubtless been one factor in the dismal private sector investment levels since the Tribunal's establishment: over the period 1959-60 to 1973-74, real gross private investment (i.e. investment expressed in terms of constant 1966-67 prices) increased at an annual average rate of 6%; in 1974-75 it fell by 10%, and rose marginally by 1% in 1975-76.

3. No justification for the PJT?

Tables 16 and 17 summarize the activity of the PJT during the first 41 months of its operation (i.e. from August 1973 to December 1976). During that period, the PJT processed 21,971 price notices; of that total, 18,583 were approved by the PJT in their original form, 2,317 were subject to lower price approvals by the PJT and subsequently accepted by companies concerned, and 795 were withdrawn by companies. Some 85% of all price notices processed by the Tribunal in its first 41 months of operation were thus approved on the basis originally notified to the PJT, and 15% were reduced or completely withdrawn. The proportion of price notices approved in their original form has declined, from 87% in 1973-74 to 82% in the latest half-year, and the proportion withdrawn by companies has increased, from 1% to 7% respectively.

The staff establishment of the PJT has grown in roughly the same proportion as the number of price notices processed, from 86 positions at the end of June 1974 to 160 at the end of June 1976.

The data in Tables 16 and 17 clearly demonstrate that the vast majority of price notices processed by the PJT have been approved in their original form, without alteration: to date, some 85% of all price notices processed fall into this category. It is therefore little wonder that the Tribunal's recommendations have been largely adhered to: most notifications have been successful, so it is to be expected that most price recommendations have been accepted by the companies concerned.

In sum, then, to the extent that the PJT takes little cognizance of market signals, its activities tend to distort investment expenditure; and to the extent that the great bulk of its processing is mere formality, the Tribunal's effort is largely a waste of time and resources. There is little doubt that a cost-benefit study of the PJT's activities would be hard-pressed to find a justification for its existence.

TABLE 16: PRICES JUSTIFICATION TRIBUNAL ACTIVITY

Period	Total number of price notices processed by PJT	No. of price notices		No. of notices of proposed prices approved or withdrawn without public inquiry notice being issued		
		Heard public enquiry	Where public inquiry notice issued but later withdrawn and/or amended	Original notices	Substitute notices for a lower price issued and accepted	Withdrawn by companies
A) NUMBER:						
11 months to end June 1974	3,859	15	31	3,356	421	36
1974-75 fiscal year	7,502	50	140	6,271	863	178
1975-76 fiscal year	7,739	13	14	6,607	725	380
6 months to end Dec. 1976	2,871	2	11	2,349	308	201
TOTAL 41 MONTHS TO END DECEMBER 1976	21,971	80	196	18,583	2,317	795
B) PROPORTION OF NUMBER						
11 months to end June 1974	100	0.4	0.8	87.0	10.9	0.9
1974-75 fiscal year	100	0.7	1.9	83.6	11.5	2.4
6 months to end Dec. 1976	100	0.1	0.4	81.8	10.7	7.0
TOTAL, 41 MONTHS TO END DECEMBER 1976	100	0.4	0.9	84.6	10.6	3.6

Source: PJT Reports

on overseas trade, and it trades in competitive world markets in which it has little influence on either the prices it receives for exports or the prices it pays for imports. Changes in domestic conditions of supply and demand have little impact on export and import prices. More specifically, the Australian economy has the following characteristics: it is small compared with most of its trading partners; exports consist mainly of agricultural and mineral products and are produced in a capital-intensive sector; imports are primarily manufactured products and comprise mainly capital goods and producer goods which are not produced domestically.

It has been argued that the need for an incomes policy may be greater in such an economy than in an economy characterised by a dominant manufacturing sector and with some control over its terms of trade (see for example, Whitehead footnote). The argument is as follows: if domestic prices in a "dependent" economy such as Australia rise more rapidly than prices overseas, the economy will tend to experience balance of payments problems by way of cost-push pressure on exports. Exports become less profitable, as they are more difficult to sell overseas, and this will restrict both the flow of additional resources into the export sector as well as investment by enterprises already in that sector. The impact of this mechanism will be to retard export volume growth. At the same time, balance of payments pressure would result on the import side: with a higher domestic inflation rate than that experienced overseas, there will tend to be some increase in imports as Australians switch from locally-produced goods to the now relatively cheaper imported products.

Although the impact of these twin balance of payments pressures will be different in a dependent economy compared with a manufacturing country, they will nevertheless operate. The relevant question in need of answer at this point is the extent to which a wages and prices policy would alleviate the balance of payments pressures generated by inflation. Clearly, an incomes policy would have the desired effect on the balance of payments only if it proves successful in eliminating the cause of the dilemma, i.e. in reducing inflation. As indicated elsewhere in this volume,

there are strong theoretical grounds for doubting the ability of an incomes policy to lower the inflation rate.

Despite the fact that the Australian economy is a "dependent" economy, so long as economic policy is directed towards the effects of inflation (through an incomes policy) and not at its root causes, there exist no grounds for arguing a special case.

See D. H. Whitehead, *Stagflation and Wages Policy in Australia* (Melbourne: Longman, 1973).

IV PRICE AND WAGE REGULATION IN AUSTRALIA

The rapid increase in the rate of inflation during the early 1970s led to the establishment of the Prices Justification Tribunal in August 1973. And the wages explosion in the subsequent year led to the re-introduction of wage indexation (after a 22 year break). These are the 2 main areas in which "incomes policy" has been applied in Australia during the 1970s recession.

1. The Prices Justification Tribunal: a toothless tiger? The PJT was established in 1973 by the Prices Justification Act (which came into force on August 1st of that year). The PJT was set up primarily to take an active role in restraining inflation in Australia, and is an administrative organisation which plays a "watch-dog" role in the determination of prices for most goods. The name given to this body indicates that the PJT is not overtly charged with the responsibility for controlling prices; rather, the stress is on its role in assessing the justification of price rises or proposed price rises.

Whilst the distinction between justifying prices and controlling prices may be difficult to accept in practice, it is clear that the operations of the Tribunal have, by and large, had little significant impact on Australian inflationary experience since the establishment of the PJT. Not only has the inflation rate risen dramatically since its inception, but also the great bulk of price increases which have fallen within the Tribunal's ambit since August 1973 have been accepted as "justified". In other words, to the extent that the vast majority of notices of proposed price increases have

been accepted by the Tribunal, there is a strong case for arguing that the establishment of the PJT has been a costly waste of time, effort, and resources, and that it has contributed very little to anti-inflationary policy.

The functions of the PJT are to inquire into the appropriateness of prices at which companies falling within the ambit of the Act supply or propose to supply goods and services. Companies to which the Act originally applied were those with a turnover of at least $20m. Those companies proposing to increase prices are required to notify the Tribunal of their intentions, and the PJT must, within 21 days, then notify the company concerned whether or not it intends to hold an inquiry into the appropriateness of that price. The Act provides both for exemptions from the procedure of the PJT and also for companies to substitute their original proposal with another.

Amendments to the Act in 1974 broadened the scope of the Tribunal's activities. Although only those companies with a turnover exceeding $20m. are required to notify the PJT of proposed price increases, the 1974 amendments gave the Tribunal general authority to inquire into and report on prices charged by all companies, regardless of turnover. In addition, the amendments require the Tribunal to inform companies of any lower price or whether they intend to proceed with their original proposal: a public inquiry is then held if the company does not accept the Tribunal's recommended price.

The PJT Act clearly points to the anti-inflationary role of the Tribunal, for if its deliberations lead the PJT to conclude that a particular price rise is not justified, it is required to report on what lower price would be justified. While the Tribunal may, therefore, recommend a lower price than that sought by a company, it cannot recommend a higher price than that proposed.

Note that the Act includes no provision for any authority for compelling observance of the Tribunal's recommendations. Although the 1973 Act made provision for fines to be imposed on companies if they fail to notify the Tribunal of proposed price increases or if they do not follow

the stipulated procedures, the PJT has no way of compelling the implementation of its recommendations.

2. The PJT in action

From the outset, the PJT has been predominantly concerned with its anti-inflationary role. The First Annual Report of the Tribunal spelt out in clear terms that it was using the resources at its disposal so as to achieve the greatest possible anti-inflationary impact. Thus, the PJT has adopted a short-term view, by concentrating on the immediate impact of proposed price increases; as a result, it has devoted little effort to a consideration of long-term aspects of pricing such as the increased availability of goods and services. That this emphasis on short-run effects was in accord with deliberate government policy during the early life of the Tribunal is evidenced by Treasurer Crean's statement in his 1974 budget speech . . . the Government expects the principal burden of restraint to fall on upper income groups, particularly through the impact on profits of the operations of the Prices Justification Tribunal . . ." *(Budget Speech, 1974-75).*

No effects on inflation

Yet when we examine the record, it is not at all self-evident that the Tribunal has had any noticeable beneficial effect on the inflation rate. Table 15 details movements in Australia's inflation rate since the establishment of the PJT, together with the number of price notices processed by the Tribunal each year and the share of GDP accruing to corporate profits.

