Incomes Policies: A Quick Critique

A high and growing level of employment, low unemployment, a stable price level, a high rate of economic growth, and a reasonable balance of international payments are five economic objectives that have top priority in almost all countries. There are numerous economic policies or tools available to any government for use in achieving these goals. Indeed, they comprise a broad spectrum of policy measures, ranging from direct intervention in the economy to very broad and general measures that affect the economy in a primarily indirect manner. Some relatively new measures that have recently received increasing attention in this country are the incomes policies.

This article focuses on incomes policies. To provide background, however, it begins with a brief discussion of more conventional policies and notes some of their alleged deficiencies. These problems have led to development of incomes policies in some nations and, more recently, to calls for such a policy in the United States. The article points out in general terms what actions might comprise an incomes policy and asks how well incomes policies have worked in actual experience, especially with regard to their generally accepted purposes.

Monthly Review, Vol. LV, No. 12. Free subscription and additional copies available upon request to the Research Department, Federal Reserve Bank of Atlanta, Atlanta, Georgia 30303.

More Conventional Policies

On one end of the spectrum of economic policies are two general or aggregate tools—monetary and fiscal policies. Essentially, both monetary and fiscal policy actions indirectly affect the economy. They are designed to *influence* the economic decisions of individuals, rather than actually dictate the decisions. These policies do not determine directly the incomes most of us earn or the prices we pay for our purchases. There are exceptions, of course. Certainly, the income of a person who entirely depends upon Social Security would vary directly with government action. Nevertheless, these policies usually operate indirectly, rather than directly, on our economic decision-making.

Monetary policy in the United States is determined and carried out by the Federal Reserve

On one end of the spectrum of economic policies are two general or aggregate tools—monetary and fiscal policies.

System. By adjusting the supply of reserves available to banks, the Federal Reserve can affect the supply of money and available credit in the economy. This, in turn, affects the price of credit, the investment decisions of investors, and the purchasing power of consumers. Thus, total spending in the economy can be spurred either to absorb unused capacity or can be restrained to relieve the pressure on an inflationary economy.

Fiscal policy operates primarily through the budgetary activities of the Federal Government. By increasing or decreasing its own expenditures, the Government directly adds to or detracts from total spending. By lowering or raising taxes, the spending power of the private sector of the economy is increased or decreased.

Calls for Controls

Until recently, general monetary and fiscal policies have carried the burden of the fight against inflation in the United States. They have not been without opposition, however. Some critics contend that, because of the complex and indirect channels through which monetary policy operates, it is effective in cooling an overheated economy only after a long delay. Many observe that, for various reasons, monetary policy discriminates between various sectors of the economy. For example, in a period of scarce credit, housing and state and local governments are usually placed under greater strain than are other sectors.

Fiscal policy is assailed because of the time required to make policy adjustments. Even if changes in expenditures and taxation are effective policy instruments, they usually require Congressional action, which is not always rapid and may be influenced by political considerations.

Worse still, many critics argue that *even if* restrictive monetary and fiscal policies were effective in curtailing excess demand, they would still not be sufficient to stop the spiral of price increases. Thus, we are told that the nation will end up with the worst of all possible worlds—inflation and high unemployment. The current pressures on prices, according to critics, come from the cost or supply side of markets, and monetary and fiscal policies are not effective in fighting this "cost push" aspect of inflation. How can this be?

There are several reasons why prices may not respond immediately to reduced demand. First, much of the economy is not characterized by numerous, highly competitive small firms, a necessary condition for what economists call "perfect competition." Instead, the economy contains many firms which may have considerable influence over the prices they charge. Once these firms have set a price, they are reluctant to reduce it. Cuts in production are preferred to price cuts when output cannot be sold at existing prices. Also, demand slowdowns are often accompanied by rising costs. Despite production cuts, some companies may be initially reluctant to lay off trained personnel for fear of losing them to other companies. As output falls, output per man-hour, or productivity, tends to fall. At the same time, workers attempt to catch up with past inflation by demanding wage increases. With productivity declining and wage rates rising, unit labor costs of output rise. Thus, even in the face of declining demand, there remain pressures to keep prices from falling.

Eventually the decline in output and rising costs lead to layoffs. Unemployment rises. Unit labor costs begin to fall or rise more slowly. Productivity increases. Companies undertake other cost-cutting procedures. But with continued pressure on wages, the results of these efforts come slowly. Prices may continue to rise for a time. Also, unemployment may continue to rise until workers locate existing job vacancies or until growth in the economy is sufficient to provide new jobs for the unemployed.

