CHAPTER 2

Inflation Control Under the Economic Stabilization Act

Public Law 92–210, the Economic Stabilization Act Amendments of 1971, requires that the *Economic Report of the President* include a section "describing the actions taken under this title during the preceding year and giving an assessment of the progress attained in achieving the purposes of this title." This chapter is intended to fulfill that requirement. There is, however, no intent to represent the description of the control regulations contained herein as legally binding interpretations.

AT THE BEGINNING of 1971, the Administration and the President were hopeful that reliance on appropriate monetary and fiscal policies, along with the competitive forces of the free market, would be sufficient to curb inflation. At the same time, there was recognition that the course of events during 1971 would critically affect the choice of instruments to achieve the desired goals.

The Government's instruments for inflation control include a range of policies which are appropriate to various phases and types of inflation. One of these instruments is the authority to impose direct controls as provided under the Economic Stabilization Act of 1970, as amended. It became necessary to employ this authority in 1971, at first to restrain excessive wage and price increases in the construction industry, and subsequently to initiate overall restraints on wages, prices, and rents in the face of an exceptionally stubborn inflation.

In his *Economic Report* of February 1, 1971, the President noted situations where the Government had taken action to reinforce market resistance to inflationary pressures. Included were these actions:

—Measures to augment the supply of lumber and thus counteract excessive price increases.

—Steps to increase oil production on Federal offshore leases and to expand oil imports in order to restrain crude oil price increases.

—A review of the steel industry's economic problems with special refer-

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ence to inflationary price increases in early 1971 on some steel products. (After the Administration had publicly expressed its disapproval, these increases were reduced by about one-third.)

The President's *Report* also emphasized his particular concern about excessive increases in wages, costs, and prices in the construction industry, especially in view of the high unemployment that existed among construction workers. He reiterated his December 1970 request that labor and management in the industry develop a plan to bring wages, costs, and prices into line with the requirements of national economic policy, saying that a workable plan would avert the need for Government action.

THE CONSTRUCTION PROGRAM

Concern with wage-price trends in construction was founded on the experience of the previous years. Construction workers had received abnormally large wage increases in the late 1960's. During 1970 the upward trend accelerated as nearly 700,000 union construction workers negotiated collective bargaining agreements which provided wage and benefit increases averaging 19.6 percent in the first contract year and 15.6 percent annually during the life of the contract. These increases were a major factor in the sharp rise in construction costs and prices, and they may have served as a spur to inflationary wage demands by both union and nonunion workers in other sectors of the economy.

The appeal for a voluntary program of cost restraint was not successful. Late in February 1971 the President suspended the Davis-Bacon Act, which sets wage standards for federally funded, assisted, or insured construction. By late March, the Administration, working with labor and industry leaders, had developed a cooperative program designed to restrain cost increases. On March 29 the President reinstated the Davis-Bacon Act and by Executive Order 11588 formalized the cost restraint program. Under the authority provided by the Economic Stabilization Act of 1970, this Executive Order established the administrative rules, organizations, and procedures to be used in the stabilization of wages and prices in the construction industry. The administrative mechanism for restraining wage increases took the form of a 12-member tripartite Construction Industry Stabilization Committee (CISC). With the aid of Craft Dispute Boards made up of labor and management representatives for individual construction trades, the CISC was to review and pass upon the acceptability of all economic adjustments in all collective bargaining agreements negotiated in the construction industry.

Executive Order 11588 spelled out two basic criteria for evaluating proposed increases in compensation. They were: (a) "Acceptable economic adjustments in labor contracts negotiated on or after the date of this Order will be those normally considered supportable by productivity improvement and cost-of-living trends, but not in excess of the average of median increases in wages and benefits over the life of the contract negotiated in major con-

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struction settlements in the period 1961–1968"; and (b) "Equity adjustments in labor contracts . . . may, where carefully identified, be considered over the life of the contract to restore traditional relationships among crafts in a single locality and within the same craft in surrounding localities."

Because of the large number of contracts to be reviewed by the CISC, the time needed to install administrative procedures, and the return of some proposed contracts to Craft Dispute Boards for renegotiation, a backlog of unapproved cases quickly developed. Its existence caused problems when the wage-price freeze was instituted on August 15. The freeze applied to construction, as to all other industries, but it was not retroactive. Because the construction contracts in the backlog had been decided prior to August 15, the Cost of Living Council had no jurisdiction; the contracts could, with CISC approval, go into effect as agreed. Thus the CISC continued to operate during the freeze and, subsequently, in Phase II under the jurisdiction of the Pay Board, to clear up the backlog of old cases; this process continued until late December.

In all, the CISC reviewed over 1,500 new collective bargaining agreements that had been settled by the parties. Over one-fifth of these were not approved in their initial form by CISC. Construction industry collective bargaining agreements settled and approved in the second and third quarters of 1971 provided first-year wage and benefit increases of about 11 percent, a significant reduction from 1970, when such increases averaged 19 percent. CISC thus retarded the rate of growth in the compensation of unionized construction workers and its existence appears to have been an important factor in a reduction of strike activity in the industry. How much greater the effect of the construction industry program would have been if the general wage-price control system had not been established will never be known, but real progress was undoubtedly made during the period of its independent existence.

Executive Order 11588 also established an Inter-Agency Committee in the Federal Government to develop criteria for establishing acceptable pricing policies for construction contracts and acceptable compensation changes for management and staff employees in the industry. The Inter-Agency Committee had developed and published draft regulations and was in the process of drafting final regulations when its activities were superseded by the broader price and compensation controls of the New Economic Policy.

AUGUST 15: THE WAGE-PRICE FREEZE

Acting under authority of the Economic Stabilization Act of 1970, the President announced on August 15 an immediate 90-day freeze on prices, rents, wages, and salaries and creation of a Cabinet-level Cost of Living Council (CLC) to administer the freeze and to advise on further stabilization policies and actions.

The combination of conditions that led to direct Government action to restrain prices and wages was discussed earlier. These conditions did not

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automatically determine the type, duration, or rigor of the policy initially undertaken, which could, of course, have ranged from a noncompulsory type of policy operating mainly through moral suasion to the comprehensive mandatory freeze that was actually applied.

During the first half of 1971 the Administration was under increasing pressure to adopt some form of incomes policy, preferably a noncompulsory one. However, such a policy was not considered appropriate for two reasons.

First, there was reason to believe that public opinion would regard such a "soft" control policy as merely the first in a series of moves toward compulsory controls. The result would be widespread efforts to increase prices and wages in anticipation of a more stringent program; the Government's likely reaction—successive escalations of controls—would result in more inequities, distortions and, ultimately, administrative difficulties than would a comprehensive freeze. Although the situations were considerably different, experience with controls in the initial stages of the Korean conflict suggested that this would be the likely pattern of response to voluntary guidelines.

Second, the nearest American approach to a policy of persuasion, the guidelines of the previous Administrations, had been abandoned in 1966. The Administration believed in 1971 that exhortation had lost most of its force.

Beyond an incomes policy supported only by exhortation, there were, of course, many possible variations of compulsory controls. The Phase II controls that followed the freeze represent one of those variations. Common to all such systems, including the Phase II apparatus, is a need for time to formulate the program, to set up the administrative organization, and to write and disseminate regulations. Such preliminary processes instantly become public knowledge, with the predictable result that during the startup phase of a complex restraint program all elements of the economy attempt to improve their relative position before the controls become effective; the net effect is to make the inflationary spiral even steeper.

The chief virtues of the freeze were its decisiveness, comprehensiveness, and administrative simplicity. The President's announcement that practically all wage and price increases were prohibited left no doubt of a drastic change in the upward trend of prices and wages. Equally important, a freeze could be—and was—imposed immediately, precluding anticipatory price and wage increases and providing time to prepare and set in motion more lasting and flexible measures.

