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WAGE AND PRICE CONTROLS ARE WORSE THAN WE THINK

Isaac Newton was once asked why he was able to make so many great scientific discoveries. He responded; "if I have seen further than other men, it is because I have stood on the shoulders of giants." Unfortunately, when we talk about economics, we mostly stand on each others feet. For example, according to a recent national opinion poll, inflation is now regarded as the number one economic problem in the United States. And according to the same poll, 50 percent of the people feel that because of our worsening inflation problem, wage and price controls should be imposed on American businessmen and workers. This faith in the ability of wage and price controls to improve the inflation outlook is unfortunate, because the available evidence suggests that controls are ineffective in solving the inflation problem.

In fact, if we get off each others feet and try to stand back where we can get a clear view of wage and price controls, we see that they merely attack the symptoms rather than the causes of inflation. The principal causes are excessive monetary growth, large deficits in the federal budget, and government policies that inhibit the workings of our market economy. Consequently, only by cutting the government deficit, reducing the rate of growth of money, and improving the structure of our economy can we expect to make lasting progress against inflation. Wage and price control programs (including so-called TIP programs) won't work. In fact, they tend to make our inflation problem worse.

I. Why Wage and Price Controls Cause Higher Inflation

It has always been recognized that price controls can cause disruptions in economic activity. Because an economy under price controls is constrained in its ability to adjust to changing tastes and resource availability, lower production will generally accompany any controls program. If the underlying factors that cause inflation are unaffected by price controls, the economy will end up with higher, not lower, prices. That is, with the same amount of money and government debt outstanding and with a smaller volume of goods produced, the average price of those goods will be higher.

A brief look at what happened in our ill fated use of controls in 1971-74 will hopefully remind us that such wage and price policies have very unfortunate and undesired effects.

Rigid Prices Produce Bottlenecks and Shortages

In setting prices in a market economy, individual decision makers process a lot of information. Each day, some businessmen adjust the prices of their goods and services in response to new information--they increase some prices, decrease others, and leave the rest unchanged. These relative adjustments in prices ensure that markets "clear" and that resources are directed toward uses most highly valued by spenders. But the imposition of wage and price controls short-circuits this automatic adjustment process. Prices of goods are locked into fixed relationships to each other, with the result that changing market conditions produce shortages in some sectors of the economy.

For example, in the summer and fall of 1973--two years after comprehensive controls were first imposed--we had extensive shortages of a wide variety of goods. But at the same time we had substantial slack, or excess capacity, in many sectors of the economy.

Production cutbacks in the aluminum industry, for example, caused serious shortages in other key industries. In the fall of 1973, a large aluminum company announced that it was cutting production of several major items due to "poor cost-price relationships present under price restrictions." Other companies also reportedly cut production of low-profit items. At the same time, shortages of critical aluminum inputs threatened a significant reduction in production for air conditioning and refrigeration manufacturers. And according to a major architectural trade association, operations of its members were cut back 30 percent in the fall of 1973 due to shortages of aluminum. In each of these cases, many jobs were lost as production was shut down.

Similar problems developed in the steel industry. Although faced with substantial excess capacity and strong market demand in many product lines, steel manufacturers nevertheless cut production because the controls had frozen prices too low for them to make a reasonable profit. Production in both the coal and the petroleum industries was hurt by cutbacks in steel products necessary for oil drilling and coal mining. These cutbacks came in the weeks just after the OPEC embargo when energy shortages were mounting in the U.S.

Increased Exports at the Expense of Local Needs

Producers faced with controlled domestic prices often sought relief by stepping up their exports--and by selling abroad at higher world prices, more shortages were created at home. Both the chemical and fertilizer industries responded to low domestic prices set by the controllers by increasing sales of products abroad. By late 1973 foreign prices of chemicals were two to four times higher than domestically controlled prices, and some firms doubled their exports. In fertilizer, where the difference between foreign and domestic prices was also large, exports increased substantially in 1973 before controls were removed late in the year. Once controls were eliminated, planned exports of all goods dropped precipitously. (Shortages of fertilizer, I might add, had a significant impact on output per acre in agriculture and, consequently, on food prices.)