Critics of restrictive policies found support for their views in the economic development of the past six or nine months. For a painfully long time, prices seemed to have continued a relentless rise; unemployment has increased; and the economy has behaved sluggishly. Despite recent indications of better price performance, cries are still heard for different policies, either to obtain or to speed the necessary economic adjustments. But what other policies are available?

Recall that monetary and fiscal policies lie at one end of the spectrum of economic policies. At the other end lie direct or compulsory controls. These policies *directly* affect many of the economic decisions of individuals. In general, they are designed to fix specific prices, wages,

Despite recent indications of better price performance, cries are heard for different policies, either to obtain or to speed necessary economic adjustments.

profits, credit, or perhaps even types of production, especially during periods of inflation. The individual businessman would be prohibited from charging more than a certain ceiling price for his product. The individual worker could not receive more than a ceiling wage for his labor services. The individual consumer also might be prohibited from purchasing an item for which he does not have sufficient rationing points.

Clearly, such policies greatly interfere with freedom of choice. In addition, they substantially distort the workings of a free enterprise economy. Usually, these policies require a large bureaucracy merely to implement the controls. Because they are fixed, prices cannot perform their vital role as signals to producers and consumers, and cannot direct productive resources into areas of greatest demand. Consequently, compulsory controls not only hinder individual freedom but also undermine efficient production processes. As a substitute for well-conceived, responsible monetary and fiscal policies, direct controls are not particularly attractive. Even worse, historical experience has shown that they do not eliminate, but only temporarily suppress, the basic causes of inflation. For example, direct controls could not offset ill-conceived, irresponsible monetary or fiscal policies.

Incomes Policies

The undesirability of compulsory controls has led most critics to seek milder measures. Most often, they have urged that wage-price guidelines be established for the United States economy. This measure has been sought *as a supplement to, not a replacement for,* corrective monetary and fiscal policies. Critics maintain that guidelines would assist the more general measures by shortening the time required for them to slow the rise in prices and thus prevent at least some of the rise in unemployment. Guidelines would assist in offsetting cost-push pressures.

Wage-price guidelines are one variation of another type of economic policy, *incomes policies.* During the 1960's, incomes policies of various sorts were employed to help achieve the goals of stabilization policy in numerous countries. These policies vary from country to country in both objectives and methods, and there is no generally accepted definition of an incomes policy. In the spectrum of economic policies, they fall somewhere between the general or indirect monetary and fiscal policies and direct, compulsory controls. Incomes policies seldom involve actual direct controls but often restrain the more or less free reins allowed by general monetary and fiscal policies.

Most incomes policies are designed to reconcile the economic goals of individuals (such as higher profits by managers and businessmen) with the economic goals of the nation as a whole (such as stable prices). Usually an incomes policy is primarily concerned with the advance of the *general* price and wage levels, rather than with wages and prices in particular industries.

In some countries, the government not only defines acceptable limits for overall increases in wages, prices, and profits but also sets a more or less exact criterion for the distribution of incomes among the various categories of income recipients. For example, the government might decide that, in the aggregate, wage earners should receive 65 percent of the national income.

One reason for the difficulty in defining an incomes policy is the different emphasis given to the various objectives of these measures in several nations. Rather than attempt a general definition, let us look at three varieties of an incomes policy that have been used in the Netherlands, the Scandinavian nations, and the United States. This will highlight the variations in the approaches and also permit us to draw some conclusions about the effectiveness of these policies.

Incomes Policy in the Netherlands

Among the Western nations, the Netherlands has had one of the strongest incomes policies. The dependence of the nation's economy on foreign trade has resulted in extraordinary cooperation between trade unions, business, and the government. All have realized the importance of maintaining the country's international competitive position; all have been willing to accept an incomes policy.

After World War II, the Netherlands faced the task of rebuilding its economy. To assist in ac-

complishing the reconstruction without sacrificing its international competitive position, a strong incomes policy was adopted. Wage- and price-fixing machinery was established. Although controls were compulsory, they were greeted by an exceptional spirit of cooperation between all sectors of the economy. In 1945, the Labor Foundation was established to formalize cooperation between labor and management. In the same year, an Extraordinary Decree on labor relations set up a Board of Mediators with the power to fix wages and determine rules governing wage changes. The Board was also given the power to administer penalties and sanctions. However, the Board was required to seek the advice of the Labor Foundation and, in practice, generally followed its recommendations.

In 1950, another organization was established—the Social and Economic Council. The Council is comprised of equal representation from government, business, and labor. Whereas the Labor Foundation is concerned primarily with wage policy on the industry level, the Council focuses on broader, national objectives (including the distribution of income).

