

*Mr. Nixon's New Economic Policy can't work—precisely because it is aimed at the private sector, while it was the government itself that brought on the current crisis through excess money creation, oppressive taxation, bureaucratic self-indulgence*

## The Case against Wage and Price Control

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**M**R. NIXON's recent economic proposals essentially repudiate his earlier faith in free trade and free markets. Concern over a general upward trend of wages and prices is one thing, a strait-jacket on relative price and wage changes is quite another. There is no reason to believe that the existing relationships among myriad prices and wages are the most efficient or most equitable possible—even right now, much less after three months of change. Exemption of taxes and interest rates from the "freeze" leaves our frozen incomes vulnerable to the two fastest rising elements in the typical family budget.

So-called "direct" price controls are no such thing: They are a deceptive attack on the results of monetary mismanagement, rather than on the cause. The current suppression of price increases should cause few short-run problems, since the price index has been rising insignificantly (0.2 per cent last month). The impact of the enormous May increase in the money supply, however, may well hit about the same time the freeze is due to be lifted. Add this monetary snowball to three months of postponed labor demands, and we can be sure of a November explosion of wages, prices and strikes (as occurred in Britain after controls were lifted in late 1969). This situation will create a myopic clamor for still more controls, though controls were largely the cause of the wage explosion. Frozen wages and prices prevent the smooth, continual adjustments which free markets would otherwise make in response to government's inept management of debt and money.

The President's 10 per cent surcharge on non-quota imports is a blatantly inflationary move, designed to



"protect" consumers from low, foreign prices. Foreigners trade their goods for dollars so that they can spend those dollars on U.S. products. They don't collect dollars as a hobby. A tariff between the U.S. and Japan no more benefits the U.S. than a tariff between California and New York would benefit California.

By giving new names to old ideas, ancient arguments can be continually reborn with fresh, new trademarks and slogans. In this way, the tyranny of government wage and price control has been transformed into the thoroughly respectable notion of an "incomes policy."

The idea is simple enough; it goes something like this: "The inflation of the Seventies is something altogether new. Unions bargain for wages in excess of productivity gains, and these wage-costs are simply passed on, by monopolistic firms, in the form of higher administered prices. Orthodox

prescriptions of tight money are simply irrelevant to this fundamentally new situation, in which inflation continues despite massive unemployment. The only solution, which will combine reasonable price stability with a tolerable level of unemployment, is government control of wages and/or prices—at least in highly concentrated industries."

There is, of course, nothing "new" about all this, except the slogans. Shifting the blame for inflation has been attempted by most governments throughout history. The Democratic Party has also consistently embraced this scapegoat theory of inflation since before 1960, when Chester Bowles explained his party's platform by describing "a relatively new type of inflation in which prices in a few tightly controlled semimonopolistic industries are raised regardless of market consideration." More recently, AFL-CIO President George Meany has been especially vocal in demanding wage and price controls.

In *The New Industrial State*, even John Kenneth Galbraith has lost the indecision on this subject which plagued his earlier books. "The seemingly obvious remedy for the wage-price spiral is to regulate prices and wages by public authority." Unemployment, says Galbraith, "occurs when there is insufficient demand; the spiral operates when there is too much and also, unfortunately, when there is just enough . . . since the system is unstable at full employment, there is no alternative to control. However regretted, it is inescapable."

But why should wage and price controls be regretted? Aside from the inherent risk in granting anyone such potentially awesome power over incomes, there are several regrets that

Galbraith forgot to mention. First of all, controls may block price or wage increases related to genuine shortages. Prices and wages act as signals for businessmen and laborers to move to areas and occupations where they're most urgently needed. Controls stop this movement of scarce productive equipment and skills, and thereby limit the economy's ability to produce what is wanted.

Second, because of the enormous complexity of our economy, even fairly comprehensive (i.e., fascistic) efforts at control are necessarily selective and discriminatory. Very conspicuous industries are singled out for "restraint," while sectors where inflation may be greatest—professional incomes, food and services—gain even more from the resulting diversion of demand. Controlling a few wages and prices doesn't eliminate inflationary pressure, it simply shifts the pressure elsewhere.

These objections to controls are not just theoretical, but express actual effects of the wage-price guideposts of the Sixties. Indeed, the disillusioning experience with unenforced guidelines is the reason why stronger measures are now often being proposed. But the problems of price control arise from following the rules, not from evading them. The less room left for hidden price and service adjustments, the more inefficient and inequitable the distortions of repressed inflation will become.