One could be excused for making the observation that there appears to be a direct relationship between the number of notices processed by the PJT and the inflation rate: i.e., that the inflation rate increased along with the Tribunal's activity during its first few years of operation and has fallen with the recent decline in PJT activity. Moreover, there appears to be an inverse relationship between the level of PJT activity and the share of national income accruing to profits: i.e. the ratio of profits to GDP fell with increasing

PJT price "surveillance" and rose with the recent decline in the Tribunal's activity. A cursory glance at the Table suggests such correlations, albeit loose ones.

Whilst it may be overly simplistic to be dogmatic about these two observations, it is nevertheless tempting to suggest the implications of this line of reasoning: viz. that the lower the level of PJT activity, the lower will be the inflation rate and the higher the rate of corporate profitability!

TABLE 15: INFLATION, PJT ACTIVITY & PROFITS

Quarter		Annual inflation rate %	Number of price notices processed by PJT	$\frac{\Pi}{GDP}$ %
1973-74	S	10.6	3,859	13.1
	D	13.2		
	M	13.6		
	J	14.5		
1974-75	S	16.0	7,502	10.9
	D	16.3		
	M	17.6		
	J	16.9		
1975-76	S	12.1	7,739	10.8
	D	14.0		
	M	13.4		
	J	12.3		
1976	S	13.9	2,871	13.0
	D	14.4		

Source: ABS; PJT Reports

The PJT and investment risks

It is, of course, true that a number of factors have an important bearing on inflation and profit rates, but it is here suggested that PJT activity is in fact one such factor.

The rudimentary evidence given in Table 15 supports the view that the existence of a price-surveillance body such as the PJT disturbs the workings of the market.

One of the crucial results of the activities of the PJT has been to increase uncertainty and risk. By attempting to "normalize" profits, it has adversely affected the incentive to invest. In a market economy, the need for investment in a particular area is reflected in the opportunity for making above-average profit. The fact that such opportunities for making high profits tend to attract investment does not necessarily mean that the high profits will be indefinitely maintained, for self-correcting forces tend to come into operation whereby other investment is attracted into that area. This process will reduce profitability in that industry to something approaching "normality". Similarly, the existence of low profits in a particular industry suggest over-investment, that additional investment resources would be better employed in other areas.

Notwithstanding the claim that the PJT's attempts to control prices are well-meaning, the fact that the Tribunal attempts to ensure that all firms obtain roughly the same rate of return on funds essentially suppresses the market signals which indicate those areas where investment is or is not required. In other words, the Tribunal is using a concept of "normal profits" whenever it assesses whether a particular firm's profits are too high or too low; it therefore is implicitly taking account of only shortrun considerations of market performance and omitting any significant consideration of long-run factors. In so doing, the workings of the PJT have distorted the pattern of investment in Australia during the 1970s recession. The disincentive towards risk taking, as provided by the existence and operation of the PJT, has doubtless been one factor in the dismal private sector investment levels since the Tribunal's establishment: over the period 1959-60 to 1973-74, real gross private investment (i.e. investment expressed in terms of constant 1966-67 prices) increased at an annual average rate of 6%; in 1974-75 it fell by 10%, and rose marginally by 1% in 1975-76.

3. No justification for the PJT?

Tables 16 and 17 summarize the activity of the PJT during the first 41 months of its operation (i.e. from August 1973 to December 1976). During that period, the PJT processed 21,971 price notices; of that total, 18,583 were approved by the PJT in their original form, 2,317 were subject to lower price approvals by the PJT and subsequently accepted by companies concerned, and 795 were withdrawn by companies. Some 85% of all price notices processed by the Tribunal in its first 41 months of operation were thus approved on the basis originally notified to the PJT, and 15% were reduced or completely withdrawn. The proportion of price notices approved in their original form has declined, from 87% in 1973-74 to 82% in the latest half-year, and the proportion withdrawn by companies has increased, from 1% to 7% respectively.

The staff establishment of the PJT has grown in roughly the same proportion as the number of price notices processed, from 86 positions at the end of June 1974 to 160 at the end of June 1976.

The data in Tables 16 and 17 clearly demonstrate that the vast majority of price notices processed by the PJT have been approved in their original form, without alteration: to date, some 85% of all price notices processed fall into this category. It is therefore little wonder that the Tribunal's recommendations have been largely adhered to: most notifications have been successful, so it is to be expected that most price recommendations have been accepted by the companies concerned.

In sum, then, to the extent that the PJT takes little cognizance of market signals, its activities tend to distort investment expenditure; and to the extent that the great bulk of its processing is mere formality, the Tribunal's effort is largely a waste of time and resources. There is little doubt that a cost-benefit study of the PJT's activities would be hard-pressed to find a justification for its existence.

TABLE 16: PRICES JUSTIFICATION TRIBUNAL ACTIVITY

Period	Total number of price notices processed by PJT	No. of price notices		No. of notices of proposed prices approved or withdrawn without public inquiry notice being issued		
		Heard public enquiry	Where public inquiry notice issued but later withdrawn and/or amended	Original notices	Substitute notices for a lower price issued and accepted	Withdrawn by companies
A) NUMBER:						
11 months to end June 1974	3,859	15	31	3,356	421	36
1974-75 fiscal year	7,502	50	140	6,271	863	178
1975-76 fiscal year	7,739	13	14	6,607	725	380
6 months to end Dec. 1976	2,871	2	11	2,349	308	201
TOTAL 41 MONTHS TO END DECEMBER 1976	21,971	80	196	18,583	2,317	795
B) PROPORTION OF NUMBER						
11 months to end June 1974	100	0.4	0.8	87.0	10.9	0.9
1974-75 fiscal year	100	0.7	1.9	83.6	11.5	2.4
6 months to end Dec. 1976	100	0.1	0.4	81.8	10.7	7.0
TOTAL, 41 MONTHS TO END DECEMBER 1976	100	0.4	0.9	84.6	10.6	3.6

Source: PJT Reports

TABLE 17: PJT ACTIVITY BY INDUSTRY GROUPS*

	1973-74		1974-75		1975-76		2nd Half, 1976	
	Total No.	% Approved (%)	Total No.	% Approved (%)	Total No.	% Approved (%)	Total No.	% Approved (%)
Manufacturing:								
Chemicals & related products	371	88	523	86	509	91	191	82
Household appliances, electrical equipment, T.V., and radio	661	91	725	88	564	89	87	79
Food products & beverages	732	89	1139	84	1178	90	375	89
Wholesale trade:								
Petroleum and petroleum products	208	87	300	86	312	60	90	53
Retail trade:								
Motor vehicles, parts, etc.	361	84	252	72	380	77	155	62
Department, variety stores	–	–	146	82	161	94	60	77
Other:								
Finance & investment etc.	–	–	172	85	231	80	98	86

*Note: The 2 figures given for each year, for each industry group, are the total number of price notices processed by the Tribunal, and the proportion of those notices approved on the basis originally notified to the PJT.

Source: PJT Reports

4. Wage Indexation: anodyne for inflation?

The history of wage-fixation in Australia has been dominated by the Arbitration Commission. This federal body has the central role in wage setting, as its lead in varying wage rates for employees on federal awards is generally followed by the various Stage wages tribunals.

From the basic to the "total" wage

Prior to 1966, wage and salary levels comprised 2 quite separate components: the basic wage, which was a minimum wage and the basic component of all wages; and a margin, which was a payment above the minimum wage for skill. For the 32 years from 1921-1953, the Arbitration Commission automatically adjusted the Australian basic wage, on a quarterly basis, in line with changes in the consumer price level.

Quarterly indexation of the basic wage was discontinued in 1953 because of its impact on the rate of price inflation. From 1961 to 1965, the Commission's approach was to increase the basic wage on an annual basis in line with the rate of price-inflation during the preceding year, unless convincing arguments to the contrary were raised.

Then, in 1966, the concept of the basic wage was abolished and the concept of the total wage introduced. The reason for this change stemmed from the fact that unions had tended to use essentially the same arguments both for increasing the basic wage and for increasing margins: the two were accordingly combined, and wage determination on a total wage basis came into operation in 1967. Since that time, the Commission has explicitly maintained the concept of a minimum wage, quite separate from the total wage, as the minimum wage received by any wage-earner. This system of wage determination remained in force until early 1975.

Table 18 details the national wage decisions of the Arbitration Commission from the end of quarterly indexation in 1953 to the 1974 national wage case (the last increase awarded prior to the re-introduction of wage indexation in 1975). Percentage increases in prices and in average weekly earnings are also shown.