Among the Western nations, the Netherlands has had one of the strongest incomes policies.

Between 1945 and 1954, wages were controlled in the Netherlands. No increases were allowed without permission of the Board, and wage boosts were allowed only for cost-of-living increases. Some differences were allowed, however, where job skills differed, in order to induce workers to advance. Since economic recovery was underway, wages as a share of Gross National Product fell during this period.

In 1954, the Council developed a new policy. Rather than merely maintaining the purchasing power of wage earners, real wages would be allowed to increase. Wages as a share of GNP would remain constant. Overall wage increases were negotiated on this basis, largely through collective bargaining. Wage differentials between jobs, however, were permitted to increase.

A new government in 1959 instituted yet another new policy. Emphasis was shifted from economy-wide wage adjustments to changes by particular industries. Wage increases in each industry were tied to productivity advances in that industry, as estimated by the Board of Mediators. Industries with higher-than-average productivity advances had to pass on some of the advances in the form of both lower prices and higher wages. Falling prices in high productivity industries meant that wage increases could be granted in industries with slow productivity growth and reflected in higher prices without affecting overall prices.

The task proved too difficult for the Board of Mediators, and dissatisfaction with the estimates grew. Accurate estimates of productivity increases by industry are difficult to estimate. Also, rapidly rising wages in other nations put pressure on the Board's standards. Labor demand in the Netherlands was high and wages actually paid often exceeded approved levels.

By 1963, the program had to be changed again. Responsibility for individual negotiations was shifted to the individual firms and unions. Settlements were submitted for approval to the Labor Foundation, which in turn was influenced by the Economic and Social Council's assessment of the economic climate and acceptable wage increases. The Board of Mediators entered the process only if the Foundation disapproved specific settlements, but the Board did retain formal powers to control wages.

These new arrangements did not last; the same demand pressures developed again. In 1967, the entire system was dropped and free negotiations were permitted. The government, however, still retains the power to invalidate individual agreements.

But what about prices? Throughout the postwar period, the government also had extensive legal control over prices. However, the threat of control was sufficient in itself, and actual pricing policies were based almost entirely on voluntary cooperation between the government and business.

Price policy was actually carried out by the Ministry of Economic Affairs. The Ministry received advance notice of price increases for all goods and services, along with the justification for these price hikes. If the Ministry did not approve, it usually requested that they be rescinded. If this failed, legal powers were available to force a rollback.

Throughout the postwar period, price and wage policies were closely coordinated. For example, in 1951, prices were raised by 10 percent, but wages by only 5 percent, in order to restore ex-

ternal balance. A 5-percent wage increase in 1964 was passed on into a 5-percent price increase. These close policy links provided the Netherlands' government with considerable influence over wage and profit incomes and the uses to which income was put. Investment expenditures were stimulated, while consumption was minimized.

In summary, the Netherlands moved from a policy of virtually direct controls to progressively less restriction until 1969.[1] There is reason to believe that the policy greatly aided the nation to achieve a stable reconstruction without seriously eroding its international competitive position. As the recovery proceeded, the vital cooperation between economic sectors began to diminish, and the government's ability to rely on voluntary restraint dissipated. Free market forces finally dominated.

Throughout the postwar period, price and wage policies were closely coordinated in the Netherlands.

The Scandinavian Experience

Among the Scandinavian nations, Norway's incomes policy most closely resembles that of the Netherlands. Both nations faced similar problems. Direct government regulation was relied on to speed postwar recovery without damaging the international competitive position. Price and profits controls were extensively utilized in Norway, but since then have been progressively relaxed. Compulsory arbitration of labor disputes was employed until 1952. However, the various economic policies have not been so closely coordinated as in the Netherlands. Wage negotiations, conducted on a national level between union and management groups, usually set patterns for industry- and firm-level negotiations. The government does not enter directly into the negotiations but, rather, merely announces what it considers acceptable settlement limits. Throughout most of the 1950's, government influence was used sparingly. But in 1968, compulsory arbitration was reinstated to settle stalled negotiations. On the whole, government intervention in the economy was not quite as detailed as in the Netherlands; however, it has remained somewhat stronger.

Among the Scandinavian nations, Norway's incomes policy most closely resembles that of the Netherlands. . . . Sweden presents a slightly different picture.

Sweden presents a slightly different picture. The government's policy maneuvers in that country have been intermittent. The manual labor force and the white collar labor force are organized into two separate unions, and consequently, it has been more difficult for nationwide bargaining to achieve settlements consistent with national economic objectives. As in Norway, Sweden's formal administrative framework is not as elaborate as in the Netherlands.