### The Chicken and the Egg

These ill effects are often admitted, but wage and price controls are nonetheless considered The Only Answer to our dilemma. After all, it is said, monopolistic corporations raise prices to pass on the cost of rising union wages; these prices then justify further wage demands, and so on. February articles in *Look* and *Fortune* blamed unions for starting this cost-push "spiral"; George Meany blames corporations. Galbraith, the diplomat, claims neither the chicken nor the egg came first: "Wages force up prices and prices force up wages."

In a famous essay, MIT Professor Paul Samuelson offers a brief explanation of cost-push inflation: "Just as wages and prices may be sticky in the face of unemployment and overcapacity, so may they be pushing upward beyond what can be explained in terms of levels and shifts in demand."

Now, suppose a businessman is somewhat reluctant to take markdowns and cut his employees' wages. How does this reluctance relate in any way to the same businessman's ability to raise prices without losing sales to his competitors, or to raise wages without worrying about the effect on profits? Samuelson's conclusion simply doesn't follow. Downward price and wage rigidity proves nothing at all about upward "pricing power." Moreover, as Professor George Stigler of the University of Chicago demonstrated, the alleged "rigidity" of those prices which Gardiner Means whimsically classified as "administered" decreases as more firms are examined, and disappears altogether when we consider actual prices rather than prices from price lists and catalogs. No association has been found between concentration of production (the portion of business done by a few firms) and the size and frequency of price increases.

Most firms are continually searching for the combination of price and sales which will best maximize their wealth. Sure, any firm, regardless how competitive its market, could keep raising its price (even until only one unit could be sold), but such arbitrary pricing power would obviously be suicidal.

By implying no significant connection between wages or prices asked, and the amount of labor and goods actually sold, common remarks about the "new" inflation completely reject elementary economic theory. An imposed increase in the price of, say, steel, causes some steel buyers to use less steel or to substitute aluminum or plastic. The resulting lower output of steel releases productive resources (machines, workers, raw materials) to other goods, whose prices fall as their supply is thereby increased. Similarly, to the extent that relative wage gains of unions have not been an illusion, they have occurred through restrictions on entering a trade (usually by licensing laws), which increased the supply of workers in non-union sectors and depressed nonunion wages by 3 to 4 per cent. Specific price or wage increases do not create general inflation.

Probably the most compelling feature of the cost-push argument for wage and price controls is that it provides an opportunity to criticize big unions or big business. Actually, though, it isn't enough to show that unions and concentrated industries have substantial

power to influence wage rates and prices. This would explain why certain prices and wages were relatively high at any moment, but such market power alone would not explain why these prices, or why prices generally, were rising. In order to explain generally rising prices, monopolistic influences would, first of all, have to be substantial enough already greatly to affect the general level of all prices. Secondly, such pricing power would also have to be increasing at a rate much faster than that of the average price level, since the average also contains many competitive prices. In brief, unions and large corporations would have to command a predominant and rapidly growing share



of economic activity in order to cause any general increase in prices.

Because it's so newsworthy, the market power of unions and large corporations is often exaggerated. Dr. Albert Rees, a prominent labor economist, estimates that the direct union wage effect on all costs in the economy is about 4 per cent. Moreover, union membership has stabilized at less than one-fourth of the labor force, and some of the strongest unions have experienced substantial membership losses (apparently due to the effect of high wages in reducing employment). Manufacturing unions are an especially poor scapegoat for recent problems, since average wage increases for nonunion manufacturing workers exceeded those for unionized

workers in four out of the five years ending with 1969.\*

Incidentally, the fact that wages are rising faster than productivity in no way "proves" that wages *cause* inflation. Suppose that wages and productivity both rose at 3 per cent, while prices rose at 6 per cent. Obviously, this would be a 3 per cent decline in real wages, and a terrific boon to employers, because of reduced salary cost. This is, in fact, the main reason why unexpected inflation increases short-run employment, though an explicit wage cut with stable prices would have the same effect. To ask wage-earners to lag behind the general trend of other prices is to ask them to suffer a serious rela-

about 6.5 per cent of Gross National Product, compared with a more typical 9.5 per cent in 1966. The Tax Reform Act of 1969 was, as the President's Council of Economic Advisers admits, "excessively burdensome on business investment." The result was a \$4-billion reduction in investment, and a lower real output than in 1969.

