Effectiveness of the first-year pay and price standards

In October 1978 the Administration introduced a voluntary program of pay and price standards as part of a larger initiative against inflation. Even though the program was aimed at restraining inflation, the rate of increase in the consumer price index accelerated from 8.4 percent in the year prior to the standards to 12.2 percent in the program's first year. This sharp jump, however, largely reflects an acceleration in prices outside the pay and price guidelines. Indeed, looking at the sources of inflation and the pattern of pay hikes during the past year suggests that the program has had some effect in restraining inflation.

The interdependence of wages and prices plays a crucial role in the inflation process. In general, labor compensation accounts for the largest part of the cost of producing goods and services, while prices determine the purchasing power of wages. Accordingly, the guidelines set a standard of 7 percent maximum annual increases in labor compensation, and maximum annual price increases averaging roughly 5.75 percent. The ceiling on average price rises was set below the pay standard to reflect a long-run trend in labor productivity increases.[1] In addition, alternative rules were devised for situations in which compliance with the basic price standard would not have been feasible.

Prices and the price standard

The impact of the price standard needs to be gauged in light of the flexibility of the program.[2] Essentially, each company was asked to limit increases in its average selling price of goods to 0.5 percent below its own average rate of price increase during 1976 and 1977. Alternatives to the basic price deceleration standard were specified for cases where companies experienced large, uncontrollable cost increases (*e.g.*, for energy and raw materials costs), where producers could not effectively control the price of their output (*e.g.*, raw food prices), or where controlling a price would have been inconsistent with the overall objective of reducing inflation (*e.g.*, interest rates).[3] In these instances, directly limiting price increases would have been an unrealistic or counterproductive strategy, and other standards were designed to place some limit on how much a company's final selling price could exceed its costs.

In short, compliance with the price guidelines did not always require companies to reduce their rates of price increase. Indeed, depending on the sources of the price increases, the rate of inflation could rise without firms necessarily being out of compliance. In fact, the acceleration of the consumer price index during the first year of the program largely resulted from extraordinary increases in the costs of energy and home buying which were effectively outside the direct influence of the price standard. In response to OPEC (Organization of Petroleum Exporting Countries) price increases, consumer energy prices jumped 35 percent. Due to the run-up of house prices and higher mortgage interest rates, the costs of purchasing a home rose 18 percent. Food prices, also outside the standard, posted

[1] For a discussion of recent productivity trends, see Paul Bennett, "American Productivity Growth: Perspectives on the Slowdown", this *Quarterly Review* (Autumn 1979), pages 25-31.

[2] The first-year standards are discussed in detail in Council on Wage and Price Stability, *Pay and Price Standards: A Compendium* (June 1979).

[3] The link between higher interest rates and lower rates of inflation is discussed in a talk by Peter Fousek, entitled "Monetary Restraint, Interest Rates, and Inflation", this *Quarterly Review* (Autumn 1979), pages 11-12.

a 10 percent increase in the first year of the program. This substantial rate of increase was down only slightly from the exceptionally large food price rise in the previous year.

Aside from the price run-ups for energy, home buying, and food, which combined represent about half of the consumer price index, consumer price increases were more moderate. The prices of items such as rent and most manufactured goods and services—which were more directly under the influence of the first-year price standard—advanced at about a 7 percent rate during the first year of the program, only slightly more than in the year before (Chart 1). The small acceleration in these prices is not surprising since higher energy costs raise production and distribution costs. Despite this slight price acceleration, there is little evidence that many companies flagrantly violated the price standard.

Pay and the pay standard

Since labor compensation is by far the largest single cost of production for most companies, moderation in pay increases can play a key role in any effort to restrain inflation. Compliance with the first-year pay standard basically required that average increases in compensation be held to no more than 7 percent annually. Legally mandated labor costs, such as employer contributions to social security, were exempt from the pay standard, as were increased costs associated with maintaining existing health and pension plans without improvements in benefits. Because of these exemptions, the most visible impact of the pay standard should be on money wages, excluding fringe benefits.