Beginning in 1948, the Swedish Government urged unions and management to use a policy of wage restraint in order to achieve price stability. Dividend limitations and higher profits taxes were coupled with the request. The policy worked fairly well from 1949 to the Korean War boom, but in 1952, both wages and prices rose more than 29 percent, and the wage restraint policy was dropped by the government and by the unions. In 1953 and in 1954, the policy was reinstituted, but under the pressure of stronger demand again failed in 1955. Moderate national settlements characterized the second half of the 1950's. The reason was probably reduced demand for labor and goods, rather than union restraint. Prices remained reasonably stable.

The 1960's policy saw little change in Sweden. Central negotiations still set the national pattern for wage settlements. However, strong demand for labor and other factors resulted in local wage payments which have exceeded centrally negotiated settlements. In the latter part of the decade, the government appointed an arbitration committee to aid in settling stalled central wage negotiations.

In general, Sweden's incomes policy has been much milder and more intermittent than those

[1]Recently, this trend has been reversed. In 1969 and 1970, the Netherlands' government used price controls with varying degrees of effectiveness. These have now been extended in the form of guidelines until March 1971. Also, the budget proposal for 1971 provides for a temporary wage freeze.

of the Netherlands and Norway. Legal fixing of prices, profits, or wages was not used. Price stability was sought by efforts to hold down wage increases, but compulsory arbitration was not employed. However, this policy has probably been less effective. Substantial wage and price increases have occurred, and during periods of strong demand the policy has been dropped. However, in the face of excess demand, a general price freeze is now being employed.

The United States—Wage-Price Guidelines

The problems and the policy in the United States have been different. Postwar reconstruction was not necessary, and the balance of payments, although a matter of concern, is less important to the total economy. There were, however, two other problems. The 1950's were characterized by slow growth and persistently high unemployment, with the unemployment rate averaging a staggering 6.8 percent in 1958 and 6.7 percent in 1961. Prices during the period remained relatively stable, however.

The task in the early 1960's was to stimulate growth and employment without inducing inflation. Expansionary fiscal and monetary policies were used to spur the growth. To accompany these policies, the 1962 Economic Report of the President announced a set of wage-price guideposts. The statement noted the inflationary bias built into the institutions of the economy, such as the ability of large corporations to offset union-negotiated wage increases by raising prices. Many prices were not determined by competitive market forces, but were "administered." A vigorous application of wage-price guideposts might overcome this bias.

The Report noted that the change in productivity is the basic guide as to whether or not an increase in wages or prices is inflationary. Money wages can increase at the same rate as the overall rate of increase in productivity in the economy without raising the labor cost per unit of output. Thus, the wage increases would not be inflationary. If the rate of productivity in a particular industry is greater (less) than the overall rate, and if its money wages increase equaled the overall rate, the unit labor cost would fall (rise) in that industry. In this case its prices should be lowered (raised). There could be exceptions. For example, rapidly expanding industries might need to bid wages up in order to attract workers, while contracting industries would pay relatively less.

This policy was entirely voluntary. Direct government control of prices and wages was never threatened. However, the persuasive power of the government can still be great. Unjustifiably large wage settlements and price increases were called to the public's attention in order to mobilize public opinion. Shifts in government contracts, the possible freeing of government stockpiles, and the ever-present possibility of antitrust action were powerful incentives for business and labor to accept the guideposts.

The policy worked reasonably well so long as there was unemployment and excess capacity. As demand increased, however, so did pressure on wages and prices. By 1966, transportation and automobile wage settlements, among others, exceeded the guideposts. In 1967, average hourly compensation in the private sector of the economy rose by 6 percent and consumer prices by about 3 percent. The guideposts began to crumble under the weight of excess demand. The 1967 and 1968 Economic Reports of the President recognized the collapse of the policy. Without the threat of compulsory controls, the guideposts could not be enforced. With the guideposts ineffective, the government fell back on conventional monetary and fiscal policies to combat the inflation which resulted from the overheated economy.[2]

The problems and the policy in the United States have been different.

Success or Failure?

A review of the experience with incomes policies suggests that they have not been an unqualified success. Nevertheless, there have been instances when inflation probably would have been more severe if some form of incomes policy had not been in effect. These experiences suggest that

[2]Recently, the President established a National Committee on Productivity, with representatives from labor, business, the public, and the government. The Council of Economic Advisers now prepares reports that spotlight significant areas of inflation. Government purchases and regulations are under review for possible inflationary impact. It remains to be seen whether or not these actions will reduce inflation.