So, it appears there is little factual support for the crucial notion that union and industrial power is sufficient to upset greatly the whole economy, and even less justification for the idea that such power is increasing relative to the more competitive sphere. Since manufacturing unions and corporations have not fared too well during recent years, either their power is a bit overstated, or they intentionally "administered" their prices and wages in order to lose wealth.

### The Phillips Fallacy

A second flaw, in the idea that inflation can be caused by negotiated wages and administered prices, is that it assumes a passive monetary policy. Without an increase in either the amount of dollars, or the rapidity with which they're spent (velocity), general price and wage increases will result in unsold goods and unemployed laborers. It simply isn't possible for most people to be receiving incomes from continually rising wages and prices unless the Federal Reserve authorities create more and more money units (roughly, by making it easier for banks to create new checking accounts in the form of loans).

In principle, money velocity could increase for a while, to pay the rising prices. But people and businesses have been remarkably stubborn about the amount of cash (in terms of real buying power) that they hold relative to their wealth. More precisely, the demand for currency and checking deposits to hold (the converse of velocity of spending) is *predictably* related to variations in wealth, prices and interest rates. Thus, changes in velocity can be offset by the appropriate Federal Reserve actions to change the money supply.

If we are having inflation, then, it logically *must* be due to excessive increases in the amount of money relative to the amount of goods. In technical terms, if the supply of cash balances is increased beyond the amount which people wish to hold, relative to

their wealth, they will spend the difference, thereby bidding up prices (which reduces the real value of their cash holdings). This is the monetarist explanation of inflation, which the archaic "new" theories claim is now suddenly irrelevant to recent experience. What, exactly, is so unique about this recent experience?

From December 1969 to December 1970, the stock of currency and checking deposits rose 5.4 per cent. A more inclusive measure of liquid assets, including various savings deposits, increased in this period by 7.7 per cent. Output per man-hour actually declined somewhat last year, as did Gross National Product. Thus, we had too much money chasing too few goods, and this situation created a 5.6 per cent price inflation last year.

In the first half of 1971, the monetary growth became explosive: an 18.3 per cent annual rate of growth of all monetary assets. Since it takes six to nine months for the full effects of monetary changes to be felt, the Nixon Administration is certainly not being complacent when it says enough has already been done to "stimulate" the sluggish economy. Actually, that's a huge understatement. Whether the impact of the new money will be felt primarily in increasing prices, or in production and employment, cannot be conclusively determined from the fact that unemployment is fairly high. The answer will largely depend on how much of the new money can be channeled into profits and investments, rather than into incomes from unmarketable government activities.

The idea that increased wage inflation will reduce unemployment, and that increased unemployment will reduce inflation, is often called the "Phillips Curve" after the British economist who more or less discovered it. Phillips' figures, for Britain from 1861-1913, show a fairly close relationship between the rate of change in money wages and the portion of the labor force unemployed.

Samuelson and Solow's influential 1960 paper presented their "best guesses . . . phrased in short-run terms" about the relevance of the Phillips Curve to the United States. Most editorial "facts" about how much inflation will cure how much unemployment, and vice versa, are derived from these short-run guesses. *Time Magazine* (August 16), for example, somehow deduced that



tive decline. As we shall see, the supposition that price increases would then slow down proportionately is more than unlikely.

On the business side, Anthony Harberger has estimated that the annual cost of enterprise monopoly to consumers is less than \$1.50 per person, and most of this is government-created monopoly. All major research shows no increase whatsoever in industrial concentration since 1909 (firms are bigger, but do not get a bigger share of the growing market). Big business is a particularly unlikely villain in last year's drama, since after-tax corporate profits were only

\* *Economic Report of the President* (U.S. Govt., 1971) p. 59. All subsequent statistics are also from this source, unless otherwise noted.



"well over 10 per cent" unemployment would be needed to stop inflation.

Actually, this alleged trade-off between unemployment and inflation only occurs while the inflation is unexpected. Once employees realize that they can no longer buy as many things despite their apparent wage increases, their resulting demands for higher *real* wages will restore the previous rate of unemployment. The only way of continually fooling people into thinking a pay cut is really a raise, is to keep increasing the *rate* of inflation, which soon becomes obvious too, and results in a spiraling situation as people rush to unload money for goods.

