3. The assumption that the reported increases in private output per man-hour indicate what is available for distribution.

4. The assumption that real labor income should or could increase at uniform annual rates.

5. The assumption that unorganized sectors would follow the leader.

Let me say a few words about each of these assumptions.

The assumption that average labor cost increases equal to average gains in output per man-hour would result in general price stability is based on a very crude labor theory of price determination and one that has support neither in economic theory nor in economic history. In the short run, prices are not determined by unit labor costs, by wages, or by total labor costs. And the long run is a composite of short runs. Labor cost is only one factor in the determination of total costs. Thus, when we are told that prices are determined solely or primarily by labor costs, there is omitted from consideration (1) all factors affecting demand; (2) all factors affecting supply, except costs; and (3) all elements of cost, except labor.

Economic theories concerning long-term relationships between costs (note costs, not labor costs alone) and prices are concerned with the pressures influencing the allocation of resources. Thus, if costs are greater than prices, profits disappear, marginal facilities may be abandoned, and some producers may be forced out of the industry. Conversely, if profits are very high, producers may expand capacity and new producers may be attracted into the industry, thus increasing supply and setting the stage for lower prices. Costs and prices must be out of line to set these corrective actions into operation. The economist is describing tendencies in the economy and the effects of cost-price relationships rather than the way in which prices are set by any company.

Demand is important in the short run when prices and costs may be and often are quite far apart. The wide fluctuations in profit margins between good times and bad illustrate the lack of relationship between costs and prices and the importance of volume, a factor recognized by the CEA.

Thus, a fundamental assumption underlying the wage-productivity-price formula has no basis in fact. Prices fluctuate independently of unit labor costs and hence stability in such costs (which would result from the wage-productivity balance) cannot and does not assure stable prices.

The CEA proposal that companies with above average gains in output per man-hour should cut prices in a period of strongly surging demand and capacity operations was completely unrealistic. Thus, it is now forced to conclude that the greatest failure of observance of the price guidepost lies in the failure to reduce prices on a considerable number of the product lines of a large number of industries. The only surprising thing about this situation is the surprise of the CEA.

Prices have a rationing function—to allocate limited supplies among the more urgent users as indicated by their willingness to pay the price, which is particularly important in periods of shortage. If price doesn't allocate supplies, then this must be done on a first-come, first-served basis, or by favoritism, or by Government priorities or ration-