The Administrative System

The Cost of Living Council (CLC) consisted of the Secretaries of the Treasury (Chairman of the CLC), Agriculture, Commerce, Labor, Housing and Urban Development, the Director of the Office of Management and Budget, the Chairman of the Council of Economic Advisers (Vice-

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Chairman of the CLC), the Director of the Office of Emergency Preparedness and the Special Assistant to the President for Consumer Affairs. The Chairman of the Board of Governors of the Federal Reserve System was named adviser to the CLC. A small staff headed by a full-time executive director supplied services including policy review, planning and analysis, public information, legal counsel, and administrative services.

The CLC, under the authority delegated by the President in Executive Order 11615, issued a series of orders putting the general freeze into operation and made the principal policy decisions during the freeze. Policy was implemented through an organizational system headed by the Director of the Office of Emergency Preparedness (OEP) which was delegated the authority to administer, monitor, and enforce the freeze. The OEP, through its nationwide organization (which is designed to meet national emergencies or natural disasters and plan for economic contingencies arising from possible emergencies) successfully carried out this assignment during the freeze period. The OEP was assisted in interpreting and enforcing the freeze regulations by the Treasury Department's Internal Revenue Service, a specially designated unit of Department of Justice attorneys, and Agricultural Stabilization and Conservation Service field offices.

Freeze Policies

Reflecting the basic objectives of the freeze, the CLC's policy decisions tended in the direction of the most emphatic possible stop to the inflation. Only a minimum of exceptions to the freeze on prices, wages, and rents was permitted. Because of the complexities of the markets for many goods and services, however, it proved difficult to develop precise definitions that applied with equal effect in all situations. The basic principle of the freeze, as applied to wages, prices, and rents, was that the rate of payment during the freeze period—August 16 to November 13—could not exceed the rate in effect during the base period—July 16 through August 14.

Wages and Salaries. The crucial question in applying the basic principle of the freeze was what "in effect" meant in cases where a prefreeze contract or other arrangement called for a larger wage payment during the freeze period than had actually been paid during the base period. It was argued at the time that contracts have a sanctity which must be respected and that a logical line could be drawn to distinguish contracts from other arrangements incorporating the expectation of a wage increase. However, the opposing argument was that there was neither a logical nor an equitable distinction in this type of situation, and to give preferential treatment to contracts as the bases for granting wage increases would discriminate against workers not covered by contracts.

This issue was resolved by deciding that wages would be limited during the freeze to the rates actually paid workers during the base period, even though they might have entered into an agreement calling for higher rates to take effect sometime during the freeze. Such resolution of the issue

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was deemed to be the most explicit and straightforward application of the freeze. Moreover, approval of these higher rates would have seriously undermined effectiveness of the freeze and probably would have eroded public support, which was based on equal treatment of all groups. Another important concern in this decision was the desire to avoid negative effects on production or investment. To allow wage increases to go into effect during the freeze, while keeping an immovable lid on prices, would have squeezed profits severely in some cases and might have resulted in some firms' temporarily curtailing production and employment, especially since relief might have been expected after the freeze. To identify such cases and permit selective price increases only where they were necessary to prevent this result was not administratively feasible in the time limits of the freeze period.

Prices and Rents. The decision not to permit wage increases to take effect during the freeze even if they had been contracted for earlier was paralleled in the CLC regulations for both prices and rents. Rent increases were not allowed, even though tenants before August 15 had signed leases, secured by deposits, calling for increases.

In the case of prices, the ceiling for the freeze period was the highest price at or above which a "substantial volume" (interpreted to mean at least 10 percent of the total) of transactions had taken place in the 30 days preceding the freeze. If no transactions had taken place during that period, the nearest preceding 30-day period in which transactions occurred was to be used as the base. A price transaction was deemed to have occurred when the seller shipped a product to the buyer, not when the order for the product was received. Thus, sales contracts entered into before August 15 providing for deliveries during the freeze at higher than base period prices were set aside.

In keeping with the principle of the freeze, price increases were not sanctioned on the basis of cost increases; inequities and hardships arising from this rule were assumed to be endurable for the 90-day duration of the freeze. Raw agricultural products were exempted in the Executive Order, however, and certain limited exceptions—for example, import price increases and seasonal price adjustments—were allowed.

Raw Products. The exemption of raw agricultural products, including seafood products, from price control created problems for some processors who found their operating margins squeezed between uncontrolled costs and frozen selling prices of the processed foods. Nevertheless, increases in the uncontrolled prices were not allowed to be passed through, although there were some minor extensions of the definition of "raw" products.

Imports. Imported products were subject to price increases during the freeze at the level of the importer from three sources:

1. The surcharge on dutiable imports (generally 10 percent of the customs valuation). No surcharge was applied to duty-free imports or those under quota.

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2. An increase in dollar price resulting from fluctuations in international exchange rates.

3. Price increases in world markets which were reflected in the delivered price in the United States.

On the principle that U.S. Government actions were directly responsible for the surcharge, the CLC permitted the dollars-and-cents amount of the surcharge on a particular imported product to be passed through successive transactions, including processing, to the final purchaser. Increases due to dollar depreciation or price changes on world markets were allowed to be passed on as long as the imported good retained its original form. If an import was physically transformed, the price increase had to be absorbed.

Seasonal Price Adjustments. Sellers of goods and services which were characterized by a marked seasonal fluctuation in price were likely to be unfairly penalized by ceiling prices based on the immediate prefreeze period. Therefore, the CLC ruled that prices showing a "large distinct fluctuation at a specific, identifiable point" in each of the past 3 years would be allowed to increase to the level reached during the same seasonal period of the preceding year.

New Products. As in past periods of price control, the definition of a product became controversial. The CLC decided that to be considered new a product or service must be "substantially different" and not merely changed in fashion, style, form, or packaging. In the event of introduction of a genuinely new product or service during the freeze, two alternative methods of pricing were permitted; the price could be based on the price of comparable products or services or on the unit cost plus the normal markup of similar products or services.

Other Rulings. The CLC determined that price ceilings did not apply to exports and that increases in various welfare payments, workmen's compensation, and employers' contributions to previously effective fringe benefits were not covered by the freeze. Pay increases resulting from bona fide promotions to jobs of greater responsibility and progression of apprentices or learners to more skilled levels according to preestablished programs were permitted on the grounds that they were not increases in the wage for a given job. Actual wage increases were also permitted to meet requirements of minimum wage laws or to eliminate illegal discriminatory employment practices.

Exemptions. In all, nearly 6,000 requests for exemptions and exceptions to the freeze regulations were considered by the CLC; five individual exemptions were made. Many requests were from persons in financial difficulties not due to the freeze. Many others were from persons whose proposed changes were permissible under existing regulations.

The freeze generated numerous problems for its administrators, but most of their concern was occasioned by a small proportion of the economy's millions of different wages, prices, and rents. The public was kept informed by a series of questions and answers that amplified and interpreted the

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definitions of the original Executive Order released by the CLC; the substance of these interpretations and definitions was incorporated in the more extensive regulations and circulars published in the *Federal Register* by the Office of Emergency Preparedness.

Dividends and Interest. The Economic Stabilization Act of 1970 did not include provisions for regulating interest or dividends. Control of dividend payments during the freeze period was carried on through a program of voluntary compliance. The Secretary of Commerce sent telegrams to about 1,300 large corporations, asking them voluntarily to forego increases in dividends during the freeze, and he received practically unanimous support. Although interest rates were not controlled during the freeze, most rates dropped significantly, in part because of the abatement of inflationary expectations.