This is likewise the verdict of most recent factual research on the "Phillips Curve"—that it is a short-run approximation at best, being based on a failure to distinguish between nominal and real wages. It is not true, then, as Samuelson claims, that the combination of high unemployment and price inflation confirms the folklore of cost-push inflation. It would do so only if we were willing to accept the Phillips Curve fallacy as well.

Yet, even if we swallowed a crude trade-off between high unemployment and low inflation, there are at least two reasons why we might expect unemployment and inflation to coexist right now. First of all, at least 45 per cent of the increase in *civilian* unemployment last year (700,000 of 1,570,000) was due to defense cutbacks. This government-planned unemployment clearly has nothing to do with aggregate demand, nor with some inherent instability of the private economy. By subtracting the defense unemployment, we find that 1970 unemployment in this sense was 3.4 million (about 4.3 per cent), which is considerably less, even in absolute numbers, than in any of the years between 1958 and 1965.

Secondly, the 1970 labor force increase of 1.9 million was more than double the increase in nondefense unemployment, largely because of more teen-agers and married women filing for unemployment benefits. These benefits rose from \$1,890,900,000 in 1966 to a mere \$3,960,000,000 in 1970. Average weekly checks increased more in the last two years than in all the years from 1961-67 and the average check is now equal to about thirty hours of work at the minimum wage.

Perhaps it would not be too cynical to suggest, that we should *expect* more

housewives and students to list themselves as "unemployed," when their leisure time is so limited, child care so costly, and unemployment benefits so lucrative relative to part-time employment.

The President's Council of Economic Advisers (CEA) is usually noted for its ability to whitewash existing governmental policy. The latest *Economic Report of the President*, however, is remarkably candid about government's role in raising the cost of living, and in discouraging efficient investment.

First, there is government suppression of competition through import restrictions, maximum interest payments on bank deposits, restrictive residential building codes, laws fostering closed entry into unionized trades, and minimum rate regulation in the transportation industry. Journalists make much of the strikes and "administered" prices in the auto industry. But how many of us are affected by (fictitious) new car list prices, which have only risen a total of 7 per cent in the last three years anyway? How often do we hear mentioned the government's deliberate increases of regulated transportation rates—which affect nearly everything everyone buys? Professor Yale Brozen estimates the wastes and overcharges resulting from transport regulation amount to \$10 billion a year. If that's a sample of government price control, it surely isn't too encouraging.

A related source of inflated prices and restricted output is government tinkering with wages and prices (*more* of which is now, paradoxically, suggested as a cure for inflation!). As the CEA put it: ". . . where government has intervened to set prices for certain goods and services and otherwise to control their availability, the results have often prevented the efficient use of resources." Examples of such distortions could be found in farm and dairy price supports, state "fair trade" laws, subsidized recreational areas, minimum-wage laws and restrictive professional licensing laws.

### Government Fraud

If governments are to decree the "proper" level of private incomes, it seems worthwhile to ask who will regulate the regulators' incomes. The Federal Government is the largest employer in the country, with more than 2.5 million civilians on its payroll. Employ-

ment of all levels of government is 16 per cent of total employment. The number of state and local government employees has more than doubled since 1955.

In the first quarter of 1970, the Federal Government pay raise added 1.2 percentage points to the whole economy's measured annual rate of inflation. This price index increase has now become part of the "proof" that we need more government regulation of incomes—of *private* incomes, of course.

Quoting the *Economic Report* again (page 34): "State and local government purchases, which have been rising steadily for many years, continued to increase at a rapid rate. . . . Employment by state and local governments rose almost 5 per cent over the average level in 1969. . . . The rise in wage and salary rates was especially large last year." So much for Galbraith's remark that "those who depend for their pay on the public treasury are . . . especially likely to suffer during inflation."

The relevance of all this is that government is the only sector which is immune to monetary policy, as was emphasized by Arthur Burns many years ago. Here we have a legitimate need for wage control, as well as an example of how effective governments might be in resisting wage demands.

The Federal Government can finance any salary expense by increased taxes, or by selling bonds to the banking system—which become reserves for inflationary loan expansion. State and local governments can and do finance unusually generous salaries by unusually large tax-rate increases, or by issuing tax-exempt bonds at artificially low interest rates.