Average wage increases slowed slightly during the first year of the pay standard. According to the employment cost index, private nonfarm hourly wages rose 7.7 percent in the year ended September 1979, compared with an 8.0 percent increase in the previous year. Similarly, average hourly earnings (adjusted for overtime and interindustry shifts in employment) also show a moderation in wage gains. Compensation per man-hour, which is a broader pay measure including fringe benefits and payroll taxes in addition to wages, shows a slight acceleration in the past year. Part of this acceleration reflects higher social security contributions.[4]

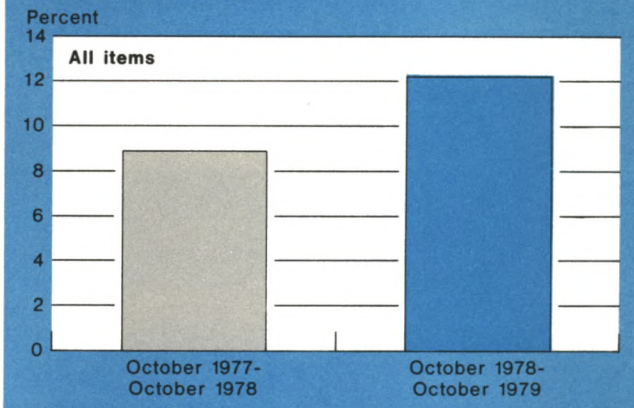
The overall moderation in pay reflects a wage slowdown in the nonunion sector, which represents three fourths of the work force. Nonunion wages rose 7.3 percent in the first year of the program, compared with 8.0 percent in the preceding year. In contrast to

[4] All these pay measures are published by the Bureau of Labor Statistics.

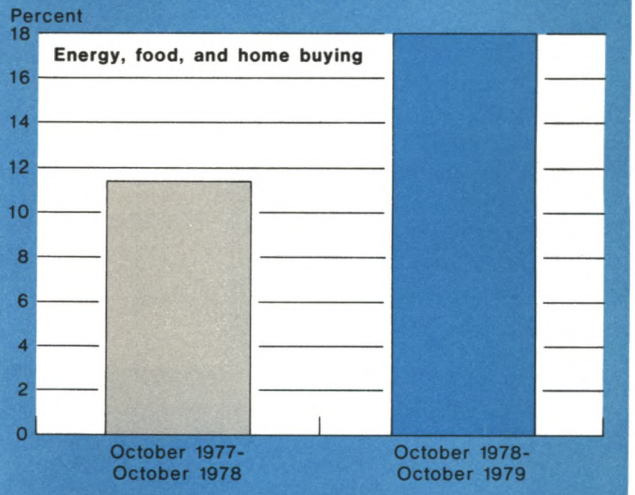
Chart 1

Consumer Prices

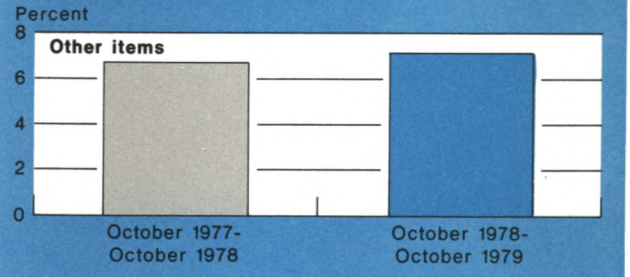
During the first year of the pay and price guidelines, the consumer price index jumped sharply . . .



. . . largely reflecting increases in prices outside the influence of the program . . .



. . . other price increases were more moderate.



Source: United States Bureau of Labor Statistics.