Administrative Record of the Freeze

Little administrative planning and no organizational preparation could be carried out before August 15. Such activity might have given public notice to the impending control program and jeopardized its prospects for success. As a result, the freeze was as much a surprise to almost all of the people who were to help administer it as it was to the Nation at large. Given these circumstances at its initiation, the administration of the freeze program must be accounted outstandingly effective.

In exercising its authority to administer, monitor, and enforce the freeze regulations, OEP had the benefit of its established facilities, including a system of 10 regional offices (two of which were specially opened during the freeze) connected to Washington headquarters by private teletype. In addition to OEP's 300 employees, personnel from many other Government departments and agencies, including 2,500 IRS employees, were engaged at least part time in the program.

Inquiries and Complaints. During the freeze period approximately 1 million inquiries regarding the stabilization program were received (mostly by telephone) ; of these two-fifths concerned prices and the rest were equally divided between wages and rents. Most of these were requests for interpretations, but nearly 50,000 were complaints of alleged violations, 75 percent of which concerned prices. Rents accounted for 19 percent of the complaints and wages 6 percent. Over 60 percent of these complaints were found not to involve actual violations; almost all of the remaining cases were brought into compliance informally or through routine investigation.

In addition, over 85,000 spot checks carried out by IRS indicated over 90 percent in compliance. Of those in violation, over half promptly and voluntarily complied when the violation was pointed out.

Litigation. About 200 cases of violators who refused to comply voluntarily after initial contact were forwarded to OEP regional offices during the freeze; all but a few of these cases were resolved without court action. Eight cases had reached court and 23 more were in various stages of prepara-

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tion in the Justice Department as the freeze ended. This relatively small volume of litigation reflects the widespread compliance with the freeze.

Effectiveness of the Freeze

Viewed as a whole and against the circumstances of its initiation, the freeze was a major success. Its primary purpose was, of course, to reduce the rate of inflation and its success in that respect may, in some degree, be inferred from the behavior of the major price indexes.

Consumer Price Index. During the freeze the rate of increase of consumer prices as measured in the consumer price index slowed by more than half from the prefreeze rate (Table 20). The index did not show a complete halt because prices of some items in the index (about 10 percent of the total weight) were unaffected, as a result of exemptions, exceptions, and inapplicability of the controls. In addition, the rate of price increase was somewhat overstated by the index during this period because time lags in the collection of price data caused some prefreeze price changes to be reported during the freeze. The exemptions and the measurement problem led to a continued rise in the index during the freeze. Partly because of this, special analyses of price changes item by item were undertaken. These showed that except for raw agricultural products the prices were unchanged between October and November for 86 percent of 120,000 consumer items for which comparisons could be made; for about 6½ percent prices declined, and for about 7 percent prices increased (Table 21). A similar pattern was found

TABLE 20.—*Changes in consumer prices, selected months, 1971*

[Seasonally adjusted except as noted]

Item	Percentage change from 3 months earlier (annual rate)			
	February	May	August	November
All items	4.0	4.2	4.0	1.7
Food	1.7	8.2	2.7	1.7
Nonfood commodities	3.2	4.2	3.1	.0
Services[1]	5.6	2.9	6.1	3.1

[1] Not seasonally adjusted.

Source: Department of Labor.

TABLE 21.—*Changes in consumer prices, selected items, October to November 1971*

Group	Percentage distribution of October to November changes[1]			
	Total	No change	Decrease	Increase
Total[2]	100.0	86.4	6.6	7.0
Food at home[2]	100.0	84.8	7.5	7.7
Nonfood commodities	100.0	87.2	6.1	6.7
Services	100.0	97.2	1.0	1.8

[1] Based on special analysis of 120,000 individual price comparisons.
[2] Excludes raw agricultural products.

Source: Department of Labor.

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for the September–October period. Some increases were, of course, permitted by the CLC regulations, but it was not possible to determine from these data whether the small proportion of increases that did occur were entirely the result of allowable increases.

Industrial Wholesale Prices. The effect of the freeze on wholesale prices, which is easier to observe because there are fewer lags in the collection of data, was even more impressive than in the case of the consumer price index. The index of industrial commodity prices, which had risen at an accelerating rate after the first 3 months of 1971, declined at an annual rate of 1.3 percent from August through November (Table 22). The decline affected

TABLE 22.—*Changes in wholesale industrial commodity prices, selected months, 1971*

[Seasonally adjusted except as noted]

Commodity group	Percentage change from 3 months earlier (annual rate)			
	February	May	August	November
Industrial commodities	2.9	5.0	6.5	−1.3
Textile products and apparel	−1.1	5.7	6.1	−.4
Hides, skins, leather, and related products	6.7	4.3	3.6	.7
Fuels and related products and power	13.0	3.6	2.8	−.7
Chemicals and allied products	3.9	−.8	.8	−1.9
Rubber and plastic products	1.5	.7	.0	−.7
Lumber and wood products	9.0	24.2	44.9	−3.2
Pulp, paper, and allied products	.0	2.2	4.5	.4
Metals and metal products	−4.7	9.3	10.9	−.7
Machinery and equipment	4.3	3.2	3.9	−1.4
Furniture and household durables	3.7	1.1	2.2	−.4
Nonmetallic mineral products	11.6	10.2	9.9	1.3
Transportation equipment [1]	4.5	.4	2.6	1.1
Miscellaneous products	4.4	−1.1	.7	.7

[1] Not seasonally adjusted.

Source: Department of Labor.

most of the industrial commodity categories; the few increases that did occur were attributable to import price increases or factors such as the seasonal fluctuations associated with introductions of new automobile models.

Average Hourly Earnings. The freeze on the wage and salary side also was effective. Hourly earnings (adjusted to more nearly approximate wage rates) had shown an annual rate of increase of about 7 percent prior to August; this dropped to an annual rate of about 1¾ percent between August and November.

PHASE II: ISSUES AND ORGANIZATION

The broad support of and compliance with the freeze reflected a national willingness to support a rigorous anti-inflationary program, even at the cost of some hardship. But it was clear from the outset that the freeze had certain important limitations if extended indefinitely. An indefinite freeze is unworkable in a dynamic economy, where technology, new products and changing demand patterns exert a continuing strong influence on prices. Movements of prices and wages serve the essential purposes of organizing and guiding the allocation of resources, and to suppress them for long

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would seriously distort resource allocation. The proper goal of the stabilization program is to reestablish an acceptably low rate of price increase by reducing expectations of continued strong inflation and eliminating, to the extent possible, practices and behavior which sustain or promote inflation. But underlying expectations of a continuing inflationary trend could not be arrested by a short freeze. A sequel would therefore be required; this plan was reported to the Nation in the President's October 7 announcement.

It was vital to the success of the effort to disinflate through a system of controls that the transition from the freeze to Phase II should be orderly, well understood, and widely supported. Many possible paths could have been followed in the Phase II price-wage control system. In a free nation with a market economy, however, these paths are somewhat circumscribed by social, political, institutional, and economic constraints. In this instance, these constraints required that the control system employed in Phase II be as effective and equitable as possible in reducing the inflation, while still permitting the maximum operation of normal market mechanisms and ensuring an early return to a free market economy. Administratively, the system also had to be streamlined and efficient, and, to work, it had to earn a high degree of public support. These considerations raised certain decisive issues. Paramount among them were these questions:

Should the program be mandatory?
How comprehensive should the program be?
How should the program be administered and enforced?
Who should set standards of price-wage behavior?
What standards should be set?