Bartering and Other Distortions

Controlling relative prices also increased the number of firms bartering to exchange one scarce good for another. In some cases a scarce good passed through half a dozen or more hands, each time being bartered for something equally scarce before reaching a final purchaser. In fact, the revenues of chemical trading specialists, who locate and acquire chemicals for their customers, doubled in 1973; they jumped from $300 million to $600 million. And I don't have to tell you how inefficient and costly bartering is compared to exchange in a monetary economy.

Illegal activities were also on the rise as the controls program unwound. There were frequent reports of tie-in sales, which forced a purchaser to buy an unneeded good in order to get a needed good in short supply. Also, suppliers of such scarce goods sometimes arranged to sell them for export at the high world price; but the "importer" turned out to be a domestic firm, and the goods never left the country.

Disincentives for Investment

These distortions could conceivably have been anticipated and eliminated by a much wiser control authority--one that possessed the collective knowledge of all market participants, an obviously impossible task. But one distortion even an all-knowing control authority could not have prevented was the stifling of business investment spending.

It is easy to see why businesses would be reluctant to expand capacity during a controls program.

In an uncontrolled economy, a producer's desired level of capacity is based on a comparison of the costs and expected benefits of holding excess capacity. When producers decide whether or not to build a new plant, they do not know for sure how profitable their investment will be. They are uncertain about raw material and labor costs and about product demand. In effect, most producers face a distribution of possible outcomes ranging from a small chance of large losses through much more likely probabilities of moderate profits to some small chance of large profits.

Price controls narrow this range of probable profits considerably, thus reducing the average or expected profits from excess capacity. That is, under price controls, even when demand is heavy firms know they can make only modest profits because prices will not be allowed to rise to reflect the increased demand. Since the expected benefits of holding excess capacity are therefore reduced, some facilities which otherwise would have been built are left unbuilt. And more generally, the economy loses its ability to respond to future surges in demand.

This is clearly what happened during the recent U.S. price controls program. In <u>manufacturing</u>, for example, the Federal Reserve Board's index of capacity grew at an average rate of 5 1/4 percent between 1962 and 1970. For the two years just before price controls, the growth rate averaged 4 percent; however, that fell to 3 1/4 percent in the first two years of controls. This drop occurred even though the controls period was one of strong economic growth, while the period just before it included a recession.

The experience of individual industries in the <u>materials-producing sector</u> illustrates even more dramatically the depressing effects of price controls on investment. In the major materials industries--including paper, steel, aluminum, chemicals, and many others--capacity grew more slowly during the first two years of the controls program than during the two years before it. And by 1973, after very rapid growth in the economy, most industries continued to expand capacity at a slower rate than before the controls period--in fact, at a rate well below the trend growth of the 1960s. This investment slowdown, I should note, came at a time when capacity utilization rates were at or near record highs in many industries. So the reluctance of firms to expand capacity had to be mostly due to the wage and price controls program.

<u>Controls Encourage Overly Expansive Monetary and Fiscal Policies</u>

Aside from lowering real output, controls produce another major problem for the economy. During the early stages of a controls program, measured price increases are lower than the actual rate of inflation. With the inflation problem thus temporarily swept under the rug, policy makers have a tendency to become less concerned about inflation in formulating monetary and fiscal policies. They are thus tempted to let the money supply grow too fast or the deficit become too large in an effort to provide a stronger "stimulus" to the economy.

This appears to have happened during the 1971-74 wage and price controls program. In 1972, the first full year of price controls in the U.S., the narrowly defined money supply--M1--grew at a 9 percent annual rate, the most rapid annual growth ever for M1. At the same time, the federal budget deficit was almost $25 billion. And this occurred, I might add, while the economy was operating at nearly full capacity.

This tendency of policy makers to seek short-term gains at the expense of longer-term goals provides still another reason why wage and price controls have a negative impact on the economy.

II. Will Tax-based Incomes Policies--"TIP"--Work?

Recently people have been talking about a form of incomes policies that hasn't been tried in the U.S.: for example, using the government's taxing power to slow the rate of inflation by penalizing "excessive" wage increases. Yet I doubt these policies work to reduce inflationary pressures, because all of the criticisms of wage and price control programs apply also to tax-based programs.