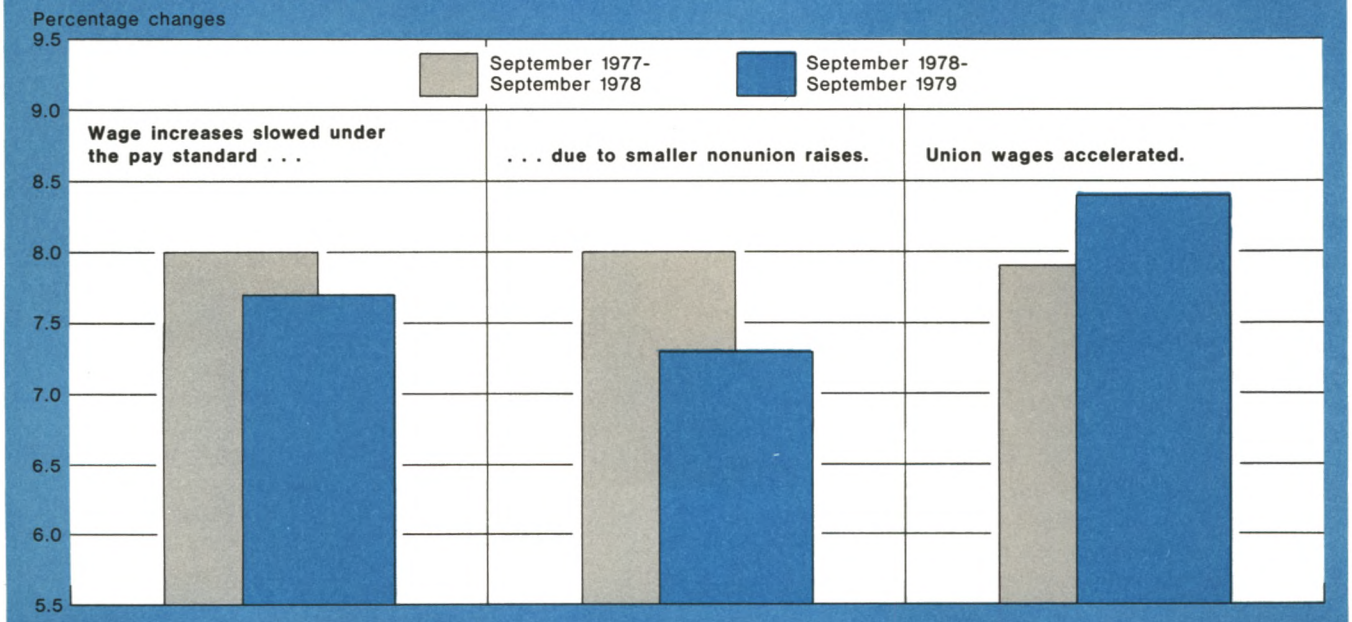
the nonunion sector, union workers' wages accelerated, rising 8.4 percent following a 7.9 percent increase in the year before (Chart 2).

The slowdown of nonunion wages is unexpected, given economic developments in the past year. An important factor affecting nonunion pay is the demand for labor relative to the supply. When there are many job openings relative to the number of individuals seeking work, employers generally offer larger pay increases to attract and maintain adequate work forces. During the year following the announcement of the pay standard, the labor market was fairly tight, as employment continued to grow and the unemployment rate held steady. Yet, despite the continued growth of demand for labor relative to supply, nonunion wage increases slowed. It therefore seems likely that nonunion wages were restrained by the pay standard.

Further support for the view that the pay standard restrained nonunion wage gains comes from private surveys of compensation plans and practices for white-

Chart 2

Employment Cost Index



Source: United States Bureau of Labor Statistics.

Average White-Collar Salary Increases*

In percent

Compensation survey	1978 actual increase	1979 planned increase†	1979 actual increase	Number of companies surveyed
Sibson & Co., Inc., Princeton, New Jersey	8.1	8.3	7.7	459
Compensation Resources, Franklin Park, New Jersey	8.2	8.4	7.6-7.7	524
Hewitt Associates, Lincolnshire, Illinois	8.3-8.5	8.6-8.7	7.8-8.0	414
American Compensation Association, Scottsdale, Arizona	8.4-8.5	8.6	7.8-8.2	1,100

* Increases vary from one survey firm to another because of the different companies in their samples and minor definitional differences. Most companies use calendar-year budget periods.