In addressing these problems of Phase II, the President and his Cost of Living Council consulted with numerous representatives of each major interest in the control program: labor and business, farmers and consumers, State and local governments, and the Congress. The discussions revealed an almost unanimous belief that the anti-inflationary effort should be continued to a successful conclusion, but a great diversity of strongly held opinion about the best strategy and procedures for achieving price stability. A consensus was ultimately fashioned upon the belief that Phase II required: (a) A clear-cut, publicly supportable goal for the disinflationary effort; (b) machinery allowing the public and major elements of the economy to participate in setting policy and administering the program; (c) an essentially self-administered system embodying strong incentives to encourage anti-inflationary behavior; (d) provision in the system for maximum continued operation of competitive pricing and free collective bargaining.

In the interests of equity and effectiveness (and for the reasons noted earlier in this chapter with respect to the freeze) it was decided that Phase II controls would be mandatory and initially as comprehensve in their direct coverage as was administratively feasible. In large measure, this decision was

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based on the intensity and pervasiveness of the prefreeze inflation. The intention was to preserve the psychological benefits already realized by the freeze, to prevent an outbreak of renewed inflationary increases in prices or wages in any uncontrolled sectors, and to establish a broad pattern of restraint and thus reassure the public that the process of stemming inflation would be as widely and evenly distributed as possible. This decision for almost universal coverage at the outset did not preclude the possibility of a subsequent relaxation of the controls by stages, as the effectiveness of the system was demonstrated, confidence in the control of inflation was strengthened, and sectors of the economy no longer requiring control were identified.

A major issue of post-freeze control strategy was which of two courses to pursue. One alternative was to follow up the freeze period with what might be called a semifreeze, holding close to the rigid standards of the freeze as long as possible. The danger here was that inequities and hardships caused by the freeze had built up so much pressure that there would be an explosion that might wreck Phase II before it got underway; also there would be increasing problems of resource allocation. The other alternative was to move quickly to the more flexible and durable standards that would eventually be needed, recognizing that this would cause a transitional bulge of wage and price increases. Because of concern that a rigid stance would both undermine the operation of normal market functions and force major confrontations that might endanger the continuation of the whole program, the second of the two courses was followed. The cost of this choice was a temporary period of wage and price increases in excess of the goal.

Maintenance of maximum cooperation and support was also a vital consideration in structuring the policy-setting bodies. On the wage side it was evident that participation of labor and management would be required to give both groups a voice in the direction of the program and to ensure equal treatment. It also was abundantly clear that administration and policymaking in this unique situation would require great expertise in the area of price-wage determination and that such ability was best found among persons with long experience and training in the field. Also, large segments of the Nation—including business, unions, and the general public—had increasingly supported a control program in 1970–71, and their insights and participation were believed to be an important factor in the successful operation of the controls program.

Structuring of the policy-setting bodies could have taken several directions but the considerations summarized above pointed toward a tripartite combination (equal representation of labor, management and the public) for policy determination in the wage area, and toward public membership only on the price-policy body. In matters of pay, the different types of expertise and, above all, the need and desire for cooperation dictated a tripartite board.

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Announcement of Phase II

On October 7 the President announced the outlines of the Phase II program. The goal of the program, as proposed by the CLC, was to reduce the rate of inflation to the 2 to 3 percent range by the end of 1972, a reduction to about half the prefreeze rate. The development of guidelines and standards to attain this goal was to be in the hands of policy-setting units comprised primarily of personnel drawn from various sectors of the economy, outside of Government but acting in the public interest. The controls were to cover the economy broadly, were to be mandatory, and were to be removed when, in the President's judgment, conditions had been achieved which promised the maintenance of reasonable price stability without them.

In its specific provisions, the administrative machinery (established in Executive Order 11627) was to operate along participatory lines to the greatest extent practicable. The CLC, consisting of high Government officials and representing the President's direct interest, was assigned the responsibility of establishing broad goals, determining the coverage of the control program, overseeing enforcement, and coordinating the anti-inflationary effort in line with the overall goals (Chart 9).

The primary bodies created to develop standards and make decisions on changes in all prices (including rents) as well as compensation (wages, salaries, and fringe benefits) were, respectively, the Price Commission, composed of seven public members, and the tripartite Pay Board of 15 members, who were divided equally among business, labor, and public representatives.

Advisory committees were also established to promote a voluntary program to restrain interest rates and dividends, elicit State and local government cooperation, and to suggest means to curtail price increases in the health services industry. A rent advisory board including landlord, tenant and public representatives was created to counsel the Price Commission, while the preexisting tripartite Construction Industry Stabilization Committee was placed under the authority of the Pay Board. The National Commission on Productivity was expanded and assigned the advisory role of ensuring that the entire stabilization program encouraged productivity growth.

For purposes of administrative efficiency, the CLC decided that smaller economic units should not be required to give advance notice or to report price and wage increases which were consistent with the basic guidelines established by the Price Commission and Pay Board. The largest firms and employee groups were required to obtain advance approval from the Commission and the Board for any change, and an intermediate group was required to report after wages or prices were increased in accordance with the stabilization rules. These tiers are shown in Table 23. The CLC also recognized that prices of some products and services were either insignificant in the overall inflation problem, relative to the administrative difficulty of controlling them, or were subject to direct controls outside the Economic

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Chart 9

Post-Freeze Organization

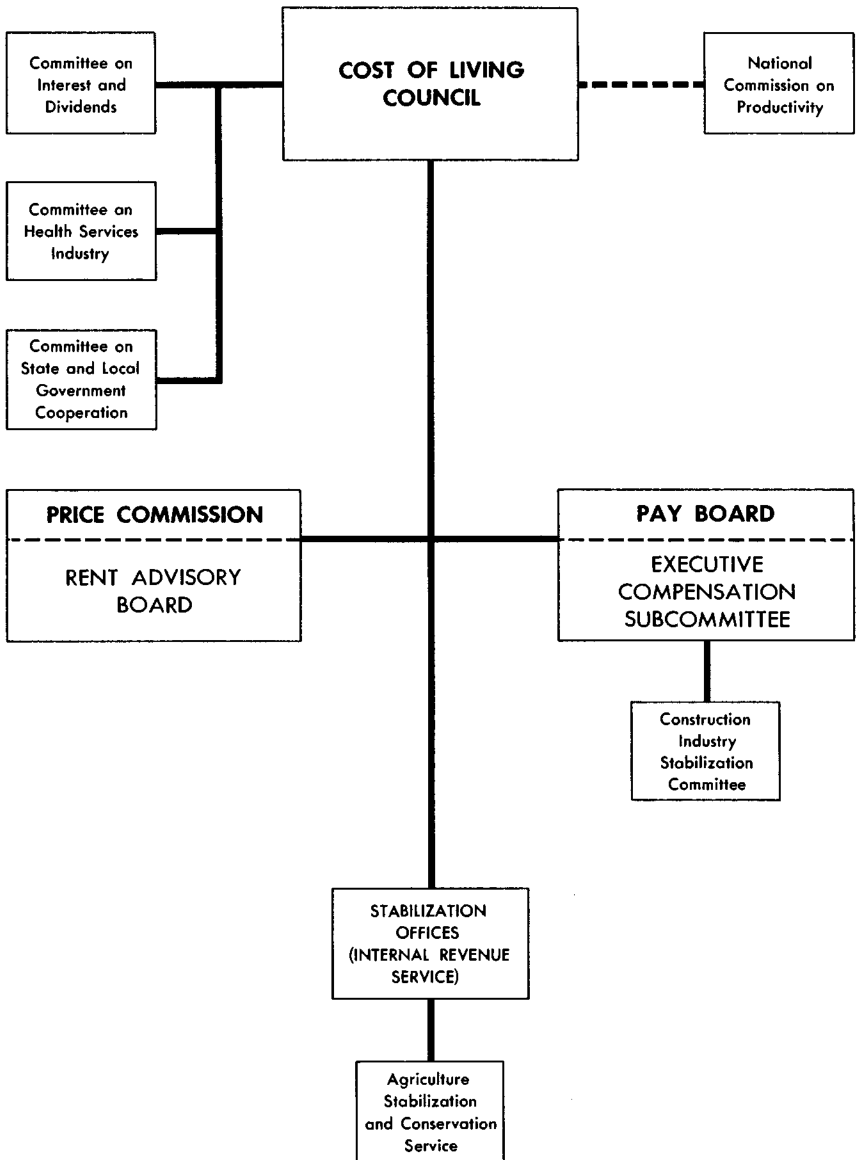

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TABLE 23.—*Required reporting of price and wage increases*