TABLE 18: WAGE DECISIONS, EARNINGS & PRICES

Year	% increase in Average Weekly Earnings %	% increase in Consumer Price Index %	National wage decision* (month of effect in brackets)
1954-55	5.6	0.6	6.3 (Nov. 1954)
1955-56	6.8	4.2	–
1956-57	4.7	5.8	3.2 (June 1956)
1957-58	2.7	1.0	3.3 (May 1957)
1958-59	3.1	1.6	1.6 (May 1958)
1959-60	7.8	2.5	9.4 (June 1959)
1960-61	4.8	4.1	–
1961-62	2.8	0.4	3.2 (July 1961)
1962-63	2.6	0.2	–
1963-64	5.0	0.9	1.9 (April 1963)
1964-65	7.3	3.8	5.4 (June 1964)
1965-66	4.4	3.8	1.2 (June 1965)
1966-67	6.5	2.7	6.9 (July 1966)
1967-68	5.8	3.3	2.3 (July 1967)
1968-69	7.5	2.6	2.9 (October 1968)
1969-70	8.4	3.2	3.0 (December 1969)
1970-71	11.0	4.8	6.0 (January 1971)
1971-72	10.1	6.8	2.5 (May 1972)
1972-73	9.1	6.0	4.4 (May 1973)
1973-74	16.3	12.9	4.2 (May 1974)

*Note: Figures given are % increase in average award wages implied by any increase in basic wage and margins (pre 1967) or total wage (post 1967).

Source: ABS; J. E. Isaac, *op. cit* (Table 6) p. 158; P. D. Jonson, K. L. Mahar and G. J. Thompson, "Earnings & Award Wages in Australia", in *Australian Economic Papers*, Vol 13, June 1974, p. 89.

The emergence of over-award wages

In the 20 years to 1973-74, the national wage decision exceeded the rise in the CPI in 9 years, was the same as it in one year, and was less than the CPI rise in 10 years (in 3 of these years there was no national wage increase granted). It is interesting that average weekly earnings typically increased at a substantially higher rate than the national wage decisions implied, indicating the importance of over-award payments in the Australian wage structure.

The rise to prominence of over-award wages clearly occurred only after the introduction of the total wage concept. During the 13-year period 1954-55 to 1966-67, although the national wage decision marginally exceeded the

increase in average weekly earnings on 5 occasions (this situation arose because of the lags associated with the timing of the implementation of such decisions), in most years the 2 series rose at very similar rates. After the introduction of the total wage concept, however, the divergence between the national wage decision and increases in average earnings intensified. The ever-increasing resort to over-award payments after 1967 led finally to a 12 percentage points excess of average weekly earnings growth (of 16%) over the national wage decision (of 4%) in 1974.

The enormous pressures generated by this rapid growth in earnings, way above the increase awarded by the Arbitration Commission, led to the question of the reintroduction of wage indexation being brought up at the 1974 national wage case. However, wage indexation was rejected at that time.

The re-introduction of indexation

Following persistent and widespread calls for the reintroduction of wage indexation throughout 1974, the Full Bench of the Commission came out with a qualified acceptance of wage indexation at the conclusion of its 1975 national wage case on April 30th. Although much of the basic ground, both for and against indexation, had been argued in detail in previous national wage cases, the Commission's deliberations resulted in a very lengthy hearing indeed, early in 1975. The national wage case began on the 21st January and the final decision, to reintroduce wage indexation, was handed down on 30th April – more than three months after the hearing began. One reason for the prolonged hearing was that, whereas both the union movement and the federal (ALP) government supported the proposals for wage indexation, the national employers' groups and various state governments were against its introduction.

In that historic decision of the 30th April 1975, the Arbitration Commission, in reintroducing a system of wage

indexation into Australia, incorporated the following four features:

(i) all ordinary award rates were to be adjusted by the full 3.6% increase in the CPI for the March 1975 quarter;

(ii) the male minimum wage was increased by $4;

(iii) under the wage indexation system introduced, there is to be no wage adjustment to compensate for a CPI rise in any quarter unless the CPI increase in that quarter is at least 1% – movements in the CPI of less than 1% are to be carried forward to subsequent quarter(s) and an indexation wage adjustment will only occur when the accumulated movement is at least 1%; and

(iv) in addition to the above increases, the only other grounds which may justify wage increases are changes in work value (such as the nature of the work), skill, and responsibility required, or the conditions under which the work is performed.

It is particularly noteworthy that, in contrast to the system of automatic quarterly wage adjustment which operated up to 1953, the latest wage indexation experiment is not automatic. That is to say, Australia's post-1975 wage indexation system does not provide for the automatic full adjustment of wages and salaries in line with rises in the CPI.

As Table 19 indicates, for the first 4 quarters of indexation, the Arbitration Commission decided in favour of full indexation, that is, of increases in wages and salaries equal to the full rise in the CPI of the preceding quarter. Although no increase was granted in the September 1975 quarter (as the CPI rise was below 1%), the December decision compensated wage levels for the increases in the combined September and December CPI figures.

TABLE 19: INDEXATION, EARNINGS, AND PRICES

Quarter	% increase in AWE (quarterly) %	% increase in CPI (quarterly) %	Indexation decision
1975 M	2.4	3.6	3.6%
J	2.8	3.5	3.5%
S	3.0	0.8	–
D	5.0	5.6	6.4%
1976 M	2.3	3.0	3.0% up to $125; $3.80 above $125
J	4.5	2.5	$2.50 up to $166; 1.5% above $166
S	3.4	2.2	2.2%
D	1.4	6.0	$5.70 flat increase
1977 M	2.5	2.3	1.9% up to $200; $3.80 above $200
J	3.1	2.4	2.0%

Source: ABS; CBA Bank Economic Review

Indexation and inflation

At the end of 1975, it became clear that, although the inflation rate had peaked earlier that year (see Table 15), the impact of wage indexation was locking the economy into a high inflation rate which was only very slowly falling. Taking cognizance of the inescapable effects of wage indexation in perpetuating inflation rates or at best allowing inflation to fall only slowly, the Arbitration Commission altered its approach from the March 1976 quarter.

Since that time, wage indexation in every quarterly decision other than September 1976 and June 1977 has taken the form of either a flat increase or a combination of a percentage increase and a flat increase (this latter approach is termed "plateau indexation"): except for the June 1976 decision, plateau indexation has taken the form of a percentage increase up to around average earnings and a flat increase above that level.

The national wage decision in respect of the December 1976 quarter awarded $2.90 per week to all wage and salary

earners in respect of the Medibank price-effect (resulting from the introduction of a revised national health scheme), plus a flat $2.80 for the remaining component of the December CPI rise. The indexation decision in respect of the March quarter 1977 put the final seal on the price-wage freeze coffin. The proposed 3-month voluntary price-wage freeze, announced at the April Premiers' Conference, ranks as one of those rare instances when state and federal government leaders agree on a common course of action. Yet it was clear from the outset that such a freeze could not work. The award of 1.9% on incomes up to $200 per week and a flat $3.80 on incomes above that level by the Arbitration Commission formalised the already-apparent end of the proposed voluntary freeze. The Arbitration Commission's March decision excluded the impact of devaluation on the CPI (estimated at 0.4% out of the 2.3% March CPI rise). This was continued in the June 1977 decision, which represented a full flow-on of the CPI rise after the marginal impact of the devaluation was excluded.

5. The system under strain

The adherence by the Commission, throughout 1976 and 1977, to less than full indexation (with the exception of the September 1976 quarter) has placed ever-increasing strains on the indexation system itself. But the shakiness of the indexation system does not stem merely from its impact in permitting the inflation rate to fall only slowly. An additional factor militating against the longer-term viability of wage indexation has been the continual erosion of after-tax earnings. One reason for the present shakiness of indexation as a wage-fixing system in Australia is reflected in the figures given in Table 20: the figures chart the course of average weekly earnings, on a gross and net basis, in comparison with CPI movements, since the introduction of wage indexation.

The figures indicate that over the 2½ years to June 1977, consumer prices rose by 32% while (gross) average weekly earnings increased by 30%; over that period, tax payable on AWE rose by 35% with the result that net take-home AWE increased by less than 28%.

TABLE 20: AVERAGE WEEKLY EARNINGS: GROSS & NET

Quarter	AWE* ($)	Tax Payable on AWE** ($)	Net AWE ($)	Cumulative & change from March 1975			
				AWE	Tax	Net AWE	CPI
1975 M	152.0	42.8	109.2	–	–	–	–
J	154.2	43.6	110.6	1.4	1.8	1.3	3.5
S	158.8	45.2	113.6	4.5	5.6	4.0	4.3
D	166.7	48.0	118.7	9.7	12.0	8.7	10.1
1976 M	170.5	49.3	121.2	12.2	15.1	11.0	13.4
J	178.1	50.6	127.5	17.2	18.2	16.8	16.3
S	184.3	52.8	131.5	21.3	23.3	20.5	18.8
D	186.0	53.4	132.6	22.4	24.7	21.5	26.0
1977 M	192.1	55.7	136.4	26.4	30.1	24.9	28.8
J	198.1	57.8	140.3	30.3	35.0	28.4	31.9

*AWE = average weekly earnings per employed male, seasonally-adjusted

** Income tax payable is gross of rebates

Source: ABS

TABLE 17: PJT ACTIVITY BY INDUSTRY GROUPS*

	1973-74		1974-75		1975-76		2nd Half, 1976	
	Total No.	% Approved (%)	Total No.	% Approved (%)	Total No.	% Approved (%)	Total No.	% Approved (%)
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Wholesale trade:								
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Quarterly indexation of the basic wage was discontinued in 1953 because of its impact on the rate of price inflation. From 1961 to 1965, the Commission's approach was to increase the basic wage on an annual basis in line with the rate of price-inflation during the preceding year, unless convincing arguments to the contrary were raised.

