represents a labor cost. However, the CEA presentation does a disservice to economic education when it uses erroneous assumptions to support this policy.

GUIDEPOSTS WERE BUILT ON ERRONEOUS ASSUMPTIONS

The wage-price guideposts were foredoomed to fail to accomplish the objectives of limiting increases in labor costs and stabilizing the price level. As is shown by the attached conclusions of an analysis I made on February 19, 1962, I do not draw this conclusion from the vantage point of 20–20 hindsight.

There are at least five basic assumptions underlying the guideposts which in my judgment are in error—

1. The assumption there is a direct relationship between unit labor costs and prices.
2. The assumption that productivity (output per manhour) is the major factor in wage determination.
3. The assumption that the reported increases in private output per manhour 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.

1. *The assumption there is a direct relationship between unit labor costs and prices.*—The guidepost policy is bottomed upon a false assumption, namely, that success in stabilizing unit labor costs in major industries would result in a stable CPI. For example, the CEA states that "if wage rates [total labor costs] increase in line with output per man-hour, prices can be stable . . ." (p. 120).

The CEA is imbued with a cost theory of pricing. Thus, it suggests an exception to its price guidepost is permissible if "costs other than labor costs had risen." (p. 123). It notes that "for cotton textiles, a sharp decline in the cost of raw cotton would have suggested price reductions," (p. 124) and calls attention to other prices (e.g. copper, sulphur, machine tools and industrial equipment) which have risen more than warranted by costs (pp. 124–25). However, it does recognize that demand was very strong for several of these products. It also notes that "some significant price reductions which the guidepost would have suggested have not occurred" and cites automobile prices as an illustration (p. 124).

The assumption that average labor cost increases equal to average gains in output per manhour would result in general price stability (see p. 131) is based on a 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. (pp. 128, 132)

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.