Tier	Action required	Price increases (size of firm)	Wage increases (number of workers)
I	(a) Prenotification of Price Commission or Pay Board (increase to be effective with approval of Commission or Board). (b) Tier I firms to submit quarterly price, cost, and profits reports to Price Commission.	Sales of $100 million and over (1500 firms with 45 percent of all sales).	Affecting 5,000 or more workers (10 percent of all employees).
II	(a) Report to Price Commission or Pay Board. (b) Tier II firms to submit quarterly price, cost, and profits report to Price Commission.	Sales of $50 million to $100 million (1,000 firms with 5 percent of all sales).	Affecting 1,000 to 5,000 workers (7 percent of all employees).
III	No reports (but increases to be made only in accordance with Price Commission and Pay Board regulations and to be subject to monitoring and spot checks).	Sales of less than $50 million (10 million enterprises with 50 percent of all sales).	Affecting less than 1,000 workers (83 percent of all employees).

Source: Cost of Living Council.

Stabilization Act. These were exempted from direct control. By year end this group included:

Raw agricultural products
Raw seafood products
Life insurance
United States Postal Service
Certain custom products and services
Exports
Imports (first sale into U.S. commerce)
International ocean shipping rates
Damaged and used products
Sales of U.S. Government property
Real estate, both improved and unimproved (except for improvements completed after August 15, 1971, for a predetermined price)
Rentals of residential units constructed (or substantially rehabilitated) after August 15, 1971
Securities and financial instruments (including commodity futures on organized exchanges)
State and local government fees and charges for services
Tuition fees and charges of private nonprofit educational organizations
Pay of Americans working and living abroad
Federal pay, fees, and charges
Wages below the Federal minimum
Prices, rents, and wages in the Commonwealth of Puerto Rico
Rents of farm, industrial, and nonresidential property.

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PRICE COMMISSION AND PAY BOARD STANDARDS

Members of the Price Commission and Pay Board assumed their duties in late October. From then to mid-November, when the freeze ended, they had to organize staff, publish specific guideline regulations, and establish prenotification and reporting procedures. Both groups were also under immediate pressure at the opening of Phase II to deal with special problems created by the 90-day freeze.

Price Standards

In assuming its responsibilities, the Price Commission announced a goal of holding the rate of average price increases across the economy "to no more than 2½ percent per year." This conformed to the CLC's goal of getting the inflation down to no more than 2 to 3 percent by the end of 1972. The Price Commission also set forth the general rule that no price might be increased beyond the ceiling price established for the freeze period, except in accordance with its regulations. The terms of these regulations were as follows:

1. *Manufacturers and Service Organizations.* These firms were permitted to increase their prices to reflect allowable cost increases which had occurred since their last price increase but not before January 1, 1971. The cost increases were to be reduced to reflect productivity gains. Such price increases could not have the effect of increasing the firm's profit margin (profits before taxes as a percentage of sales) over its margin prevailing in a base period (defined as the highest average of two of a firm's 3 fiscal years ending prior to August 15, 1971);
2. *Retailers and Wholesalers.* These firms were permitted to increase their prices consistent with maintaining: (a) Their customary initial percentage markup on products equal to or less than that prevailing during the freeze period or (at the firm's option) during the firm's last fiscal year ending before August 15, 1971, and (b) the before-tax profit margin of the firm equal to or less than that prevailing in the base period (defined as for manufacturers, above).

These regulations had the effect of placing a ceiling on the firm's overall *ratio* of profit to sales, the ceiling being determined by the experience in the past 3 years. The formula for permissible price increases normally precluded an increase in the profit margin on individual products; in the event that product mix factors had the effect of increasing the firm's overall profit margin, the ceiling became operative. However, *absolute* profits could continue to advance in step with expanded production and sales. Since the regulations applied to individual producers and sellers, competitive influences could continue to operate as an additional downward pressure on prices. This factor was immediately apparent in cases where some manufacturers' effective price increases were below those justified by their cost increases because major competitors had been permitted a smaller increase. This

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procedure also avoided the costly and time-consuming process of setting individual price ceilings for individual products, with attendant problems of product definition and of assembling and analyzing data.

Immediately after the freeze the Price Commission gave priority to decisions on requests from Tier I firms for price increases based on long-term contracts written before the freeze, on adjusted base prices, or on price adjustments posted or announced prior to August 15, 1971, as well as for price increases based on contractual wage and other cost increases where price adjustments had been deferred by the freeze. Other price increases calling for advance notification were to be dealt with on the basis of approval or disapproval by the Price Commission within 30 days.

Labor Cost Pass-Through. The Price Commission made clear soon after assuming its duties that it would not necessarily grant price increases reflecting the full amount of increases in labor costs, i.e., increases in wages and benefits minus gains in productivity. It promised "to look very carefully at any labor cost increase, even if allowed by the Pay Board, to determine its impact on price inflation," and said that "in general" it would not recognize wage increases that exceeded the Pay Board's basic standard.

Rents. Price Commission rules for increases in residential rents provided that the landlord could:

1. Increase his rent charge by 2½ percent annually above the base rental upon 30-days notice to the tenant.

2. In addition, increase his rent charge by the dollars-and-cents amount of the increase of State and local government taxes, fees, and charges for services allocable to the individual unit.

3. Increase monthly rents by 1½ percent of the total cost of major capital improvements made after August 15, 1971.

4. In the case of leases which had not been renewed within 90 days prior to August 15, establish a new base rent, defined as that in effect on May 25, 1970, plus 5 percent.

Fire and Casualty Insurance. Price Commission policies covering all nonexempt insurance coverage restricted projection of increases in company-controlled costs (as opposed to actuarial factors) to 2½ percent, limited the projection of inflationary trend factors to 62.5 percent of what they would have been in the absence of an economic stabilization program, stipulated that no changes could be made in ratemaking formulas which would increase rates and, in lieu of the general profit margin test, imposed a 2½-percent limit on increases in the profit portion of the premium. Insurance departments of the various State governments are responsible for administering these guidelines, although final authority to review rate increases remains with the Commission.

Public Utilities. Under the Price Commission's rules all public utilities with $100 million or more in annual revenues in their most recent fiscal year were required to notify the Commission when they request a rate increase from their respective regulatory agency as well as when the increase is permitted

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to be effective; public utilities with revenues of between $50 million and $100 million were required to notify the Commission when they were granted an increase. The Commission relies initially upon certification by the regulatory agency that the increase conforms to criteria specified by the Commission; however, the Commission retains the right to disapprove an increase within 10 days after it has been granted.

Firms Showing Losses or Low Profits. Notwithstanding its other regulations, the Price Commission authorized all firms currently sustaining a loss to increase their prices to the break-even level. In addition, firms with annual sales of $1 million or less were permitted to increase prices to bring their profit margins on sales up to 3 percent regardless of their experience in the previous 3 years.