† As of September 1978 (prior to pay standard).

collar employees (table). White-collar workers make up over half of the nonunion work force. These surveys show that in September 1978, just before the announcement of the pay standard, firms planned to raise white-collar pay scales in 1979 by more than the increases granted for 1978. Under the program, however, actual 1979 salary increases on average turned out to be between ½ and 1 percentage point less than originally planned.[5] These actual 1979 pay increases were smaller than the 1978 increases. Responses to additional questions in several of the surveys indicated that a majority of firms were paying close attention to the pay standard and that a large proportion had reduced their salary budgets to comply.[6]

In contrast to the nonunion sector, union wages accelerated during the first year of the program. As a result, judging the effectiveness of the guideline is more difficult. The acceleration of union wage increases reflects, to a degree, factors outside the control of the voluntary pay standard. Sizable cost-of-living adjustments (COLAs) were received by many workers whose contracts were not even scheduled for renegotiation, whereas the pay standard applied only to new contracts. The unusually large number of collective bargaining agreements scheduled for negotiation in 1979 also raised average union wage increases. Typically, multiyear labor contracts "front load" wage increases; that is, a large proportion of the contracted wage increase is paid at the start of the contract term. One reason for the larger average union pay raises during the first year of the program is that more workers received front-loaded wage increases in 1979 than in 1978.

Due to the design of the pay standard, even those union wage settlements which were very high could technically be in compliance with the program. In fact, virtually all the major contracts reviewed by the Council on Wage and Price Stability were found to comply. The apparent inconsistency of high wage agreements with a program of pay restraint reflects alternative methods of measuring the COLA. While the pay standard assumed a 6 percent annual rate of inflation in the calculation of the COLAs, most new contracts were negotiated under the assumption that 8 or 9 percent rates of inflation would prevail over the next few years. Indeed, the three-year contracts in the trucking, rubber, electrical equipment, and auto industries provided for large compensation increases, ranging from 30 to 40 percent, well over the 22.5 percent allowed under the standard.[7] Yet each of these three-year contracts assumed a 9 percent annual rate of inflation. Because over two thirds of the wage increases will be generated by COLAs, the official 6 percent inflation assumption reduces the computed costs of these contracts by 6 or 7 percentage points, bringing them closer to technical compliance levels. Further reducing official cost estimates of the contracts was the standard's exemption of certain costs associated with health and pension benefits.

Conclusion

Despite the spurt in consumer prices, the pay and price standards can be credited with some success in their first year. The pay standard appears to have restrained wage increases for a majority of workers. Potentially, this has made the price standard more feasible for firms with large labor costs. Prices have certainly accelerated in some sectors during the past year, but these extraordinary increases largely reflect developments outside the domain of the program.

The voluntary standards were never expected to succeed single-handedly in reducing the inflation rate. Rather, they were aimed at helping fiscal and monetary policy restrain inflation. Without moderation of underlying demand pressures, the long-run effects of voluntary guidelines would be negligible. To the extent that the standards reduce the upward momentum of wages and prices and lower inflationary expectations, fiscal and monetary restraint can have a greater impact on inflation, and adverse effects on unemployment and real economic growth will be reduced.

The greatest challenge for the program in the coming year is to set attainable standards that resolve the pay imbalances which arose in the first year, while still acting as an effective constraint on overall pay and price increases. Union workers on average received relatively large pay hikes. This sets a precedent for other unions in upcoming negotiations and for nonunion workers to get catch-up raises. In the context of the overall effort to achieve price stability, the standards will play a demanding but potentially very useful role.

[5] In the past, average planned and subsequent actual pay hikes had been about equal.

[6] Two surveys directly asked whether companies had reduced salary increases in response to the pay standard; affirmative responses were given by 63 percent of the companies in the Sibson survey and 48 percent in the Hewitt Associates survey.

[7] The contracts in these four industries covered nearly 40 percent of all workers with new contracts negotiated in 1979.

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