Then, in 1966, the concept of the basic wage was abolished and the concept of the total wage introduced. The reason for this change stemmed from the fact that unions had tended to use essentially the same arguments both for increasing the basic wage and for increasing margins: the two were accordingly combined, and wage determination on a total wage basis came into operation in 1967. Since that time, the Commission has explicitly maintained the concept of a minimum wage, quite separate from the total wage, as the minimum wage received by any wage-earner. This system of wage determination remained in force until early 1975.

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1956-57	4.7	5.8	3.2 (June 1956)
1957-58	2.7	1.0	3.3 (May 1957)
1958-59	3.1	1.6	1.6 (May 1958)
1959-60	7.8	2.5	9.4 (June 1959)
1960-61	4.8	4.1	–
1961-62	2.8	0.4	3.2 (July 1961)
1962-63	2.6	0.2	–
1963-64	5.0	0.9	1.9 (April 1963)
1964-65	7.3	3.8	5.4 (June 1964)
1965-66	4.4	3.8	1.2 (June 1965)
1966-67	6.5	2.7	6.9 (July 1966)
1967-68	5.8	3.3	2.3 (July 1967)
1968-69	7.5	2.6	2.9 (October 1968)
1969-70	8.4	3.2	3.0 (December 1969)
1970-71	11.0	4.8	6.0 (January 1971)
1971-72	10.1	6.8	2.5 (May 1972)
1972-73	9.1	6.0	4.4 (May 1973)
1973-74	16.3	12.9	4.2 (May 1974)

*Note: Figures given are % increase in average award wages implied by any increase in basic wage and margins (pre 1967) or total wage (post 1967).

Source: ABS; J. E. Isaac, *op. cit* (Table 6) p. 158; P. D. Jonson, K. L. Mahar and G. J. Thompson, "Earnings & Award Wages in Australia", in *Australian Economic Papers*, Vol 13, June 1974, p. 89.

The emergence of over-award wages

In the 20 years to 1973-74, the national wage decision exceeded the rise in the CPI in 9 years, was the same as it in one year, and was less than the CPI rise in 10 years (in 3 of these years there was no national wage increase granted). It is interesting that average weekly earnings typically increased at a substantially higher rate than the national wage decisions implied, indicating the importance of over-award payments in the Australian wage structure.

The rise to prominence of over-award wages clearly occurred only after the introduction of the total wage concept. During the 13-year period 1954-55 to 1966-67, although the national wage decision marginally exceeded the

increase in average weekly earnings on 5 occasions (this situation arose because of the lags associated with the timing of the implementation of such decisions), in most years the 2 series rose at very similar rates. After the introduction of the total wage concept, however, the divergence between the national wage decision and increases in average earnings intensified. The ever-increasing resort to over-award payments after 1967 led finally to a 12 percentage points excess of average weekly earnings growth (of 16%) over the national wage decision (of 4%) in 1974.

The enormous pressures generated by this rapid growth in earnings, way above the increase awarded by the Arbitration Commission, led to the question of the reintroduction of wage indexation being brought up at the 1974 national wage case. However, wage indexation was rejected at that time.

The re-introduction of indexation

Following persistent and widespread calls for the reintroduction of wage indexation throughout 1974, the Full Bench of the Commission came out with a qualified acceptance of wage indexation at the conclusion of its 1975 national wage case on April 30th. Although much of the basic ground, both for and against indexation, had been argued in detail in previous national wage cases, the Commission's deliberations resulted in a very lengthy hearing indeed, early in 1975. The national wage case began on the 21st January and the final decision, to reintroduce wage indexation, was handed down on 30th April – more than three months after the hearing began. One reason for the prolonged hearing was that, whereas both the union movement and the federal (ALP) government supported the proposals for wage indexation, the national employers' groups and various state governments were against its introduction.

In that historic decision of the 30th April 1975, the Arbitration Commission, in reintroducing a system of wage

indexation into Australia, incorporated the following four features:

(i) all ordinary award rates were to be adjusted by the full 3.6% increase in the CPI for the March 1975 quarter;

(ii) the male minimum wage was increased by $4;

(iii) under the wage indexation system introduced, there is to be no wage adjustment to compensate for a CPI rise in any quarter unless the CPI increase in that quarter is at least 1% – movements in the CPI of less than 1% are to be carried forward to subsequent quarter(s) and an indexation wage adjustment will only occur when the accumulated movement is at least 1%; and

(iv) in addition to the above increases, the only other grounds which may justify wage increases are changes in work value (such as the nature of the work), skill, and responsibility required, or the conditions under which the work is performed.

It is particularly noteworthy that, in contrast to the system of automatic quarterly wage adjustment which operated up to 1953, the latest wage indexation experiment is not automatic. That is to say, Australia's post-1975 wage indexation system does not provide for the automatic full adjustment of wages and salaries in line with rises in the CPI.

As Table 19 indicates, for the first 4 quarters of indexation, the Arbitration Commission decided in favour of full indexation, that is, of increases in wages and salaries equal to the full rise in the CPI of the preceding quarter. Although no increase was granted in the September 1975 quarter (as the CPI rise was below 1%), the December decision compensated wage levels for the increases in the combined September and December CPI figures.

TABLE 19: INDEXATION, EARNINGS, AND PRICES

Quarter	% increase in AWE (quarterly) %	% increase in CPI (quarterly) %	Indexation decision
1975 M	2.4	3.6	3.6%
J	2.8	3.5	3.5%
S	3.0	0.8	–
D	5.0	5.6	6.4%
1976 M	2.3	3.0	3.0% up to $125; $3.80 above $125
J	4.5	2.5	$2.50 up to $166; 1.5% above $166
S	3.4	2.2	2.2%
D	1.4	6.0	$5.70 flat increase
1977 M	2.5	2.3	1.9% up to $200; $3.80 above $200
J	3.1	2.4	2.0%

Source: ABS; CBA Bank Economic Review

Indexation and inflation

At the end of 1975, it became clear that, although the inflation rate had peaked earlier that year (see Table 15), the impact of wage indexation was locking the economy into a high inflation rate which was only very slowly falling. Taking cognizance of the inescapable effects of wage indexation in perpetuating inflation rates or at best allowing inflation to fall only slowly, the Arbitration Commission altered its approach from the March 1976 quarter.

Since that time, wage indexation in every quarterly decision other than September 1976 and June 1977 has taken the form of either a flat increase or a combination of a percentage increase and a flat increase (this latter approach is termed "plateau indexation"): except for the June 1976 decision, plateau indexation has taken the form of a percentage increase up to around average earnings and a flat increase above that level.

The national wage decision in respect of the December 1976 quarter awarded $2.90 per week to all wage and salary

earners in respect of the Medibank price-effect (resulting from the introduction of a revised national health scheme), plus a flat $2.80 for the remaining component of the December CPI rise. The indexation decision in respect of the March quarter 1977 put the final seal on the price-wage freeze coffin. The proposed 3-month voluntary price-wage freeze, announced at the April Premiers' Conference, ranks as one of those rare instances when state and federal government leaders agree on a common course of action. Yet it was clear from the outset that such a freeze could not work. The award of 1.9% on incomes up to $200 per week and a flat $3.80 on incomes above that level by the Arbitration Commission formalised the already-apparent end of the proposed voluntary freeze. The Arbitration Commission's March decision excluded the impact of devaluation on the CPI (estimated at 0.4% out of the 2.3% March CPI rise). This was continued in the June 1977 decision, which represented a full flow-on of the CPI rise after the marginal impact of the devaluation was excluded.

5. The system under strain

The adherence by the Commission, throughout 1976 and 1977, to less than full indexation (with the exception of the September 1976 quarter) has placed ever-increasing strains on the indexation system itself. But the shakiness of the indexation system does not stem merely from its impact in permitting the inflation rate to fall only slowly. An additional factor militating against the longer-term viability of wage indexation has been the continual erosion of after-tax earnings. One reason for the present shakiness of indexation as a wage-fixing system in Australia is reflected in the figures given in Table 20: the figures chart the course of average weekly earnings, on a gross and net basis, in comparison with CPI movements, since the introduction of wage indexation.

The figures indicate that over the 2½ years to June 1977, consumer prices rose by 32% while (gross) average weekly earnings increased by 30%; over that period, tax payable on AWE rose by 35% with the result that net take-home AWE increased by less than 28%.