Health Care Services. The Price Commission approved policies for this sector recommended by the Health Services Industry Advisory Committee which operated under the jurisdiction of the CLC. The guidelines divided the industry into two categories: *Institutional providers,* such as hospitals and nursing homes, were to be permitted only such price increases as were justified by allowable costs adjusted for productivity gains. Increases from 2½ to 6 percent had to be reported to the Internal Revenue Service with supporting justification and to the appropriate medicare intermediary; and increases above 6 percent required an exception granted by the Price Commission. *Noninstitutional providers,* including physicians, were permitted average aggregate increases in their prices, based on allowable cost increases, of no more than 2½ percent per year. Such increases might not have the effect of increasing profit margins of the providers above the average of the highest two of the past 3 years. Nonprofit providers were not permitted to increase the ratio of their net revenues to their gross revenues as compared to the base-year average.

Term Limit Pricing. The Price Commission late in 1971 established a simplified approach to approvals for price increases by Tier I companies: Under the term limit principle (TLP) a company might apply for a weighted average price increase covering all product lines for a 12-month period without specific Commission approval of changes in individual product prices. This modification was particularly useful to firms with complex product lines which included thousands of individual items. The Commission required such a firm to keep records and file quarterly reports; and the firm had also to establish a monitoring procedure which would assure that the weighted average of increases did not exceed the approved limit.

Prices, Fees, and Charges of Federal, State, and Local Governments. The distinction between prices, fees, and charges on the one hand and the taxes levied by State and local governments on the other is often very arbitrary. Since taxes cannot be controlled under the economic stabilization authority, an inducement to raise taxes rather than increase fees might be present if the latter were controlled. Therefore, these fees (except those of

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hospitals and public utilities) were exempted from control. However, all State and local governments were requested to take steps to make sure that such fees did not increase more than 2½ percent per year; their chief executive officers were also asked to report semiannually on fee increases. Similarly, the Federal Government was scheduled to report the fee increases at the end of each fiscal year.

Interest and Dividends.

Interest rates were lower during 1971 than 1970, and net borrowing by households and nonfinancial business units increased substantially. The decline of interest rates may have reflected some abatement of inflationary expectations. Despite the decline of interest rates there was considerable public concern about the future course of interest rates and the Committee on Interest and Dividends was directed by the CLC to maintain close surveillance of interest rates with a view to formulating and preparing to implement a program of voluntary restraints on such rates, particularly for home mortgages and consumer loans.

The Committee proposed voluntary compliance with dividend guidelines that requested that companies limit dividend increases to 4 percent per share in 1972 (adjusted for splits and stock dividends) over the largest per-share dividend paid in fiscal 1969, 1970, and 1971, or in calendar 1971. Various special guidelines carefully defined acceptable procedures where new companies, mergers, and special situations were involved.

Pay Board Policies

General policies governing pay adjustments were adopted by the Pay Board early in November. These became effective at the end of the freeze and were applicable to all employees other than Federal employees and persons earning less than the Federal minimum wage. These guidelines included three provisions. First, permissible annual pay increases would be those normally considered supportable by productivity improvement and cost-of-living trends. The initial general standard for new contracts and adjustments was set at 5½ percent and was subject to periodic review by the Board. Second, existing contracts and pay practices established before November 14 would be allowed to operate, subject to challenge by five members of the Board or a party at interest. Third, retroactive payments for wage increases temporarily foregone during the freeze would be permitted only upon approval of the Board.

The Pay Board delegated to the CISC the responsibility of carrying out Board policy with respect to the construction industry. The Board also agreed upon and issued a series of definitions. Among the most important of these were a base date (November 13) from which future wage increases were measured against the standard and definitions of employee units. The Board also waived reporting requirements for existing contracts until year's end, a deadline later extended to January 31, 1972.

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In mid-November the Pay Board issued standards regulating certain permitted exceptions to the general 5½ percent pay standard. These exceptions provided that: (a) Pay increases of up to 7 percent would be permitted where tandem relationships (situations where pay rates for certain employees or firms are based on rates for other groups of workers or firms) could be proven to exist under certain stringent definitions. (b) Pay increases of up to 7 percent would be permitted where they were deemed necessary, within certain narrow criteria established by the Board, to attract or retain essential labor. (c) Pay increases of up to 7 percent would be permitted until March 31, 1972, where pay increases had aggregated less than the sum of 7 percent per year for each of the past 3 years (under this exception only the difference between the sum of 7 percent per year for 3 years and the sum of the actual increases might be added to the 5½ percent increase normally permissible). (d) The portion of a pay adjustment tied to changes in the cost of living might be calculated as a weighted annual average increase, provided that the sum of this portion and the remainder of the adjustment did not exceed the general pay standards. The first and second exceptions required prior approval by the Pay Board, and the maximum permissible adjustment, under any or all of these criteria, was not to exceed 7 percent.

Policies on executive and incentive compensation not covered by collective bargaining agreements were announced late in December. Essentially these provided that executive compensation increases (including salaries, fringe benefits, and perquisites of all types) were not to exceed the 5½ percent general standard. Existing incentive compensation and bonus plans were permitted to continue as long as their costs did not rise by more than 5½ percent from the appropriate base period. Existing stock option programs were permitted to continue if they met certain detailed legal and historical tests, including the stipulation that the number of shares made available should not exceed the average number made available during a 3-year base period. Also late in December, the five business members of the Pay Board reported their intention to challenge all deferred pay increases in excess of 7 percent called for by existing labor contracts.

Government Pay. Federal Government employees' pay, subject to existing legislation and executive decision, was to be monitored by the Federal Pay Agent to ensure consistency with the stabilization program. The CLC was to advise the President on the consistency of future Federal pay decisions with the economic stabilization program. The pay of State and local employees was subject to the Pay Board's rules but advance notice of such increases within the Board's general standards was waived. If a governmental unit certified to the Pay Board that it would abide by the Board's standards, it was required to report pay increases only semiannually.

PHASE II OPERATIONS

At yearend the economic stabilization machinery of Phase II had been operating about 7 weeks. Progress had been made by the Price Commission

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and Pay Board in adopting and publicizing standards for price and wage behavior, in establishing criteria for evaluating individual cases, in recruiting and organizing necessary staff, and in setting up reporting procedures and internal systems for handling applications.

To expedite the evaluation of applications and to consider regulatory issues, the Price Commission had recruited a supporting staff of approximately 500 people, while the Pay Board, whose needs for staff were much smaller, had recruited 75. A stabilization office was established under the Internal Revenue Service; it utilized 360 local IRS offices with about 3,000 persons to administer, interpret, monitor, and enforce the wage, price, and rent regulations of Phase II. A special unit of the Justice Department provided legal support, with 170 people assigned to this task.

Price Commission

By early January there had been 3,460 advance notifications of price increases filed with the Price Commission by an estimated 1,075 companies (among the estimated 1,500 companies in Tier I). The Commission had approved requests of 335 industrial companies for price increases, covering products having a sales volume of $322 billion. (The total sales of all Tier I firms was estimated at over $800 billion.) A total of 27 companies were denied requested price increases. The approved increases averaged 2.9 percent on a weighted basis measured against sales of affected products by applicant companies and 1.4 percent of total sales of the companies covered. Companies receiving approval for increases were among the Nation's largest producers in the automotive, steel, aluminum, and coal industries.

The average approval rate should not be construed as a general indicator of the price behavior of all Tier I firms. In fact, at the end of the year, the trend shifted to lower approvals. In addition, many large companies had indicated to the Price Commission their intention to hold the line on prices.

The Price Commission was giving close attention to a more detailed articulation of the standards for price behavior, which would provide clear rules both for the large companies required to report to the Commission and for the millions of smaller businesses and individuals in the economy. Particular priority was accorded to interpretation of the requirement that "productivity gains" be taken into account.