An essential requirement is that an incomes policy must be accompanied by appropriate monetary and fiscal policies.

such a policy is more likely to succeed if certain conditions are present.

An incomes policy seems more likely to hold down wage and price advances in an economy that is less than fully employed than in an economy in which there are few unused resources. Although there is an absence of general demand pressures in an underemployed economy, there may be cost-push pressures in some sectors. This type of policy could be useful in discouraging wage and price increases resulting from the concentration of economic power by either big labor or big business in certain industries. In this case, the incomes policy may hold down excessive administered price and wage increases while monetary and fiscal policies are adopted to help bring the economy to full employment. This seems to have been the case in the United States during the early 1960's.

On the other hand, experience suggests that if the economy were more than fully employed, an incomes policy would collapse. Such was the situation in Sweden in 1952 and 1955. In the United States, wage and price guidelines apparently had some marginal success until 1965 when, with the economy almost fully employed, the policy became ineffective.

Another essential requirement is that the policy must be accompanied by appropriate monetary and fiscal policies. It cannot be used as a substitute for limiting excessive demand. This is especially true when the policy relies wholly on voluntary cooperation. If the government is stimulating purchasing power through deficit financing during a period of full employment and the monetary authorities are adding to purchasing power by expanding the monetary base, no amount of exhortation would prevent businessmen and wage earners from giving in to the temptation to seek higher prices and wages.

An incomes policy would be more effective when there is a well-designed organizational framework of labor and business and when there is a strong consensus by these organizations in support of the policy. In the European countries where it was apparently effective during certain periods, there were strong labor and business organizations. The Netherlands is an outstanding example. Lacking such a well-designed and well-defined framework, the wage-price guidelines in the United States had to depend a great deal upon rallying the support of the American public on essentially moral grounds. For example, certain price increases in the early 1960's were said to be unjustified or contrary to the public interest. The huge power and influence of the Presidency was brought to bear on those seeking to exceed the guidelines.

As a practical matter, an incomes policy is more likely to be effective when productivity is increasing than when it is not. Conditions of rising productivity make possible an increase in real wages over time without pinching the profits of businesses. Under these circumstances, the policy is more likely to receive support than when productivity, real wages, and profits are declining.

Would an incomes policy be appropriate and effective in the current American economic setting?

Moreover, it is more likely to succeed if it applies to all sectors of the economy. The application of the policy to wages but not to prices would be ineffective. It must apply to both. For example, in the Netherlands, wage and price policies were closely coordinated.

An incomes policy is more likely to be successful when there is a strong threat of foreign competition than when a greater part of the economy is insulated from economic developments in other countries. This was important to the success of such a policy in the Netherlands. Foreign competition mobilized strong public support for it and provided an environment in which prices and wages were under external pressures not to increase too rapidly. On the other hand, if a country—at the same time it adopted an incomes policy—set up barriers to imports, the likelihood of success would be diminished. But it might also increase the need for an incomes policy.

Another implication to be drawn from experience is that success of this type of policy is closely tied to its timing. It might be appropriate at one time and not at another. For example, it could be worthless if applied before other restric-

tive measures begin to bite. If excessive demand pressures have been eliminated and price increases are stemming mostly from cost-push pressures, the policy stands a better chance of success.

An Incomes Policy Now?

Would an incomes policy be appropriate and effective in the current American economic setting? It is contended by many persons that excess demand has now been largely eliminated in the American economy. The slowdown in the rate of economic growth, the large amount of unused capacity, and the higher unemployment rates are cited as evidence that total demand has been brought under control. At the same time, the continuing rise in prices in some sectors of the economy suggests to these persons that most current increases in prices stem from cost-push factors. This seems, then, to be an appropriate time for applying some kind of an incomes policy.

On the other hand, there are persons who cite the diminishing strength of inflationary forces as evidence that, given time for the economy to adjust, monetary and fiscal policies will turn out effective. These persons argue that, even if the results are not completely satisfactory, one could not expect an incomes policy to do much better. In rebuttal, proponents of an incomes policy, however, argue that it would reduce the time required for monetary and fiscal policies to work, and, at the same time, hold down the rise in unemployment.

Just as it is extremely difficult—if not impossible—to determine how much influence incomes policies have had in the past, it is an open question as to how effective such a policy would be under present conditions in the United States. In any case, too much should not be expected from an incomes policy, should one be put into effect. It would not be a panacea, and it would not work without sacrifice. At best, it would be marginally helpful and would not be harmful to other well-chosen policies.

ROBERT H. FLOYD