TABLE 20: AVERAGE WEEKLY EARNINGS: GROSS & NET

Quarter	AWE* ($)	Tax Payable on AWE** ($)	Net AWE ($)	Cumulative & change from March 1975			
				AWE	Tax	Net AWE	CPI
1975 M	152.0	42.8	109.2	–	–	–	–
J	154.2	43.6	110.6	1.4	1.8	1.3	3.5
S	158.8	45.2	113.6	4.5	5.6	4.0	4.3
D	166.7	48.0	118.7	9.7	12.0	8.7	10.1
1976 M	170.5	49.3	121.2	12.2	15.1	11.0	13.4
J	178.1	50.6	127.5	17.2	18.2	16.8	16.3
S	184.3	52.8	131.5	21.3	23.3	20.5	18.8
D	186.0	53.4	132.6	22.4	24.7	21.5	26.0
1977 M	192.1	55.7	136.4	26.4	30.1	24.9	28.8
J	198.1	57.8	140.3	30.3	35.0	28.4	31.9

*AWE = average weekly earnings per employed male, seasonally-adjusted

** Income tax payable is gross of rebates

Source: ABS

Taxation versus indexation

In other words, in the 2½ years since the introduction of wage indexation, gross weekly earnings of the "average" Australian male have risen by around 95% of the rise in the CPI, but the impact of the progressive income tax has been such as to limit the growth in take-home pay to around 90% of the growth in the CPI.

Thus, the purchasing power of average weekly earnings has fallen quite noticeably during the period of wage indexation, a wag-fixing system which was supposed to ensure the constancy of real wages. And although tax indexation (designed to ensure that income recipients pay no greater proportion of their income in tax simply because inflation and wage indexation have increased pay-packets) has been in operation since the start of the 1976-77 fiscal year, this decline in purchasing power of after-tax earnings has continued.

Note that the above in no way necessarily implies that the "average" Australian income-earner has lost under wage indexation: the conclusion is merely that the growth in average earnings (both gross and after tax) has been below the rate of price inflation since the introduction of the wage indexation system in 1975. It may well be demonstrable that the "average" Australian has gained under wage indexation rather than lost, because of the enormous expansion in the provision of social welfare services through the tax system. Although take-home average earnings have increased less rapidly than the price level, at the same time the "average" Australian is no longer required to provide for health costs out of take-home income; he has improved holiday and sick leave; he has no need to provide for the education of his children (or himself); and can look forward to tax-financed improved retirement benefits.

Indexation in the recession

A convincing argument can be made for the claim that wage indexation has tended to lift the wages floor: that is, that wage indexation has acted as a wages floor rather than as a wages ceiling. This is implicit in the oft-expressed view of commentators to the effect that the Federal government

should not only refrain from raising its own indirect taxes and charges, but also avoid policies which would force state and local government authorities to raise their taxes and charges, because of the impact of such taxes and charges in raising the CPI and hence wages via wage indexation.

The recent decisions by both the Arbitration Commission and the federal government in excluding certain variables from wage and tax indexation are an implicit expression of the view that indexation has raised the wages floor. The Commission has excluded the impact of Medibank and devaluation on the CPI from wage deliberations, while the government has also reduced the benefits of tax indexation by eliminating the impact of these two occurrences.

The pressure on wage indexation continues to build up, as evidenced by the decision to carry out an extensive review of Australia's wage fixation system: this review began late in June 1977.

In the meantime, wage indexation continues in the face of definite signs that its euthanasia will be completed soon. With inflation receding only slowly, it is clear that wage indexation has contributed little in the Australian fight against "stagflation", and that indeed, it is playing a positive role in perpetuating the recession.

V. CONCLUSION

Our analysis suggests that Australia's recent experience of incomes policies reinforces the view that the Prices Justification Tribunal has been a largely ineffectual body which has assisted the process of distorting investment by its neglect of a consideration of market signals, while the system of wage indexation has proven to be slowly self-destructing whilst at the same time raising the wages floor in the Australian economy.

The preceding analysis suggests the implication that, regardless of what incomes policies are pursued by the Australian authorities, their success will be limited until the maintenance of a stable currency as a policy objective takes precedence over incomes policies and other measures designed to placate interest groups.

(ii) Much ado about nothing: The Australian wage and price freeze, April 1977

Peter Samuel

"She'll do mate" is one of those phrases that is supposed to encapsulate something about the Australian character – the idea that we are a casual, happy-go-lucky people who do not take things very seriously. We give it a burl and if we are not winning, well too bad. No sweat. We cut our losses quickly.

Something of that colloquial spirit seems to have been invested in the recent "freeze" fiasco. Rarely in the long, dismal history of government attempts to control prices and wages has any authority so casually embarked on a freeze and never so quickly and casually abandoned it, as the Australian Federal Government did in April, 1977.

It started on April 13th and some wit in Canberra pointed out that April is the fool's month and the 13th, the unlucky day. It was foolish of course. Any attempt by a government to impose itself over individual prices is foolish, or worse. It could have been very unlucky for Australia, except that it was so casually pursued that it was not able to wreak the damage that seriously pursued controls have invariably produced. Some damage it undoubtedly did do.

Until May it looked as though unemployment had stabilised. But the May survey of the Bureau of Statistics showed a major rise in joblessness, the largest rise since the onset of the recession in the second half of 1974. The June quarter covering the period of the "freeze" also saw a major setback to corporate revival. After six successive quarters of good growth, the National Accounts Estimates came up with a major drop in company "gross operating surplus" (roughly profit before depreciation allowance). It would be wrong to attribute the unemployment and the profit drop entirely to the "freeze". Higher minimum wages decreed by the Arbitration Commission in March may have played a part, and in addition, the economy was suffering from the shock of the 17½% devaluation of November 1976 and the extraordinary mismanagement of the exchange rate through the early months of 1977. Liquidity had been alternately heavily squeezed by the futile attempt to hold the old exchange rate, then it was buffeted by the shock size of the devaluation and by the frantic backtracking as dissident officials tried to raise the currency again in what was called a "managed float" (that was the euphemism for what was perceptively dubbed in Canberra the "mismanaged grope").

But the other vicissitudes of government policy aside, the freeze contributed heavily to the economic downturn evident in the second and third quarters of 1977. More significant however was the political weakness evident in the fiasco, the sheer lack of the most elementary commonsense or wisdom demonstrated by various government and business leaders. Almost without exception, Liberal politicians and even business leaders joined in a chorus of collectivist cajolery. It was almost Maoist, in the sense that the view was put that if only everybody could together summon up sufficient "national will" and "community spirit", the country's economic problems would suddenly be eliminated, like sparrows or flies remorselessly pursued by millions of people in one enormous campaign by the masses.

It should not be necessary to point out that controls have never solved inflation, as the previous chapters so well explain. But the lesson has been so little learnt that it will bear repeating perhaps that generally rising prices and wages

are *not inflation*, but the symptoms of inflation. You never treat diseases by treating the symptoms. You can for a while remove the symptoms, but the disease will be unaffected and may indeed be worsened and will at last break out in other manifestations. In the case of "treating" inflation by means of price controls, the greatest damage is done through the damage to the central nervous system by which the economic animal senses changes in the economic environment, communicates these and develops responses.

The freeze of April 13th 1977 demonstrated the abysmal economic illiteracy of our national leaders. It was born out of political expediency in large degree. The Premiers' Conference out of which the "freeze" announcement came, was called to discuss proposals for the second stage of Prime Minister Fraser's income tax sharing arrangements and was a dismal failure in this regard, since none of the state Premiers was prepared to take responsibility for raising his own revenue. With this political failure in prospect, the Liberal leaders at least were anxious to find some other news to distract attention from this disappointment.

Yet it would be pleasing to be lieve that the "freeze" was just political expediency, a distracting gimmick of the kind politicians frequently engage in. Unfortunately the evidence is that politicians concerned really believed in the freeze. Leakage of the text of the closed discussions shows many of the government leaders expressing profound faith in the freeze. The proposer of the freeze, Victorian Liberal Premier Dick Hamer referred to it in extravagantly hopeful terms. He said it was going to "bring about a permanent check" to inflation. He said "we should all pull together . . . recognising that we all have something to contribute to the fight . . ." It would give "the whole community a breathing space". What was needed was "a real national consensus to try and stem the tide of inflation". He declared at one high point in the rhetoric: "This is not airy fairy; it is feasible if we have the will to do it". NSW Premier Wran also subscribed to similar sentiments, referring to the "curious lack of motivation in Australia amongst all sections of the community to come to grips with what we know is a divisive and difficult problem . . ." Everyone, he claimed,

"would be thrilled if we could get some national consensus . . .". We were to hear a great deal of this woolly collectivist nonsense from the Prime Minister and his colleagues in the next few weeks as his government tried to launch the freeze, or pause as it was sometimes called (there were immediately quarrels over terminology).