Pay Board

Up to mid-January 1972, the Pay Board had received 114 applications for pay increases from prenotifying Tier I organizations. The Board had acted upon 16 applications, approving 11 and disapproving five. Two of the contracts that were approved—the coal contract and the railroad signalmen's contract—provided initial wage and benefit increases in excess of 10 percent. Both contracts represented special situations: The coal pact was actually signed before the November 13 deadline after which Phase II rules became effective and part of the signalmen's increase had been legis-

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lated by the Congress. Deferred increases in both contracts are subject to review in 1972 and 1973. The Board had also approved a 4-percent increase for municipal workers in Chicago.

Early in January the Pay Board rejected five proposed contracts covering over 100,000 aerospace workers. The proposed contracts had provided first-year wage and benefit increases of about 12 percent. Also in early January the Board approved wage and benefit increases of less than 5½ percent for workers in eight major organizations in the prenotifying category.

Inquiries, Complaints, and Litigation

Inquiries about various aspects of the stabilization program averaged over 24,000 per day from Phase II's initiation to mid-January. Inquiries about rent regulations accounted for more than half the total; the remaining inquiries were divided equally between wages and prices.

Complaints about alleged violations of Phase II rules averaged nearly 800 per day during Phase II, a somewhat lower volume than during the latter days of the freeze. Complaints about prices averaged 56 percent of the total; rent complaints were 40 percent and wage complaints 4 percent. The cumulative total of complaints during Phase II was over 30,000, of which about two-thirds had been resolved by IRS action. Of some 8,700 requests received for exemptions or exceptions from stabilization rules, over 2,500 had been resolved. The bulk of the remainder involved rent questions.

There were only a few court cases involving Phase II regulations by year-end. Two injunctions had been issued against threatened evictions and proposed rent increases. In a case covering Phase I and Phase II the Government had brought action against a municipal transit company to remedy violations involving fare increases and reduction of service.

Program Administration

Because of the newness of the controls and systems, as well as the new staffs and procedures, there was some early confusion in the control system and some misunderstanding. Probably the most notable example of confusion involved specific price ceilings and the lists of base prices (applicable during the freeze period) which the Price Commission required each retailer to post. Under the regulations, prices of the same product could vary from store to store, and products essentially similar sold by different firms could also vary in price. Moreover, the legal ceiling prices in retail stores could vary with fluctuations in the stores' wholesale purchase prices. During earlier periods of price controls, ceiling prices were set by product and were therefore more uniform. Under the present system it was difficult for the public to assess accurately whether actual prices, when they were above the posted base price, had been increased in accordance with Price Commission regulations or not. Therefore, in cases where prices increased substantially beyond the posted base price the public was encouraged to ask the store to explain the increase. If not satisfied, the consumer could file a complaint with the IRS stating the basis for his complaint.

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In the final analysis, however, effective enforcement depended on the advance notification, reporting, and spot-check system, which permitted the authorities to analyze cost and profit data.

EXTENSION OF THE STABILIZATION AUTHORITY

The Economic Stabilization Act of 1970—the legal basis for the freeze and Phase II control programs—was scheduled to expire at the end of April 1972. In response to a Presidential request, the Congress extended the Act to April 1973. Extension of this authority provides sufficient continuity and duration of the stabilization program to permit it to succeed. In extending the Act, however, the Congress substantially amended it, and some provisions of these amendments may significantly modify certain policies developed under the initial economic stabilization program. Under the revised Act:

1. Wage and salary increases which were scheduled to take effect after the freeze according to contracts entered into before August 15, 1971, were to be paid unless "unreasonably inconsistent" with Pay Board standards.
2. The President was directed to take action to permit wage and salary increases which were scheduled to take effect during the freeze according to contracts negotiated prior to the freeze, but not paid because of the freeze, to be paid retroactively unless "unreasonably inconsistent" with Pay Board standards.
3. The President was directed to take action to require the retroactive payment of wage and salary increases provided for by law or contract prior to August 15, 1971, where prices had been advanced, productivity increased, taxes had been raised, appropriations had been made, or funds had otherwise been raised or provided for in order to cover such increases, regardless of Pay Board standards.
4. Employer contributions to pensions, profit-sharing, annuities, and savings plans qualified under the Internal Revenue Code, as well as contributions to group insurance and disability and health plans were not to be included in the definition of "wages and salaries" for control purposes unless they were "unreasonably inconsistent" with standards for wages, salaries, and prices.
5. Wage increases to any individual whose earnings were substandard or who was a member of the working poor were not to be limited in any manner, until such time as his earnings were no longer substandard or until he was no longer a member of the working poor.

ASSESSMENT

The Economic Stabilization Act requires this *Report* to give "an assessment of the progress attained in achieving the purposes of this title." As stated in the Act, the aims are "to stabilize the economy, reduce inflation, minimize unemployment, improve the Nation's competitive position in world trade, and protect the purchasing power of the dollar."

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These purposes cannot be achieved by operations under the Economic Stabilization Act alone. The freeze and Phase II contribute to their attainment as part of a combined program which also includes fiscal and monetary measures, exchange rate readjustment, and trade measures. The relation of the wage-price controls to the rest of the package is important. If monetary and fiscal policy keep the growth of demand moderate, the price and wage controls can bring about more quickly and surely the lower rate of inflation that competitive forces would cause in such circumstances. But if demand is allowed to grow excessively, the price and wage control system will lose its value. Correspondingly, if the presence of the price and wage control system becomes an excuse for laxity in monetary-fiscal policy, the system's effect on controlling inflation will be negative.

As discussed in Chapter 3, we believe that the combination of policies in effect in 1972, including the price-wage control system, will produce substantial progress toward the goals of the Stabilization Act. The goals may be summarized as less unemployment, less inflation, and a U.S. economy which is more competitive in international markets. In this section of the *Report* we concentrate on the contribution of the steps taken under the Economic Stabilization Act.

Evolution of Prices and Wages

In the accomplishment of its own objectives, the freeze was an unqualified success. It had the desired shock effect on the public's inflationary psychology, and it held the line on prices and wages, allowing time for a more flexible and durable system to be devised and put in place. The statistical evidence on price behavior during the freeze is presented in Tables 20, 21, and 22.

Assessment of Phase II is obviously more difficult. It has been in operation too short a time to generate any substantial body of evidence, statistical or other, about its effects. The data on prices and wages for December, the latest available, are not a measure of the effectiveness of Phase II and should not be so interpreted. A temporary period of faster than desired wage and price increases was an inevitable byproduct of decisions made with respect to the transition from the freeze to Phase II. Several months of experience are required before Phase II regulations and rulings will be fully reflected in price and wage trends. At this time, therefore, the future outcome of policies which have only just been inaugurated is chiefly a matter of speculation. The principal questions are: Will the standards of the Pay Board and the Price Commission lead to the desired results? Will the standards be observed?

The standards announced by the Pay Board and the Price Commission imply the following arithmetic: If compensation per hour of work rises by 5½ percent per annum, and if output per hour of work rises by 3 percent per annum, labor costs per unit of output will rise by approximately 2½ percent 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 2½ percent, a rate within the range of the goal set by the CLC.

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Pay Board Decisions

A number of important factors must be taken into account in assessing the prospects of achieving the goal. The basic standard of the Pay Board is a 5½ percent permissible pay increase. Under certain circumstances, however, existing Pay Board regulations permit increases in excess of this average standard. One of the most important of these exceptions is the rule that permits wage increases scheduled under existing contracts to be granted, even if they exceed 5½ percent, unless they are challenged by five members of the Board or a party to the contract; in that case they will be reviewed by the Board. If all the known deferred increases in excess of 5½ percent that are scheduled for 1972 under major collective bargaining situations were granted and increases arising from cost-of-living escalator clauses were restrained by a small rise in the CPI (2 to 3 percent), they would add about 0.25 percent to the average rate of pay increase for the year (i.e., if the average outside of situations providing deferred increases were 5.5 percent and scheduled deferred increases were all granted, the average rise in hourly wages for all private sector workers would be about 5.75 percent). The business members of the Pay Board have indicated their intention to challenge all deferred increases in excess of 7 percent. If all known deferred increases that are in excess of 7 percent were limited to 7 percent, then deferred increases would add a little more than 0.1 percent to the average rate of wage increase in 1972.