A common version of a "TIP"--or "Tax-based Incomes Policy"--plan would tax employers who increased wages more than some percentage set by the government. In effect, the "TIP" plan falls somewhere between full wage controls and no controls at all. Unlike a standard controls program, which effectively imposes an infinitely large tax on wage settlements larger than government guidelines (since such settlements are prohibited), the TIP plan would permit wage settlements that exceed guidelines and would tax these settlements at some finite rate.

Just as any other incomes policy, this one is not likely to reduce inflation. TIP could be evaded by "promoting" employees receiving above-guideline pay increases and by expanding fringe benefits. The only way to avoid this would be to have detailed rules and regulations which were "enforced" by a large bureaucracy--just like any other wage and price control program.

In sectors where demand grew rapidly, TIP could actually increase inflation. Firms in these industries would want to bid labor away from other industries so that production could be increased to meet demand. But this would require firms in growing industries to raise wages more than the government allowed and thereby pay higher taxes. The total wage cost--including both wages paid to employees and wage taxes paid to the government--could therefore be higher under TIP than without it. Thus, under TIP the very industries producing goods most highly valued by society would be placed at a disadvantage relative to industries facing weaker demands.

TIP could lead to higher unemployment. The tax penalty levied against "excessive" wage increases represents a tax against labor. And everybody knows that whenever the government puts a tax on a particular item, that item becomes less popular in the marketplace. Put another way, the TIP tax on labor would encourage businessmen, seeking to keep their costs down, to substitute other factors of production for labor.

TIP would be hard and costly to administer too (as is any controls program). For example:

- Since TIP would be tied to the corporate income tax, how would unincorporated businesses and nonprofit institutions be treated?
- How would the program be applied to new firms with no past records of salary expenses?
- How would TIP be applied to salary increases based on previously negotiated contracts?
- How would it handle costs associated with work contracted out?

How would demands for "catch up" wage increases be handled? Might not aluminum workers, for example, argue that a large pay increase is required in their next contract to preserve comparability with steel workers who received a large settlement in 1977?

In short, TIP would require detailed and cumbersome regulations, enforced by a large, costly bureaucracy, and cause many of the same kinds of economic distortions that we had in the recent U.S. control program--without reducing inflation.

III. Conclusion: There is Still No Free Lunch

Those who currently propose incomes policies to reduce inflation appear to think that a modest control program will yield major benefits in terms of reduced inflation. But, as we've seen, things don't work that way. Controls produce shortages and other distortions, and they reduce the incentives of businessmen to invest in the plant and equipment necessary to sustain a growing, dynamic economy. The economy with its massive needs for continual adjustment to changing conditions stagnates under controls as the natural adaptive mechanism of the market is destroyed. Prices themselves may be held down temporarily. But the inevitable lifting controls unleashes even more inflation.

The evidence suggests that we are worse off after any incomes policies than before. The lower supply of goods aggravates inflation, and inequities of all kinds are created. Bureaucratic waste and a growing stack of government regulations emerge as the controllers adjusted to endless unanticipated effects of shackling the economy. And if maintained long enough, controls erode some of our basic political and personal freedoms.

Inflation is a serious problem--our most serious economic problem--but we cannot solve it through programs that ignore its fundamental causes. The price level and its rate of growth are largely determined by government policies. Businessmen and consumers operate within this framework to determine the relative prices of goods and services. The solution to our inflation problem, therefore, cannot be wage and price controls; it can only be more responsible fiscal, monetary, and other governmental policies.

Attempts to try the "free lunch" of stable prices with the currency of incomes policies are doomed to failure. Whether we call it jaw boning, TIP, wage and price controls, or anything else, they are not going to provide easy answers to a most difficult problem. I hope we will have the courage to stop looking for the easy way out, and instead meet the inflation problem head on. For if we continue to try for a free lunch through incomes policies, we will all too soon again realize we can't really afford the price. Prudent monetary, fiscal, and other government policies are the only really cost-effective alternatives we have.