That such inflated and empty rhetoric could be expressed in private is an indication of the extent of delusionary beliefs that somehow inflation (and other difficult problems) can be solved not by the rational application of tough-minded analysis followed by remedial policy action but by a greater upsurge of collectivist exhortation about restraint and consensus and all working together, somehow. Instead of justifying the freeze in terms of explanations as to *how* it should work, the politicians simply pointed out how many other fools there were, continually quoting messages of support and opinion polls on the subject. Faith was seen as a substitute for reason.

That explains how the freeze could be adopted without any expert economic advice whatever. There were no departmental submissions. There was not even a Cabinet meeting on the subject. It was a crude act of faith on behalf of Prime Minister Fraser and Premiers Wran and Hamer (to their credit, Premiers Dunstan, Bjelke-Petersen and Court expressed mild doubts about the scheme, but at first were reluctant to come out publicly against it).

The proximate causes of the "thaw" of the "freeze" lie in its inherent absurdity. No one had thought how to freeze prices determined flexibly by auction and tender every day – such as the prices of a whole range of food products, building jobs and contracted services. What to do about imports whose prices are beyond anyone's powers to "freeze"? And what about price rises "in the pipeline", approved by government regulatory bodies, or notified, but not yet in effect?

Some large shopping chains, foolishly seeking popular acclaim and publicity boldly announced they would pay no more for any of their stocks, whereupon it not surprisingly transpired that they quickly started to run short of many

lines. There was enormous confusion about the details of how the freeze was supposed to work.

It was originally said that the freeze was to be dependent on everyone agreeing to stop raising prices and wages; that businesses would not be expected to freeze their prices if the costs of inputs were not also frozen. It was also declared to be voluntary. Both principles were quickly abandoned. One business which declared that it could not abide by the freeze on prices, was viciously denounced and threatened with retaliatory action. The unions denounced the scheme and it was quickly clear that the whole thing was a chaotic gimmick, lots of noise and little thought or action. Its end was acknowledged on May 24th, just 41 days after its inauguration. The Arbitration Commission and the unions put the final torpedoes into an already sinking hulk and few mourned its disappearance.

The major lesson to be learned is that many of our leaders and opinion-makers live in a mental world of medieval delusions. They sometimes denounce the market economy as "nineteenth century economics", but their thinking is far more primitive. In imposing such madness as the "freeze" they reveal themselves captive to primitivist notions of the existence of objectively "just" prices and wages and guild-type concepts of regulation. Historians of economic thought would probably date their thinking as somewhere in the fourteenth century.

PART D
A SUMMING UP

8. The Political Economy of Wage and Price Control

The Political Economy of Wage and Price Control

(i) Samuel Brittan & Peter Lilley

(ii) Milton Friedman

THE AUTHORS

(i) Samuel Brittan and Peter Lilley. (see Chapter 2)

(ii) Milton Friedman was born in 1912 in New York City and graduated from Rutgers before taking his M.A. at Chicago and Ph.D at Columbia. From 1935-37 he worked for the U.S. National Resources Committee and from 1941-43 for the U.S. Treasury. Since 1946 he has taught at the University of Chicago, where he is now the Paul Snowden Russell Distinguished Service Professor of Economics. He has also taught at the Universities of Minnesota, Wisconsis and Columbia as well as lecturing at universities throughout the world from Cambridge to Tokyo. Since 1946 he has also been on the research staff of the National Bureau of Economic Research, and, from December 1976, a senior Research Fellow at the Hoover Institution of Stanford University. Professor Friedman was awarded the 1976 Nobel Prize in Economic Sciences.

The Political Economy of Wage and Price Control

(i) Incomes policy — the case against*

Samuel Brittan and Peter Lilley

1. PRICES – OR COMPULSION?

It is at the level of particular wages and prices that controls can do some of their greatest harm. We have become so accustomed to thinking of the rate of increase of the cost-of-living index, or of average wage rates or earnings, that it is easy even for economists to overlook the importance of relative prices and relative wages.

The evils of a general increase in prices, especially of a rapid and unpredictable kind, are by now common knowledge. The 'cost of living' has for several decades been at or near the top of the lists of voters' concerns as registered by the opinion polls. But the importance of relative prices – having the right ratio between the prices of different goods and services – is much less widely understood. Still less appreciated is the need for changes in these ratios. In the early mediaeval period a book of average price might exchange for the equivalent of two cows. Today a single cow would be worth several dozen hard-cover books and several hundred paperbacks.

People can appreciate that the development of printing

*from Samuel Brittan and Peter Lilley, *The Delusion of Incomes Policy*, Maurice Temple Smith, London 1977, pp. 14 - 18, 26 - 33.

has over the centuries made books cheaper relative to other things, while the technology of cattle rearing has not proved susceptible to such revolutionary improvements. But it is not so easy to appreciate the reasons for the more rapid upsets of our own day, why mortgage rates should rise and fall, why fares should rise so quickly, or why it is sometimes necessary to pay far more than the nationally negotiated hourly building wage to get some simple repairs done in one's home.

Variations in relative prices and wages have a dual role. One is to transmit information: about changing customer requirements, changing availability of labour, materials and other resources, and changing technology. The second is to give everyone in the market – firms, government agencies, workers and consumers, an incentive to act on that information in the most efficient way. Some prices, such as fresh fruit or stock market securities change from hour to hour; others such as specific consumer durables or cars, at intervals of many months. If these changes are frustrated the price mechanism will not be able to secure even a rough balance between supply and demand; and there will be shortages of some goods and some types of labour side by side with surpluses of others.

A control system faces a truly herculean task. It is difficult enough to pitch price ceilings to allow an appropriate level of profits for the whole economy. (If the prices fixed are too low, firms will have to dismiss workers, and investment will fall engendering fewer new jobs. If they are too high, the whole point of the exercise is lost.) It is next to impossible to fix tens of thousands of individual wages and prices in the whole economy.

Yet if they are wrong – which means too different from that which would prevail in a competitive market – too many of some goods will be produced and not enough of others, and many workers will be left without jobs. Even small wage or price discrepancies may result in quite substantial distortions. This is inevitable given how small profits are: even gross profits have not exceeded 16 per cent of GDP since the early 1950s (see Chart 1) and have usually been much less. Measured as a proportion of gross revenues (which

is how they appear to entrepreneurs) profits are an even smaller fraction. It follows that if, for example, product prices were frozen but the pattern of wage rates was altered under an incomes policy even by fairly small percentages, many goods previously in profitable production would be rendered unprofitable. Bankruptcy and unemployment would be widespread.

For precisely that reason any incomes policy that attempts to influence the pattern of market wage rates must allow businesses to adjust prices to reflect wage (and other) costs. So incomes policies almost by necessity involve cost-plus pricing. This removes, at a stroke, the long term competitive pressure to make economic use of scarce resources. If market signals and incentives are prevented from functioning, not only will output be wastefully low, but unemployment needlessly high.

It is small consolation that some of the worst effects are averted by the ineffectiveness of the controls – either because they merely ratify market levels or because they are avoided. Nor is there the slightest reason to think that the prices and wage levels which help to clear markets and promote output and employment, have anything to do with a pattern of awards based on merit.

Shortages and surpluses of workers and goods, and inefficiencies in production and distribution, are by no means the worst of the effects of controls which do succeed in enforcing non-market levels of remuneration. If the price mechanism is prevented from exercising its coordinating role there will eventually be demands to put something in its place, which can only be government compulsion. The ordinary voter may not see much harm in directives to large corporations; and he may even welcome moves to force financial institutions to invest in approved ways (until he finds that the sums do not belong to an abstract entity called the City, but are his own pension funds). But he will certainly notice it if the attempted suppression of market forces on the job market leads to direction of labour, which it is almost certain to do if carried far enough for long enough.

The prospect is not just a doom-monger's nightmare. Already there are tell-tale symptoms. Demands can be heard to prevent or tax the emigration of people with marketable talents; the process could begin with a tightening of capital controls for those who leave the country. The present vogue for so-called 'job creation' as an alternative to unemployment could easily become a way of using the threat of dole deprivation to force people to carry out certain tasks against their will. Calls for peacetime national service are a recurrent theme of authoritarians of all political persuasions. The economic meaning of these demands is that instead of paying the market rate for the least pleasant jobs, young people should be conscripted into doing them at cut rates (and with 'discipline' thrown in on the side).

Yet no amount of argument can take away the fact that the lobbies in favour of pay controls are very deeply entrenched in Britain. They are basically lobbies for regulating wages, with price control thrown in as a sop to make them acceptable to the unions. The whole mixture is known euphemistically as 'incomes policy' – a usage too well entrenched to be worth disputing.

Incomes policy advocates are particularly well placed to secure the ear of politicians, business and trade union groups. A good many people in the British Treasury had nostalgic memories of the Cripps Pay Restraint of 1948-50 and were never reconciled to the absence of a pay policy under the Conservative regimes of the 1950s. But the main conversion of that Department came early in 1961, when it was still 'under the Tories' and coincided with the publication of a pro-incomes-policy report by the Organisation for European Economic Cooperation (OEEC) entitled *The Problem of Rising Prices*. There followed in July of that year the Selwyn Lloyd pay pause, which was enforced by government and private employers, but without formal legislation.