The Pay Board rules also permit increases in excess of 5½ percent if they are necessary to bring the cumulative increase during the last 3 years to 7 percent a year, or to preserve certain limited traditional relationships with other wages, or to attract labor in shortage situations. Pay increases allowed under any or all of these exceptions may not exceed 7 percent (that is, 1½ percent above the general standard) and the 3-year catchup provision expires on March 31, 1972. While the direct impact on increases in compensation for the entire economy of these exceptions probably will be small, their impact through tandem wage relations and relative wage pressures could be significant.

As this *Report* is written, the Cost of Living Council has not yet issued an interpretation of the terms of the Economic Stabilization Act which excludes from control substandard wages and wages of the "working poor." Neither has the Pay Board interpreted the exclusion of increases in certain fringe benefits unless they are "unreasonably inconsistent with the standards for wage, salary, and price increases."

The foregoing are all provisions of the regulations which would permit wage increases to exceed 5½ percent in certain circumstances. Moreover, even if no particular wage rate rose by more than 5½ percent, the average compensation per hour of work could rise by more than that percentage because of increased overtime or a more than average increase in employment in sectors where wage rates are above the average. Both of these causes tend to operate in a period of economic expansion such as is envisaged for

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1972. In addition, labor costs per hour of work will rise slightly in 1972 from an increase in employers' Social Security contributions arising from an increase in the taxable earnings base.

On the other hand, and this point is most important, the standards of the Pay Board are only the standards of *permitted* wage increases, not the standards of *required* wage increases. Certainly in the conditions of 1972, when labor shortages will be highly infrequent, we should expect many wage increases to be below the normally permissible amount. In 1970, when the average wage increase in large union contracts was 8.8 percent, 22 percent of all the workers covered by such contracts received increases below 5 percent. If in 1972 it develops that 5½ percent is the standard, or most common, wage increase, there will be many increases below that, including many instances of no wage increase at all. Some support of this expectation may be found in the fact that several of the pay increases approved thus far by the Pay Board have been significantly below the standard.

Our expectation is that the combination of the Pay Board rules and the natural forces at work will, after the initial post-freeze bubble, hold the rate of increase of compensation per hour close to 5½ percent. Certainly the rules themselves contain nothing which makes this rate clearly unobtainable. However, the course of events and decisions will have to be closely observed to see what wage outcome is in fact being generated by the system.

Unit Costs

The simple arithmetic outlined above assumed that output per hour of work in the private economy would rise by 3 percent per annum, which is about the average rate of the post-World War II period. The rise of productivity was below average in 1969 and 1970 but faster in 1971; it could reasonably be expected to be even higher in 1972, since the rate of increase in productivity commonly exceeds the historical average in years of strong expansion. One reason is the same as that which makes the rate of increase of average compensation relatively high—a shift of employment and output to industries with above-average productivity and wages.

Thus it seems not inconsistent with the existing rules that the rate of increase of labor cost per unit of output should be in the range of 2 to 3 percent. Other costs will also be taken into account in the price ceiling formula—notably depreciation costs, indirect business taxes and interest. The anticipated rate of increase of these nonlabor costs combined in 1972 would probably not be so large as to force the rate of increase of total costs per unit of output outside of the 2- to 3-percent range.

Price Commission Decisions

Whether the average behavior of prices will, in fact, approximately follow the behavior of unit costs is an important question. Under the general rules of the Price Commission, price increases are permitted in proportion to cost increases. However, there are several circumstances in which permitted price increases may be either larger or smaller than actual cost increases.

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1. Prices may not be raised as much as costs if the effect would be to raise the net profit margin above that of the best two of the past 3 years.

2. The Price Commission will not automatically recognize all cost increases in calculating "allowable cost" for determining permitted price increases.

3. The price regulations for wholesale and retail trade do not permit such firms to pass on cost increases except increases in the costs of purchased goods.

4. The operation of the term limit principle may result in a firm's acceptance of a smaller average permitted price increase than its costs would justify in order to qualify for use of simpler and more flexible procedures.

5. If it is necessary to use industrywide trend estimates of productivity, in the absence of other information, in projecting costs, permitted price increases will turn out to be larger or smaller than actual cost increases where the actual productivity increase is larger or smaller than the estimate used. In a period when actual productivity rises may be exceeding the trend, this would mean price rises exceeding cost rises, on the average, but this effect would be limited by the profit margin ceiling.

6. As a result of specific exemptions by the CLC or the statute, items in the CPI comprising 21 percent of its total weight are not controlled by the Price Commission.

7. Public utilities may be granted above-standard rate increases where necessary to meet essential service demands.

8. Exceptions from the general cost-justification rule have been provided for firms with losses or very low earnings.

9. If costs decline, the system does not require price reduction unless the "windfall profit" situation is encountered.

In the foregoing circumstances, and possibly others, legally permitted price increases may be greater or less than cost increases. The net of all this is impossible to estimate. Without more experience no more can be said than that the rules and procedures do not seem inconsistent with permitted price increases coming out on the average fairly close to permitted cost increases.

The actual behavior of prices will be determined not only by what the Price Commission permits but also by what the market permits. The limitation of the market, including competition by firms with relatively small cost increases, will work in the direction of holding price increases below those legally permitted.

Although much remains to be seen, a reasonable judgment at this time is that the standards so far promulgated, applied in the context of strongly-rising productivity without excess demand, are probably consistent with achievement of the anti-inflation goal for the end of 1972. This is not, of course, inconsistent with the expected bulge of prices in the early part of the year as the transition from the freeze is completed. The longer-run effect of the present standards will depend on specific policy decisions and interpretations by the control authorities, as well as on the cooperation of business and labor. And the outcome of the system as a whole will depend on the

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ability to amend the rules if it should appear that the existing rules are not leading to the desired end.

Compliance

A further question which must be asked is whether the rules of the system are likely to be observed by businesses, landlords, and unions. In fact, the question is twofold: Whether the rules will be overtly defied, and whether they will be covertly evaded. This issue also allows only a judgment on the basis of limited experience. Overt defiance seems unlikely, given the extensive support for the system which seems to prevail among the public and the legal sanctions provided by the Economic Stabilization Act. Evasion may be a greater problem. A control system is imposed upon millions of economic units by an administrative staff of 3,000 or 4,000. Whether control measures can succeed will depend upon three things:

(a) The continued belief of the American people that compliance with the program is essential to the national interest;

(b) The ability of the managers of the system to devise self-executing rules;

(c) The judgment of the Cost of Living Council in excluding from the system, at the appropriate time, sectors of the economy which do not add greatly to inflation but make important inroads on the resources of the control system. In mid-January, the CLC moved along this path by exempting from coverage all retailers with annual volume of less than $100,000 and, under certain circumstances, rental units owned by individuals with fewer than four such units. Exclusion of these numerous small units from coverage will permit the administrators of the controls system to focus their efforts and resources on large economic units which have a far greater impact on markets and whose competition will in turn limit price increases by the uncovered units.

On the basis of the experience so far, we believe that the program will help achieve the economy's transition to a situation in which reasonable price stability can be expected without controls. The outcome will depend in large part upon decisions made, and still to be made, by the Cost of Living Council, the Pay Board, and the Price Commission. However, it will depend even more upon the support and self-restraint of the American people. This is the inescapable character of the system.

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