Thus, government officials, since they have little incentive to worry about the pinch of salary costs on revenues, are in a unique position to create a four-fold inflationary pressure: 1) highly productive employees are induced out of less remunerative private employment, thus reducing the supply of marketable goods and services; 2) regulated rates are increased in government enterprises, such as the postal service monopoly; 3) some of the added salary expense is usually financed with inflationary management of government debt; and 4) the rest of the expense is passed on in enlarged tax requisitions, which have an obvious direct effect on the cost of living.

Table C-30 of the *Economic Report*

of the President shows average gross weekly earnings by type of employment—except that government is conspicuously absent. We can arrive at an estimate of mean weekly earnings in government employment by dividing government annual wage and salary disbursements (\$114 billion; Table C-17) by the number of government employees (12,599,000; Table C-27). The result is \$174 a week, which is 45 per cent higher than the nonagricultural private economy's average of \$120, and 14 per cent higher than the supposedly monopolistic manufacturing sector. Moreover, the corresponding gap between public and private averages was

torializing about the "cost of living," while not even mentioning taxes. Ralph Nader should investigate consumer fraud originating in government. According to tax authority Joseph Pechman, families with annual incomes between \$2,000 and \$4,000 received 11 per cent of their 1965 incomes from government welfare payments—but they paid 27 per cent of their incomes in taxes. The most quickly increasing taxes are the highly regressive Social Security, property and sales taxes. Social Security payroll deductions already take over \$1.5 billion from families officially classified as poor, and rates have risen from 6 per cent of incomes up

allowing the AMA to legally restrict the supply by controlling the licensing of medical schools (the number of medical students was the same in 1955 as it was in 1904).

But how can we believe there has been an increase in demand for education and general government? The growth has been in supply, despite well-publicized, overwhelming taxpayer disapproval. On the CEA's definition, the "demand" for the Vietnam war must still be enormous.

Of the private sector's price increases, we could well argue that much of the apparent inflation represents significant quality improvement: polyester knit ap-



only 27 per cent in 1960 and 39 per cent in 1965, indicating a growing source of inflationary expenditure. As we have seen, wage-push inflation can originate only in the government sector, because only governments are immune to the incentives of monetary restriction.

The plight of the private employee is neatly summarized in Table C-32 of the *Economic Report*. Average gross weekly earnings rose from \$95.06 in 1965 to \$119.78 in 1970, for an illusory increase of \$24.72. Adjusting for inflation by converting to 1967 prices, however, shows only a \$2.58 real improvement, or .5 per cent per year. Subtracting only Social Security and income taxes, we find average real spendable earnings, for a family of four, actually declined \$1 from 1965 to 1970. Neither inflation nor federal taxes have risen so rapidly as regressive state and local taxes, however, so average real private income, net of all taxes, has doubtless declined even more than this figure shows.

There is a subtle dishonesty in edi-

to \$4,800 in 1960, to 9.6 per cent of incomes up to \$7,800 in 1969. State and local tax receipts have risen from 7.1 per cent of GNP in 1951 to 11.9 per cent in 1968. Federal, state and local taxes claimed at least 44 per cent of the incomes of families earning less than \$2,000 in 1965, thereby creating most of the poverty problem these agencies claimed to be solving.

### Pull, Not Push

The CEA's *Economic Report* (page 100) illustrates the deceptive way in which this tax burden is typically glossed over: "The sectors where strong growth in demand has occurred are education, health and general government. . . . Those sectors where expenditures are increasing are also the sectors where prices have risen very rapidly." Much of the fantastic inflation in the price of medical services is indeed due to the fact that government greatly increased the "demand" for such services by paying 40 per cent of the bills, while

parel instead of cotton, more low-cost restaurant meals appearing in the food budget, self-cleaning ovens, aerosol cans, disc brakes on cars etc. It would certainly be difficult to create a comparable argument about bloated statism: Hard to say, for example, that the doubling since 1963 of state and local expenditures on education and welfare is due to a tremendous improvement in quality.

What we are experiencing is more of a tax-pull than a wage-push situation. Inflated government has raised the cost of living through high regulated rates and excess money creation, while it reduced real incomes and economic growth with oppressive taxation. Now, some people are seriously suggesting that what we need is even more government intervention, with price controls and an onerous state-freeze on private wage "increases." The logic involved is reminiscent of the rock concert where some genius hired several members of the Hell's Angels to promote peace and order. □