Mr. Harold Wilson's first Labour Government, which came to office in October 1964, temporised for 21 months with the 'Statement of Intent' and an 'early warning system'. But by July 1966, it had opted for a statutory freeze: and there were further statutory restraints imposed in 1967-68 after devaluation. Mr. Edward Heath, who became Prime

Minister in June 1970, determined not to go down the same road; but after 29 months he too had imposed statutory controls.

The second Wilson Government which was elected in March 1974, also tried to hold out against pay controls, while maintaining and intensifying the price controls it had inherited. Its resolve lasted sixteen months before it adopted the £ 6 pay limit followed by its 1976 '4½ per cent' successor. The pay controls were meant to be enforced by a combination of TUC cooperation and severe price control sanctions on employers. They were certainly regarded by Ministers as compulsory although not statutory – a distinction unknown to British law.

After the 1976 pay deal was announced the Chancellor of the Exchequer, Mr. Denis Healey dropped hints that there might be a return to normal collective bargaining in the following year. But whoever is in charge of economic policy in 1977 will have to face very strong establishment pressure to continue pay controls in some form and to tighten them if they have been eroded too far.

Indeed so much has been bottled up during the British pay restraint phases of 1975 and 1976 that it would require a miracle to prevent a pay acceleration in subsequent years. The mere consolidation of the £ 6 pay rise into overtime and bonus rates could add a good many per cent to labour costs, before taking into account the effects of restoring differentials and removing the rigidities accumulated over two years. Thus the advocates of pay controls will be in an apparently good position to say 'I told you so'.

II. A DIALOGUE ON INCOMES POLICY

You have spoken of 'the apparent short-term success' of wage controls. How would you summarise the record to date, taking Britain as your instance?

If incomes policy had been such a shining success, the onus of proof might be on its opponents. There have been some particular years when pay controls appear to have

worked and others when they have ended in an explosion. But if we take one year with another – or better still look at a run of business cycles – the rate of inflation has been on a long-run upward trend and so has unemployment since the early 1960s. This has been true of the industrial world in general and Britain in particular. The British inflation rate rose from around 3 to 4 per cent in the early 1960s when incomes policy first came back into vogue, to an average of 16 per cent per annum in 1972-6. It is of course open to supporters of pay controls to say that without their labours the trends would have been worse still; but this strains credulity, especially when there are convincing alternative explanations of the long-term deterioration in prices and employment.

Both the temptation and the trap of pay controls lie in the peculiar time scale of their success and failure. The initial phase of an emergency wage freeze or ceiling nearly always surprises people by its remarkable success, which gives rise to hopes for the longer haul which are doomed to failure. This is partly because a zero norm, or a ceiling, is equally unfair to everyone. It is also normally imposed during or at the onset of a recession when market forces are in any case tending to limit wage increases. The second phase of tight, but slightly more flexible, control has a mixed record. In the third and fourth phases, which are supposed to lead the way to a more permanent system, the policy is liable to explode and disintegrate and we often end up with higher wage increases than before the policy started.

In a nutshell, incomes policy will always come unstuck on the rock of relativities which cannot be frozen (or compressed by uniform amounts) indefinitely although the attempt to do so may distort the economy for a long time. As soon as different groups begin to obtain different amounts, the hoped-for norm or average begins to melt away. One way of putting the point is to say that the accumulation of anomalies and rigidities destroys every incomes policy. In other words, neither a uniform amount or percentage, nor some centrally agreed pattern of wage increases, can be maintained against the pull of market forces operating differently in different industries, or against the push of rival

union monopolies jostling for relative position.

As the detailed pattern of breakdown is different on every occasion and in every country, the advocates of incomes policy can always point to specific pieces of bad luck or bad tactics, such as unwise official handling of a strike, an 'unexpected' deterioration in the terms of trade or a surprise increase in the price of oil. Such events are not of course Acts of God, but are in large part a reaction to inflation either in the country concerned or in the industrial world as a whole. But the moral is still drawn that one must have another attempt and try to do better next time.

The temptation to do so is extremely great in a political world where a week is a long time. Inflation – or to be more accurate an unexpected increase in the rate of inflation – is painful. But so is a genuine cure through tightening the monetary tap. On the other hand there are many policies with attractive short-term effects which will ultimately lead to higher or even runaway inflation. Incomes policy appears to provide a much less painful method of curbing inflation without having to curtail the other more attractive policies. The inflationary kickback may be deferred for years; and so may the adverse side effects of pay and price controls, or at least their public recognition. The temptation of politicians, officials and journalists to go for the apparent immediate gain is obvious.

Is there not a difference between pay and price controls? Surely the price controls are mainly cosmetic and have very little effect either way?

Our imaginary interlocuter is on to an important point. The more effective the price controls are, the more harm they do for the reasons given earlier. But the converse does not follow. The controls can be ineffective in limiting prices and still do harm.

The easiest way of avoiding price controls is through changes of classification or quality. It is impossible for any price controller to police the size of meals served in restaurants or the quality of the ingredients or cooking, still less intangibles such as the efficiency of service. During

the Nixon price controls there was a public controversy, never quite resolved, on whether a soup manufacturer had or had not reduced the number of matzo balls in his soup. But quality deterioration can be more subtle. Articles can be made available in a smaller or less convenient number of packages. Minor services thrown in free by petrol pump attendants can be abandoned or charged for.

Quality variations amount to concealed price increases, and the consumer gets less value for a constant money outlay. The official price index becomes gradually more misleading and – in the nicest and most gradual way – can be said to be rigged.

If price controls are severe enough to reduce the price of articles of a given quality below their competitive level, physical shortages will normally result. That is why wartime price control was accompanied by official rationing schemes. The object of the control is to reduce the price below the level at which demand balances supply in the market place. At a lower price demand must be higher, supply less and shortages develop. Some method of allocation is required; and in the absence of a government coupon scheme goods will go to those who have the time and patience to stand in queues; or there will be unofficial rationing by suppliers, or there will be black markets and side payments; or some combination of all methods.

Price controls usually exempt imports, whose consumption would otherwise be encouraged, and this immediately generates another kind of avoidance. US cattle ranchers during the Nixon controls would send their animals to be slaughtered in Canada and then bring back the imported meat. A British manufacturer of cosmetics reported in the early 1970s that he had to import from the Continent a scarce ingredient which he believed had been originally exported from the UK to escape the Price Code.

Some American corporations with low base-period margins were considering selling out to other corporations. A UK company reported that it was considering closing or selling a profitable subsidiary employing 250 people with £2m of export sales for similar reasons. Other companies, cited in a CBI survey did not, however, consider it worth

devoting too much effort to eliminate loss-making activities, as this would have brought them up to the edge of permissible margins for the whole of their activities.

The dividing line between avoidance, quality change and allocation of goods by rationing or queues, is not easy to define. After all, standing in line for an article which might run out before our turn arrives, amounts to a reduction in the quality of service. But these methods, preferable though they are to supplies drying up altogether, are far from costless; and the same applies to illicit markets.

It takes time and trouble to work out how to get round controls or to ensure that one's company is not unnecessarily squeezed through sheer ignorance. The time and energy, not only of accountants but of chairmen and top executives, were devoted for several years after 1972 to making the detailed submissions required by the British Price Commission – some 1,000 in three years in the case of ICI, a third of these involving annual sums of £50,000 or less.

The great advantage of open rationing by *price* is that information and incentives are provided which will lead to an elimination of shortages. The various non-price methods of allocation weaken both the signals and the incentives. The greater the impact that the controls are meant to have on price levels the greater is the harm done.

The hyperinflation in Germany after World War I, in which people carried notes in suitcases or wheelbarrows and the printing presses could not keep up with the demand for notes, is frequently discussed. But it is often forgotten that there was a runaway rise in prices in Germany after both World Wars. The difference is that the inflation after World War I was an open one with most prices and wages determined by market forces; whereas after the Second World War wages and prices were rigidly controlled. Although the earlier inflation was far more severe, output and employment remained high until the crazy last six months in 1923 when the currency collapsed completely. After the Second World War, by contrast, output fell by half. The shortfall cannot be attributed to war damage, as output shot up soon after Dr Ludwig Erhard – then bizonal controller and afterwards Economics Minister – abolished all controls in 1948.

But surely British price controls in the 1970s had nothing like these effects? There were not even the queues and shortages of which you make so much.

By and large British controls were not severe enough either to have much impact on prices or to drive goods out of shops. They were in force for a great deal of the time during periods of recession, when the controlled prices for many commodities were above what could be charged on the market. Imports also provided a safety valve for goods which were short in Britain. But as price controls – whenever they were effective – also provided an incentive to export the net result was an artificial and absurd expansion of shipments out of and into this country, as already discussed. It was also remarkable how many varieties and sizes of products became unobtainable or were subject to long delivery dates even in the depths of the severest postwar recession.

The worst effect of the controls, however, was that businesses were not sure whether they would be allowed to earn a commercial return on new investment. The deterrent was masked by the business upturn which began in the winter of 1975-76; but it undoubtedly affected both the quality and the quantity of the new projects planned. One British company told the CBI that the Price Code had transformed an estimate of £1m profit on an investment into a £300,000 loss. Another was reviewing a £170,000 project to save imported fuel and improve heat insulation, which would normally yield savings of £100,000 a year. But all this benefit might disappear under the Code's provision for the passing on of all cost reductions. Even the relaxation in the summer of 1976 did not allow companies to keep any of the benefits of cost reductions other than those resulting from the spreading of overheads. Of course, if price controls were relaxed so much as to become a formality, or a fancy label for anti-monopoly policy, and if the relaxations were expected to be permanent, then these effects would dwindle away. But we doubt if such emaciated price controls would buy much wage restraint.

The deterrent effects thus cannot be removed merely by 'liberalising' price controls. Such liberalisation might at best make businesses confident that they could secure the average prevailing market rate of return on capital. But many of the most important projects are not expected to earn an average rate of return. They are undertaken in the hope of being able to make a killing if they turn out well, and in the knowledge that all the sums spent may have to be written off, and severe losses incurred, if they turn out badly. This is what is meant by risk investment.

Such investment would be discouraged by price controls, even if all major companies and investment institutions were state-owned or workers' cooperatives. An important effect of discouraging risk capital is to raise the sustainable rate of unemployment. One way in which entrepreneurs take risks is to employ people, at wages which other businessmen do not think they are worth, to make a product or provide a service not previously regarded as profitable. If exceptional rewards for risk are banned, there will be no point in putting out tentacles to the less obvious sectors of either the labour or the goods market, and it will be much better to play safe all round.

Why cannot you have pay controls without price controls?

The case for price controls is indeed weaker than that for wage controls. There has been no profit-push in the UK – or most other Western economies. Gross trading profits after stock appreciation fell from 15 to 16 per cent of the national product in the late 1950s to 6 to 8 per cent in the mid-1970s. After allowing for replacement costs they fell from 12 to 13 per cent to between 0 and 4 per cent. The amount of profits going to shareholders and available for squeezing is, on the crudest arithmetic, a trivial proportion of the national income. Even if profits were 'too high' it would be possible to regulate the total by variations in corporation tax, a way which – unlike price control – would still allow individual companies to compete for their share of the available total.

For such reasons the revival of incomes policy in the 1960s, under Selwyn Lloyd, Reginald Maudling and George

Brown, did not involve price or profit margin control. The price investigations of the Aubrey Jones Prices and Incomes Board were of specific cases and had no automatic statutory force.

But politically this half-way house could not last. If unions are asked to accept control of specific wages, they will want control of specific prices, or at least profit margins as a *quid pro quo*. In James Callaghan's words: 'Pay *restraint* and price *control*, in the eyes of the ordinary people of this country go together.' (Our italics). In almost every country where wages have been controlled, prices and profits have eventually been controlled as well.

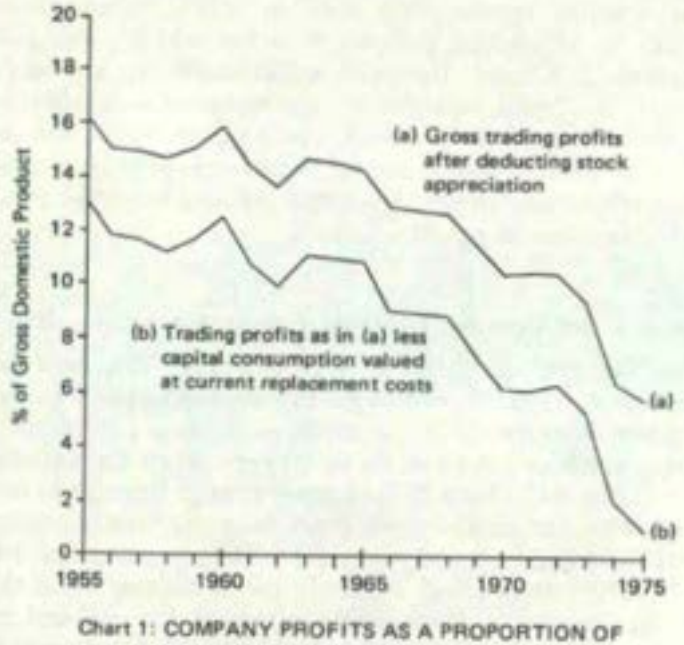

Chart 1: COMPANY PROFITS AS A PROPORTION OF GROSS DOMESTIC PRODUCT

Source: Treasury Economic Progress Report, May 1976

The dislocation and misallocations arising from the control of individual wages and prices may not matter all that

much in the context of, say, a one-year freeze; but for the reasons already discussed, once governments embark on a policy of controls, the temptation to prolong them is overwhelming. In the UK there was over a year's break in wage control in 1974-5 between the disintegration of the Heath Government's 'Phase Three' policy and the Labour Governments £6 pay limit. But there was no such gap in price control which existed from 1972 in a form more stringent than in any advanced non-Communist country.

In fact wage controls would be a doubtful blessing even if they could be enacted without other accompanying measures. Apart from brief periods of emergency, they are even more liable to be eroded than price controls. Quality and classification changes occur very easily in the labour market where they are often known as 'wage drift'. If controls were on a weekly earnings basis, pay increases could take the form of shorter hours. There can be improvements in fringe benefits or working conditions. There can be a shift towards more overtime. People can be promoted and jobs reclassified. Periodic piecework recalculations are almost impossible to police; and workers themselves can drift to the higher-paying firms. Every set of guidelines apart from a simple freeze or ceiling gives rise to growing scholastic questions of interpretation such as 'What is a principal increase?' 'What is an establishment?', or 'How do you treat a productivity bonus?' and 'How can you consolidate the £6 of 1975 and the unconsolidated portion of 1976-7 awards without an explosion?'

Moreover although variations in relative wages among different groups of works may not have to be proportionately as large as variations in profits among firms, it is still important that they should take place. If relative wages in terms of thousands of different jobs are frozen, or differentials narrowed in opposition to market forces, all sorts of unwelcome consequences follow. The uniform £6 flat sum agreed in the 1975 pay deal directly priced out of work some of the less skilled or lower paid who might otherwise have settled for less. In many cases – including the whole public sector – the £6 became a minimum as well as a maximum.

(ii) Price controls, business and government*

Milton Friedman

I should say a word at this point about one panacea (for inflation) that is proposed, namely, price and wage controls. I saw in today's paper that there was a business group that asked for Government restraint on wages. I am sorry to say that the businessmen of Australia, like the businessmen of America, have a suicidal impulse. There is nothing that will destroy private enterprise more certainly than the imposition of wage control and price control. You may think that there will be wage controls and not price controls. But anybody who can count heads and votes will know that, in fact, it will be the other way around. You will have in that case ineffective wage controls and effective price controls. If you look at what's going on in Britain today, you will see what the consequences of such a policy would be. Britain is holding down the prices that industries may charge while they are permitting wages to go up. The result of course is to squeeze every enterprise and force many into liquidity difficulties. The enterprises then come running to the Government to be bailed out. The Government is glad to bail them out by taking them over. That is an almost certain road

*from *Milton Friedman In Australia*, Constable & Bain, Sydney 1976, pp. 61 - 62.

to complete socialisation of an economy. This is why I say the businessmen who ask for wage and price controls are asking for their own elimination and the socialisation of the society.

And they are asking for it for nothing, because controls are not in any way a cure for inflation. On the contrary, they are one of the worst consequences of inflation. Their imposition invariably tends to make inflation worse and not better. That is true on the record of history of 2000 years from the time of Diocletian to the present. You know why price and wage controls are imposed? They are imposed whenever a Government wants to inflate. The imposition of price and wage controls is a sure sign that the Government wants to inflate. After all, Governments are not foolish. The people who do these things aren't stupid. They know the record of history. They know as well as you and I do that wage and price controls don't have anything to do with inflation, then why do they impose them? Because they want to inflate and this is a way in which on the one hand they can inflate and on the other can give the public the impression that they are doing something about inflation. In addition, they want to postpone the evil consequences of inflation. They want to have as much of their inflation as possible come out initially in the form of increased output. After all, politicians are necessarily short sighted. As elections come near, they try to postpone the problem. Look at the record in recent years. In the United States in 1971, Mr. Nixon imposed price and wage controls at a time when our rate of inflation was running at the horrendous level of 4½% a year. That temporarily suppressed inflation but the final result of those wage and price controls was an inflation at the rate of 12% a year. It was perfectly clear that the reason Mr. Nixon imposed price and wage controls at that time is that he wanted to take expansionary fiscal and monetary measures that would create a favourable economic climate for the 1972 elections. Mr. Heath did exactly the same thing in Great Britain. I can assure you if you look at the record you will find that what I have said characterises essentially every period of imposition on price and wage controls.

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